galileocapital
Challenging Conventional Wisdom

NEWSLETTER

Special Edition Newsletter – May 2014

Note from Theo and Warren

This is a special edition of our company newsletter as we have some celebrating to do and to report back on our visit to Warren Buffett's annual meeting in Omaha, America.

-- Theo and Warren

Galileo Capital recognised by the financial industry

We are exceptionally proud and grateful to all our clients who voted for us in the Business Day Investor's Monthly survey of the top Private Banks and Wealth Managers in South Africa. We won the 'People's Choice award, which means we gathered more votes than companies like Nedbank, Investec, Sanlam, Citadel, FNB and ABSA. This is a great accolade and we are humbled, thank you!

We also did well in the actual rankings as judged by the competition officials.

- We were joint winners of the category as the best Wealth Manager for someone who wants to invest a lump sum e.g. retirees with their retirement funds. (joint first place with Sanlam Private Investments, PSG and Citadel were a joint third)
- We also came second in the category of Wealth Managers who advise up-and coming professionals. (Sanlam Private Investments came first and PSG came third)

It might be stating the obvious but we are very proud to have competed favourably with companies that are much larger than us. We believe the rankings are an endorsement of our passion to look after our clients and provide the best advice possible.

May 2014 visit to Berkshire Hathaway's "Woodstock for Capitalists"

We were privileged to visit the Berkshire Hathaway annual general meeting (AGM). Berkshire Hathaway has been run by Warren Buffett and his partner, Charlie Munger, for the past 49 years.
It consists of more than 80 companies, including sweet manufacturers, airplane, power and railway companies, as well as banks. During the conference, 83-year-old Buffett and 90-year-old Munger answered questions from journalists, shareholders, analysts and audience members for more than five hours.

On the day before the meeting we decided to visit one of Berkshire's subsidiaries, Nebraska Furniture Mart. This furniture, electronics and accessories store is bigger than anything we've ever experienced. This shopping emporium takes up an area bigger than five rugby fields…for one shop.

We also drove past Warren Buffett's house – an ordinary house in an ordinary neighbourhood, without any guards or walls. In fact, you could probably peep through the kitchen window or walk in through the front door if you wanted to. It’s quite something to consider that one of the world’s richest and most visible people lives in a house without any privacy or security to speak of – except one CCTV camera. And he’s lived there his entire adult life – for more than five decades!

Alec Hogg of Biznews.com and Kokkie Kooyman from Sanlam prepared us for the events of the day on the morning of the AGM, Saturday, May 3. Kokkie described the thousands of people who are mostly well-to-do Berkshire Hathaway shareholders, streaming into the venue on the hunt for good seats, as the “Billionaire’s Dash”.

It works like this: the gates to the venue open at 7am and the formal events begin with a video show about the company at 8.30am. But the queue to get a good seat starts at about 4am and goes on for 3 or 4 city blocks. We were up before sunrise to get into the queue at 5.30am, so that we at least avoided getting the worst seats in the basketball stadium. And we did okay in the Dash!

Right next to the stadium is an expo centre, where some of the companies in the Berkshire Hathaway group were displaying and selling their wares. Long before the formal events took place, Warren Buffett and Bill Gates were having a friendly competition to see who could land a newspaper on the front stoep of a house that was built inside the expo centre by one of the companies. Both Buffett and Gates started their working careers as newspaper delivery boys. The challenge was to see whose newspaper would get nearest to the welcome mat on the house’s front stoep. Who would have thought two men who are so famous and wealthy would still remember their first jobs and want to compete with each other?

At exactly 8.30am, the programme started, first with a welcoming display of cheerleaders, disco lights and music, and then a 30-minute video from Berkshire Hathaway, which was mostly tongue-in-cheek. What stood out here, was that the South African Coca-Cola TV ad (with the dog, Bobby, who’s looking for a Coke bottle with his name on it in Hillbrow) was shown to great applause. Berkshire is the largest single shareholder in Coca-Cola and owns about 10% of the company, and the flighting of that ad, just confirms that South Africans can make great ads. Coincidentally, this genuine South African ad will be rolled out to 52 countries by Coca-Cola in the next few months.

The Q&A session ranged from extremely technical questions (cash flow margins in a subsidiary) to personal advice (how to find one’s passion for a career). The two geriatrics answered every single question in a morning session that lasted three hours and an afternoon session of two hours. About halfway through the afternoon session, Buffett counted up the questions and estimated that more than 80 had been answered already, but they still took questions after that and answered each one as though it was the first one of the day.

To do justice to what can only be a summary of what was said, we decided to divide the questions and answers into subjects, in an effort to give you the highlights:

1. **Trust in senior management**. Buffett says they have always placed too much faith in people, but that it works for them. Although more than 300 000 people work for the group, and he knows that somewhere, someone is doing something wrong, there are many advantages to trusting his managers. One day, someone will do something wrong, and people will say that it’s a result of too little supervision. But the advantages of trusting people are much bigger than the cost of the mistakes they might make, he believes. He adds that the current focus on compliance, rules and regulations will cost the world far more than the advantages it will yield.

   He gives the example of a business (with a turnover of about R40-billion) that they bought 10 years ago. He has never visited the business in 10 years, and reckons he’s spoken to the CEO four times in that period. He believes that if you have the right people, you should leave them alone and trust absolutely that they will run their businesses. They just don’t interfere in the businesses they own.

2. **Investments gain value over the long term**. It is striking how easily Buffett and Munger take responsibility for their mistakes. Berkshire Hathaway exists because of an investment mistake – it was originally a textiles company that Buffett later had to liquidate, and they also had to liquidate one of their subsidiaries in the last 12 months. They see mistakes as opportunities to learn, as well as a chance to create opportunities to gain bigger interests in businesses while they are going through deep waters. Munger puts it nicely: "We are good at deconstructing our ignorance, and we still have lots of ignorance to deconstruct." It's refreshing to see that a very successful 83-year-old and his 90-year-old partner still think they have lots to learn.

3. **Cash.** Buffett thinks holding cash is a good thing if you know how to use it, but a poor asset if you don't. For him, keeping cash (and they have about $40-billion at the moment) is so that you can use opportunities when they present themselves. As an example, he mentions that they invested billions of dollars in the market after the fall in 2008. However, they would have done better to wait (they invested in October 2008) as the market only reached its lowest point five months later. Because they had the cash and were prepared to use it at a low point in the market, eventually it worked to their advantage. "Cash is king if you use it for investments, but if you just hold onto it, then that's a stupid thing to do," Buffett said.

4. **It's surprising how well things are going in the US.** Although Buffett says we still don't know how everything is going to end (with regards US monetary policy and interest rates), he believes that the US economy is doing well. In particular, he has high praise for the former chair of the Federal Reserve Bank, Prof Ben Bernanke, and the way in which he handled the crisis.

5. **Changes.** Buffett says it's usually the slow, long-term changes that hit investments harder than sharp, short-term movements. Buffett says, "We know there will be change but we do not know who the winners will be. We try to be in businesses where we know who the winners will be and just watch the rest." An example of this is climate change – they would never take an investment decision on the grounds of any climate change predictions. There's simply no-one who knows who the winners and losers are going to be, and also how to position oneself appropriately to make money from the changes. There are many simpler opportunities where it's easier to understand the cash flow in the investment than to try and support forecasts.

6. **Business schools are often wrong.** Theo was amazed at the extent to which Buffett criticised many of the fundamentals that are taught at business schools. He criticised them a number of times, especially when it came to valuations, return on capital and use of capital. He said that after 40 years of nonsense, business schools are finally busy moving away from incorrect dogmas and teaching students in a more sensible way. (Warren Ingram was less amazed as he has long thought business schools, especially MBA courses are money-making ventures)

7. **Non-executive directors.** Buffett is very critical of non-executive directors who get paid for their services, especially when it comes to compensation committees where the directors earn fees. He says these types of committees easily become the lapdogs of senior management – both look after each other and their own incomes come first. They don't necessarily look after what is in the best interests of the shareholders.

8. **"If short-term underachievement is a failure, then we'll gladly fail".** Berkshire Hathaway has done worse than the S&P 500 index (which measures the broader American market) for the past five years. Coincidentally, the S&P 500 index is also the yardstick Buffett measures his success against. Munger handled the question about the five-year underachievement from the "if we underachieve over the short-term, then I'll gladly underachieve again" position. Buffett previously mentioned that when markets are strong, they would do worse than the market, but when you look at the whole cycle (up, down, and up again), they should achieve their goal. They don't focus on short-term gains at all (they see five years as short-term) but focus on adding value to their business over longer periods.

9. **Ninety-seven percent of shareholders voted against a dividend.** In the almost 50 years that Warren Buffett has managed Berkshire Hathaway, he has never paid shareholders a dividend, and is outspoken against this practice. He grows Berkshire by investing more in it, and if investors need an income, they are free to sell their shares. He decided to leave the declaring of dividends to shareholders, and let them vote on it. Almost 97% of them agreed that Berkshire Hathaway should not pay dividends.

10. **Index investing.** The question about investment advice was raised again, specifically his advice to investors. Buffett repeated what he regularly says: if you want peace of mind that your financial goals will be reached, invest in a low-cost index fund. "If 100% peace of mind is your goal, invest 90% of the money in low cost index funds and the other 10% in cash," he said.

    In terms of Buffett's personal Will, all the money he plans to leave his wife must be invested in this way i.e. 90% indexed funds and 10% in cash. The rest of his wealth, all his shares in Berkshire Hathaway, must be sold and the money given to charity. This donation will be worth more than $40-billion dollars and will be administered by the Bill and Melinda Gates Foundation.