THE MANUAL OF IDEAS ™

Value-oriented Equity Investment Ideas for Sophisticated Investors

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"If our efforts can further the goals of our members by giving them a discernible edge over other market participants, we have succeeded."

Investing In The Tradition of Graham, Buffett, Klarman

Year VI, Volume VI
June 2013

When asked how he became so successful, Buffett answered: "We read hundreds and hundreds of annual reports every year."

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About The Manual of Ideas

Our goal is to bring you investment ideas that are compelling on the basis of value versus price. In our quest for value, we analyze the top holdings of top fund managers. We also use a proprietary methodology to identify stocks that are not widely followed by institutional investors.

Our research team has extensive experience in industry and security analysis, equity valuation, and investment management. We bring a "buy side" mindset to the idea generation process, cutting across industries and market capitalization ranges in our search for compelling equity investment opportunities.

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- ► MOI Signal Rank and Top Holdings of 50+ Investors
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- ► Exclusive Interview with Thomas A. Russo
- ► 10 Essential Screens for Value Investors

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Inside:

Exclusive Interview
with
Thomas A. Russo,
Partner,
Gardner Russo & Gardner

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Exclusive Interview with Thomas A. Russo

We've had the distinct pleasure of catching up with superinvestor and global value investing thought leader Tom Russo of Gardner Russo & Gardner ahead of the 2013 annual shareholders meeting of **Berkshire Hathaway** [BRK-A/B]. Tom, who is a partner at Gardner Russo & Gardner, oversees $6 billion at the firm through separately managed accounts and Semper Vic partnerships. In the wide ranging conversation, Tom helped us better understand the key issues for Berkshire Hathaway investors, updated us on several of his major portfolio holdings, and shared other insights of interest to global value investors. We are delighted to bring you the full conversation in the form of the transcript below.

(The following is a lightly edited interview transcript and may contain errors.)

Thomas A. Russo: It's a pleasure to be here especially on account of Berkshire. It's a fun time to reflect back on all of the earlier years of Berkshire Hathaway meetings and anticipate the upcoming meeting. This might be my 27th or 28th visit to Omaha for the Berkshire Hathaway annual meeting. It's a process of reaffirmation of the core values. I personally think there are values that have become more refined and more focused over the years. What I take away through my own investor evolution during that time is an ever increasing awareness of the value of companies that have the ability to reinvest internally. That's not something shared broadly if you think of the difference between a domestic food company in North America and **Nestle** [Swiss: NESN].

"Nestle is enriched by a legacy of having been in 120 markets for over 100 years. Their brands are already well-established and they have a global culture that puts the capital to work efficiently in exploiting the opportunities those markets offer today because of growth in income and disposable income."

Nestle is enriched by a legacy of having been in 120 markets for over 100 years. Their brands are already well-established and they have a global culture that puts the capital to work efficiently in exploiting the opportunities those markets offer today because of growth in income and disposable income. That's something that's quite valuable. It's not captured in the share price. As an aside, over the last twelve months, Berkshire would have taken advantage of a company that has a somewhat similar portfolio of assets in the purchase that Berkshire made of its large interest in the going-private **Heinz** [HNZ] transaction. It's a terrific transaction for Berkshire and it recognizes that businesses that have the capacity to reinvest, in the case of Heinz, it'll be in India, in China and some other emerging markets where they'll heavy up their investment, I suspect. Those are very valuable.

So you start with a belief that not every business has the kind of strength competitively that allows them to move forward and to compound. Then you have the question about, does management have the right incentives and the right protection that's required to invest the proper amount? In the case of Berkshire Hathaway, that's just an absolute yes. We can think back over time together of investments that Berkshire's been able to uniquely profit from because they're able to do things at times when nobody else would act. And so the playing field of competitors for the types of deals that have made us an enormous amount of money at Berkshire is very, very narrow because most companies don't have the capacity to absorb the adverse consequences to reported profits that accompany the right amount of investment.

If you're Nestle and you want to take advantage of that wonderful heritage you have in markets, you'll have to be willing to spend $3.5 billion a year on developing manufacturing, marketing, distribution, advertising, promotion, point

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of sale, all of the things that are required to pull more consumers towards your product are very expensive. In the process of those upfront structural cost investments, whether they're investments in working capital, in plant and equipment or whether investments of the income statement and advertising, promotion, you're going to end up burdening your current reported profits.

If there's one lesson I've seen Warren take advantage of so well over the years, it's the profits that come and the wealth that's driven long term by companies able to take the short term burden on reported profits. Wall Street doesn't allow that option for most public companies. Management in most public companies feel too trapped or too wed to smooth the stated, reported profits that they don't dare migrate from that treadmill, and those companies who can have an enormous competitive advantage. Berkshire's one of them.

It's probably the key lesson that I've learned over the 27 years of going to Berkshire is the importance of being willing to abandon the course that most companies are sucked into and the competitive benefits that accrue from that.

The Manual of Ideas: Tom, you've been studying Berkshire Hathaway for decades. It remains your largest position across your $6 billion portfolios. What perhaps has surprised you reading this year's annual report?

Russo: There are some things I'm quite looking forward to hearing more about. The increasing role of both Ted Weschler and Todd Combs is very important. I think it's systemic. It's more than just a fact that each of them is receiving allocations of increased capital to oversee directly. It's the assistance that they're increasingly providing Warren and the firm across all sorts of non-portfolio areas. That's where we have a peek at what the future, the very longest term at Berkshire, will look like because they will, if things continue to develop, most likely share terribly important positions for the very longest term with Berkshire. We have the ability to learn more about the evolution of the organization.

"We are in the middle of a housing recovery after all, and there's an enormous exposure in Berkshire, whether it's Johns Manville, whether it's MiTek, whether it's Shaw, whether it's Benjamin Moore, Acme Brick and Clayton Homes."

It's a moment to cheerlead some companies. We are in the middle of a housing recovery after all, and there's an enormous exposure in Berkshire, whether it's Johns Manville, whether it's MiTek, whether it's Shaw, whether it's Benjamin Moore, Acme Brick and Clayton Homes. We have this extraordinary portfolio of companies that have been really tightened down and made leaner over this wrenching downturn of the past five years, and they're poised to show some very interesting performance. It will be off of a much more cost effective base, and so we'll hear about the promise within the portfolio of existing wholly-owned companies.

I'm looking forward to hearing about the firm's view on their involvement with 3G through the acquisition of Heinz. There's an awful lot of interesting story behind that investment, it's a large investment.

This year, a friend of mine has been added to the question providers, Jonathan Brandt, alongside of a short seller. We'll have Jonathan's hand at helping to surface some of the nuances of Berkshire. He's the most deeply-studied of all in the subject and they will have a short seller's point of view, so that'll be engaging.

Over the last several years, some aspects of Berkshire have been tested. Certainly, the situation with David Sokol has probably put Berkshire on a much more tightened and even keel as it concerns how in the future the firm will police its governance and its organization broadly. Very important. It came as a result of something that was in the grand scheme of things, reasonably

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manageable, obviously personally harmful and disturbing. But it ends up with a firm that now, probably better than before, understands what conduct is allowed and not.

"In diapers [in China], I heard from Procter & Gamble [PG] two years ago, maybe three years ago, that at the time, of the number of households that were eligible for using diapers the country had 2% penetration. Out of the entire universe of child-bearing families only 2% of them used diapers at the time. And of those families, on average, they only used one diaper a day."

Those are some of the general thoughts. I learned an enormous amount by walking among the booths before the meeting and talking to the management. One of the most interesting aspects of that over the years has been to talk to the management of companies that are newly-acquired and really the question they provide most insight from is, how's life different? And without question, the comment I get back, whether it was with Matt Rose from Burlington Northern or whether it was the head of Benjamin Moore, the head of Shaw carpets, is that within Berkshire they're allowed to do what they're supposed to do.

Robert Shaw gave an interesting story about that years ago, after they were acquired. He found himself committed to Wall Street by virtue of their own expectations that they could rollout a series of Shaw stores so that carpet stores at Shaw would compete in effect with **Home Depot** [HD] and **Wal-Mart** [WMT] and the people who have historically been their customers. It was a thought of how to capture the downstream margins and actually improve the performance and competitive advantage of Shaw generally.

But they found midway through the experiment that doing so was beginning to really, really alienate their main customers and they lost one of the two, Home Depot or **Lowe's** [LOW] as a customer, as a result to that. They found that they were damaging their pre-existing route to market considerably. They knew it. However they promised Wall Street that they'd rollout a hundred stores and they were only twenty stores into the rollout, and they were frightened about taking on the investor disappointment, so to speak, if they did what was right long term for the business and stop the experiment before they got to a hundred stores. They knew at that point, every additional store probably was costing them future value rather than delivering more future value.

Robert Shaw, head of the company, said, the fabulous outcome of joining Berkshire was the next day they're a part of Berkshire Hathaway they did the right thing. They closed down that operation and they redoubled their efforts to try to win back disaffected customers.

That's a story you hear again and again and again that once joining Berkshire Hathaway, businesses are free to start to do the right thing. It's an enormous competitive advantage. I read that the same thing happened with Burlington was the amount of capital available for making strategic investments without regard to the income statement went up considerably. With Lubrizol, the year after they were acquired, they made three or four strategic investments that they had lined up but were reluctant to pursue as a public company because they feared that Wall Street reaction might be a negative and so they had delayed those transactions though they still esteemed them. Upon acquisition, immediately thereafter, they made the acquisitions.

This culture of doing what's right, no more and certainly no less, is rare and it's one to celebrate. It's one of the expressions of which are lessons learned each year in different manners and so it's what invites you back if you're a student of Berkshire every year.

MOI: Just to come back to the latest big investment, the Heinz deal, you mentioned there's an interesting story behind it. Do you care to share more about that?

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"Heinz has been, obviously for Americans, from the United States perspective, one of our celebrated businesses. But around the world it has a different expression. In England, it's considered a British company and the products there are tomato soup and baked beans."

Russo: It's a story of the developing emerging markets. Heinz has been, obviously for Americans, from the United States perspective, one of our celebrated businesses. But around the world it has a different expression. In England, it's considered a British company and the products there are tomato soup and baked beans. That's something that we don't quite even appreciate. Ketchup was a very slow product to take overseas.

Anyways, the global exposure is pretty strong. In the developing emerging markets they have products that are quite interesting. In India, they have a standard infant formula business that's maybe the third or fourth largest in India. It's important and it's growing and they can commit more capital to it and probably accelerate the growth.

If you think about the kind of opportunities you see in China, I can speak to diapers probably more than to the infant formula, which was what Heinz will offer them. In diapers for example, I heard from **Procter & Gamble** [PG] two years ago, maybe three years ago that at the time, of the number of households that were eligible for using diapers the country had 2% penetration. Out of the entire universe of child-bearing families only 2% of them used diapers at the time. And of those families, on average, they only used one diaper a day.

So here you have a question of penetration and frequency. Penetration is very small. Frequency almost deplorable because you can't imagine as a parent of a young child which day part you'd use that diaper because only one a day is not nearly enough in America. They probably use twelve a day or something. But there you have the story, penetration 2%, frequency one a day. If you went two a day at 4%, you've already quadrupled the business. And that's at 4%, you go three a day at 8%, you can just imagine the kind of investment opportunities and the return on investment. The amount of white space, pardon the pun in the diaper business, but the amount of white space in that investment is extraordinary.

The same could be true about baby formula with the caveat being that the companies have to be above reproach in terms of how they source the product because China has a history of poor conduct with its local competitors in infant formula. The western competitors, whether it's Nestle, which we have a big investment in, or whether it's **Mead Johnson** [MJN], or whether it's Heinz, have to certify that the market is safe for the parents to use. And as they do so, and move through modern trade, it's a very important business. In India, they have a product that's almost unfairly attractive. It's a highly nutritious, high protein drink that Indian mothers are assured will help their young boys become taller and smarter. It's hard to imagine you're allowed to sell something with such suitable claims to a mother's anxieties about what they would all wish for their child. The fact of the matter is that it's a protein nutritious drink whether it'll make the children taller or meaningfully smarter based on just the consumption is really quite unimportant. The fact is it promises a lot and it actually has a nutritional base that does improve the development of children and it's a very powerful product.

They can invest behind the promotion, the route to market, the marketing of these businesses in markets where the current penetration or frequency are very, very low. That's what they probably saw in the business. They also would have seen in Heinz a business that had the capacity to reorient their focus in the mature markets to deliver probably against the market's needs and maybe to do so by spending a lot less.

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Wall Street in general tends to focus on variables that don't always apply broadly. For example the R&D budget at Heinz, Wall Street may demand of Heinz that they spend 4% on R&D. In truth, it's quite arguable that there's not all that much innovation that can go into ketchup. We've figured out that the bottles turned upside down are better than straight up because they squirt easier, they're plastic and all the rest. But at some point, you're done.

The potential for overspending to meet that Wall Street demand is always there. The same ratio drive by analysts for public companies shows up elsewhere. For example, I read recently a report congratulating a company because they had a very high conversion ratio which in Wall Street terminology means the ability for the company's net income to end up as free cash flow and they celebrated a high conversion ratio.

I actually personally would celebrate a very low conversion ratio because I admire companies that generate enormously high amounts of profits but who have even better amounts of capital demands for reinvestment of that money into future businesses. The fact that a business throws off cash flow that's indeed free of the ability to reinvest is less interesting to me.

When you think about the components of a reinvestment scheme, which was what I'm looking for, you have a business that has a core profitable center and the ability to invest against their opportunities in markets that are developing, an investment that indeed will lower reported profits so on the conversion ratio you have to deal with impacted lower profits. But then, ideally, they would be spending multiples of their net income to position the business to make money on behalf of investors and to develop wealth for decades later to come.

"When you think about the components of a reinvestment scheme, which was what I'm looking for, you have a business that has a core profitable center and the ability to invest against their opportunities in markets that are developing, an investment that indeed will lower reported profits..."

Wall Street rewards a high conversion ratio. Wall Street rewards a low working capital as a percent of sales. In the case of those companies like Nestle, you're supposed to invest in working capital because the route to market requires that the retailers have funding so they're not out of stock. It's a very difficult process to stock a traditional channel. And the last thing a company like Nestle would want to do is starve that channel of capital. It'll show up on higher receivables, ultimately.

The other thing that they cannot afford to do is run roughshod over their suppliers in a country that's developing. So, instead they invest an enormous amount of money in the process of local sourcing – very expensive, very costly, builds a much higher accounts payable business. And so the two sides of the working capital story, investing heavier in supply, investing in the channel in both cases lead a company like Nestle growing sharply in developing emerging markets to a higher percent of working capital.

All of these are by-references to what is it that Wall Street requires of businesses is often exactly the opposite from what is best for the long term wealth of owners. When managers respond to Wall Street's playbook rather than shareholders' playbook is where businesses fall short of the extraordinary example that Berkshire has provided us because on all those same measures, Berkshire will take the choice that will inevitably compromise the near term and reward us for the longest term.

MOI: What do you make of the deal structure itself? Again, a very well-negotiated deal, you've got warrants, you've got preferred, what do you make of that?

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Russo: My goal is to commit capital at high rates of return for owners. This transaction, much like many of the transactions that took place in 2007, 2008, 2009 is a blend, and even as recent as 2011 with **Bank of America** [BAC]. It's a blend. It's an extraordinarily executed risk management balance between equity and certain return of capital with a high current return. That's the blend between equity or warrants and a preferred or a fixed income from the recipient.

In all of those cases, if you think back about what was done, Berkshire shareholders would have ended up because the world avoided financial armageddon, we would have done better in almost every one of those transactions were it not for the fixed income portion, but rather if these were equity investments. The fixed income portion has the burden of giving back the capital at a later moment when the world is less uncertain. And so the high returns that you get for example with the **General Electric** [GE] or **Goldman Sachs** [GS] transaction at the time when the markets were most fearful, that capital comes back at the time when interest rates and the thirty-year bond today are less than 3%.

The requirement to redeploy that money attaches to the deals at the start when those deals are balanced to protect the downside as much as they were. You're forced to reinvest at a later date and it's at less interesting terms because there's less chaos and less fear, and less loathing in the market place.

In the case of Heinz, from my perspective, if the company had been more leveraged with outside lenders, the return to equity holders, as Berkshire [is] a 50% equity holder, would over time be much better. Berkshire has the benefit of a preferred return for a while, but that cash comes back to Berkshire. I'm not sure with the preferred that we've taken out enough public market thirty-year financial obligations at today's historically low rate.

As a Monday morning quarterback, I would have probably preferred a large stake of equity like we received and then the company itself going to the marketplace and borrowing at 3.5% thirty-year paper in lieu of that preferred. But that's something that probably wasn't available and the deal that was struck is going to be extremely interesting, I think.

"In the case of Heinz, from my perspective, if the company had been more leveraged with outside lenders, the return to equity holders, as Berkshire [is] a 50% equity holder, would over time be much better."

MOI: It seems that with the last few years, certainly during the financial crisis and now again with the Heinz deal, really what comes to fore is Warren Buffett's extraordinary ability to negotiate these deals. Whereas perhaps in history just passively investing in **Coca-Cola** [KO], publicly listed, that was much more prominent within Berkshire, whereas now you have these private businesses and the importance of these negotiated deals. Does that worry you at all in the context of any succession issues at Berkshire and who can negotiate such deals in the future?

Russo: Quite honestly, the story about Todd and Ted is that story. It's my understanding that Ted may have been very involved with the ResCap transaction, he may have been very involved with the **Media General** [MEG] funding in a very clever creative way, I understand – just the sort of thing that you'd want and expect from Warren. But if, in fact, there's another set of hands capable of executing at the same level of "wow" element, then that's extraordinary valuable to know about. That's what we learn as we see more of the two investors who have come in and who are increasingly responsible for financing transactions, possibly even creating and conceiving of them.

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Warren Buffett has said that he came up with the Bank of America transaction alone in the bathtub. But I understand that Bank of America had been a long standing and meaningful investment for Todd Combs. And so I wondered whether Todd was somewhere near the bathtub at the same time only to the extent of being able because of an enormous amount of knowledge specific to that company, of being able to provide some assurance.

Because at the end of the day, we did as a firm extend $6 billion plus or minus in an investment and in fact returned for that receipt the most spectacular warrants I've ever seen which were 700 million plus warrants that struck at roughly the share price and had a ten-year life.

At Berkshire, if the world becomes safe for banking again over the course of the next decade, those warrants could make us $20 billion or $30 billion dollars. It's a phenomenal, phenomenal return on a $6 billion preferred. It's an extraordinary return. There are already four points in the money, it's a $3 billion plus unrealized gain. I do think that the ability to see through all the potential pockets for trouble within, as broad a firm as Bank of America probably requires the assistance or the judgment of someone else who is deeply-schooled in the subject. And there you see the possibility of one of those two investors adding great value.

MOI: Warren Buffett states in the letter that he asks the managers of his subsidiaries to unendingly focus on moat-widening opportunities and they find many that make economic sense. Can you walk us through some of these moat-widening opportunities that you see within the Berkshire portfolio? Where are you most excited about these opportunities?

Russo: I would respond first by just referring to Warren and his own celebration of the ability two businesses provide Berkshire to deploy a phenomenal amount of capital going forward. The first would have to be MidAmerican. If my memory serves me, Warren said that they have the ability to deploy $100 billion over the next twenty years. That order of magnitude is extraordinary, especially if you consider that much of the investment out of MidAmerican is a return on capital provided by regulated returns. And so if you're getting double digit returns, let's say 10%, 11%, 12% and you can reinvest $100 billion plus longer term, it's an enormous opportunity. Berkshire's looking for a place to deploy capital and it's a very big recipient.

"If my memory serves me, Warren [Buffett] said that [Berkshire Hathaway] has the ability to deploy $100 billion over the next twenty years. That order of magnitude is extraordinary..."

The second is Burlington, where again the ability to deploy capital to make up the already great network that Burlington possesses even better, is very high. Those are the two really big pockets of certain redeployment of capital.

If you think about the other businesses, one of the things I was surprised with quite frankly over the past six years was that in all the areas of the housing-related businesses that there wasn't more activity during the housing collapse when volumes dropped from 2.5 million homes a year to 500,000 or something. Businesses just stopped and there would have been distress broadly in the marketplace, but we didn't buy a lot of companies. Clayton Homes acquired some mortgages some years earlier, but there was not a lot of activity and that surprised me a little bit, because you'd have thought that you could possibly pick things up. Maybe some of the businesses just went out of business in the meantime, that's possible. The really big opportunities are those two I cited.

MOI: It's interesting in the case of MidAmerican when you talked about the regulated nature of that business, and there was one sentence in the letter where

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Buffett talks about putting a large amount of trust in future regulation when it comes to these businesses. I was curious to get your view on that, and especially U.S. versus internationally. It seems that Buffett places trust in future regulation, but are there any doubts there?

"…there are regulatory issues in three of Berkshire's biggest businesses. It's the railroad business. It's the utility business. And it's the insurance business. At the end of the day, GEICO has state insurance commissioners that they have to look at and satisfy. In all of these, these are businesses that at some point the regulators have had a very disruptive hand in the past, in railroads in particular."

Russo: Two answers. The first point you mentioned about that just observed reference of the U.S. versus non-U.S. This year's annual report was really patriotic, really patriotic. Warren said we spent a certain amount of capital expenditures, maybe it was eight billion, he said 96% of that was spent in the good USA, that there's plenty to do in America. You don't have to go anywhere else. It's a departure.

When we bought Iscar, six or seven years ago now, at the time there was a real celebration of the ability to bring in a company with that kind of leadership based abroad through which we could then invest subsequently in foreign markets. They went into China with quite a fanfare, Iscar did. There's a feeling at the time that Berkshire would become even more internationalized and it really slowed, and even in the annual of this year it was extraordinarily patriotic.

Now, to your point, there are regulatory issues in three of Berkshire's biggest businesses. It's the railroad business. It's the utility business. And it's the insurance business. At the end of the day, GEICO has state insurance commissioners that they have to look at and satisfy. In all of these, these are businesses that at some point the regulators have had a very disruptive hand in the past, in railroads in particular.

There's no reason to suspect that Berkshire's conduct will trigger censure. But I would tell you that if you lived in and around Sandy-afflicted eastern markets and you heard the political rhetoric surrounding Long Island Power Authority's (LIPA) failure to invest in preparation of the risk that a storm like this exposed, you could quite easily see how the regulatory agencies involved with LIPA might come back and say you failed us, now we have to take the following steps to assure that our users are better served.

It was a commercial, a for-profit utility that was subcontracted by LIPA to provide the power grid. They just frankly didn't protect it and they didn't spend the money. Warren's celebrating the ability to spend $100 billion to make the utilities that we're involved with always better, always best. But it's not about the best in the business that drives regulatory reaction, it's about the worst. When you have something like the experience with Sandy, you just have to worry that the regulatory reaction overreaches and that's a big issue. It's true with the rails. It's true with insurance.

MOI: I do want to pick up on this U.S. versus internationally, and you've successfully invested internationally for decades. When one reads the letter, it's almost an impression that outside of the U.S. there is all this danger and perhaps even in this particular point about regulation, you don't know what you're going to get in India and some people have made that experience or elsewhere. What is reality and what is perhaps noise around that?

Russo: There's no question that the businesses that Berkshire owns, mainly the public companies have global reach and you can celebrate the kind of prospects whether it's Coca-Cola or **IBM** [IBM]. The promise abroad is great and that's part of the story of those investments.

The ability to redeploy capital, certainly Muhtar Kent at Coca-Cola talks about the vastness of the Chinese opportunity for Coke and has gone so far as to

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say that China for Coca-Cola will be so large in twenty years that it will rival the world's developed Coke business that we know today. It would be a doubling in twenty years of the size of the organization, just off China alone. That presumes 3.5% growth rate per year for twenty years in China. It's a big deal and it's a part of the story of Coke that's international.

Heinz is probably an international example, and it's in our partly-owned portfolio company, and he's harnessing in that investment the really powerful skills of the 3G team that have been teethed in Brazil and other emerging markets, and presumably will deliver great value for us as shareholders when they get their arms around the opportunities to grow and to reduce cost at Heinz.

But you're right. We don't see large new positions in international investing. A decade ago, Berkshire made a fortune off **PetroChina** [PTR]. They invested deeply in **POSCO** [PKX] in Korea. They took a stake in **BYD** [Hong Kong: 1211] and it came sort of unglued, and I don't know to what extent.

The current patriotism is a pushback as a result of the really unexpected, but probably predictable experience that BYD offered. What looked so promising turned out so troubled and it may have undermined the appetite for the time being. But, ultimately, there will have to be international in Berkshire by virtue of the places around the world that show the growth.

MOI: Perhaps there's even a conclusion one can draw from the nature of the investments that Berkshire has made and their outcomes, in a way. Coca-Cola – consumer, IBM…, so non-regulated businesses that are succeeding. Well, PetroChina, a regulated business, was a success, POSCO…I don't know if that's taking it too far, but would you say that Warren Buffet would feel much more comfortable investing outside of the U.S. in non-regulated, consumer type businesses? Certainly that has been your area of success predominantly.

Russo: You're probably right. Berkshire talks about early days. in his earliest writings and annual reports. about his contentment with North America because after all it was a huge opportunity based on his then scale. He could look across the U.S. and understand that he was 4% of the market or something and now he's 30% or 40% of markets. There's less new opportunity than what he looked at early days. When he was looking at early days he said, I don't really need the rest of the world. There's just so much to do in North America.

*"A decade ago, Berkshire made a fortune off **PetroChina** [PTR]. They invested deeply in **POSCO** [PKX] in Korea. They took a stake in **BYD** [Hong Kong: 1211] and it came sort of unglued, and I don't know to what extent. The current patriotism is a pushback as a result of the really unexpected, but probably predictable experience that BYD offered."*

I doubt that he'll have the same ability to say that for Berkshire, whoever says it, ten or fifteen years from now. They'll have to have some thoughts. At that point, when Warren described his early domestic focus, he said and after all it's hard to know what motivates people in international fields because he didn't have the ability to know their histories and he couldn't size up the people.

Since everything is at the end of the day in business about the people who you entrust your capital with, the inability to get a quick read on someone from the references that we have in North America that are familiar, like whether you're a Nebraska football fan or not, you can size anybody up across the continuum of what they feel about Nebraska football let's say. You have no idea about Manchester United. If Manchester United is the kind of vernacular around which character is definable in international markets broadly speaking, you don't know a thing about Manchester United, all of the associated references that come from a position that's expressed, you're less effective.

There's a healthy sense of where your circle of competence is drawn in terms of the ability to really trust and know what people are like in the political

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sense or in the commercial sense with whom you have to deal as you commit capital abroad. The reluctance to state that decision when Warren's been such a great judge of characters in North America has probably shaped the current portfolio mix as being so domestic as it is. Over time, they'll have to be moved more abroad.

MOI: That goes again to the culture of a business and how the leadership is shaping that over time. You've said before that corporate culture is key to making sure Nestle stays on track. I'm curious to hear a bit more how do you actually assess that culture? Also at Berkshire, in the letter there's a lot of references to people and the culture, how do you actually assess that? If you are comfortable in the U.S. and then going abroad, how would you gain comfort to assess that?

Russo: You have to go. You have to get up and go see businesses conducted in their homeland or in the adapted homelands for these multinational companies with whom we're involved. To see on the ground the steps they've taken to engage the market and also to engage other stakeholders in those markets, and to do it in a way that will secure the long term, even at the cost of the short term.

"It becomes fairly obvious when you spend time with the managements at all levels of the organization because what you're really looking for is confirmation that what you're told by the CEO in a public forum for equity investors in London is what's practiced on the ground in Mozambique or Tanzania or Angola. You just have to go."

I visited Angola to meet with **SABMiller** [London: SAB]. They're building a new factory in Luanda. You could see because of their relationship with the Chinese business partners that they have that they're able to deliver a state-of-the-art brewery and Coke bottler at the same site, a co-shared site, at a fraction of the western costs because they were able to bring Chinese technology and Chinese workforce into that marketplace. Then you can see how with that new brewery and new containers, bottles, they're able to then develop a route system in a market that was only becoming commercial.

Historically, Angola would've been 90% sourdough-based homemade beer. It's becoming commercial and you watch them rollout refrigeration and routes to market, depots and all the rest. You realize that they have a playbook that they've used in Columbia, South Africa and all around the world, and that playbook works in a market at that time of its development. They're not puzzled as to how to act just because it's Angola versus Columbia or South Africa. It's basically the same. It was the same in Poland thirty years ago when SAB first moved there.

You get a sense that the firm has a culture, they have a knowledge base and they have the right incentives at the top not to force early success but to invest in the marketplace for long term success. You have to go to see those and you want to talk to the senior people as they advance up. It becomes fairly obvious when you spend time with the managements at all levels of the organization because what you're really looking for is confirmation that what you're told by the CEO in a public forum for equity investors in London is what's practiced on the ground in Mozambique or Tanzania or Angola. You just have to go.

Partly then you have compensation structures that incent the right behavior. If compensation is too heavily skewed towards stock options that have a finite life, you know that management who will receive the benefit from those options are more urgent in trying to satisfy the demands placed by Wall Street who control the value of the stock and hence the bounty of your options. There's a tie that probably takes the eye off the ball as what you'd want them to do if you're looking long term.

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To that extent, we have found the use of family-controlled companies to keep the management's eye on the ball. They also tend to use fewer options and they also stress that if the management focuses on delivering value twenty years out that they won't lose their jobs twenty months out because of the shortfall of reported profits that attaches to the proper spending level. When you speak with the management, if they're clearly nervous about making or losing quarterly numbers, you know you're probably in the wrong universe.

MOI: To come back to the focus on moat-widening opportunities that Buffett talks about, I'd be curious in terms of your portfolio, where are you most excited about these opportunities when you look at your major positions?

Russo: Berkshire is one, it's the largest holding. It's partly because it's had a burden placed on its valuation for quite a long time over fear of change and what the uncertainty will be. It's built an enormous amount of value and the process of declaring, and then implementing a big share buyback helped reaffirm to the market that the intrinsic value relative to book value, relative to the share buyback is probably reflective of more confidence in what the business is worth than what the public thought that number might have been. You saw a fairly sharp reevaluation as a result of the buyback announcement and execution.

*"In China, there are 550 million cases of hard liquor sold a year. Only four million are Western. We have three investments that compete for that four million, **Pernod Ricard** [Paris: RI], **Diageo** [DEO] and **Brown-Forman** [BF/A]."*

In the other major businesses, the most standard analysis is simply, how big is the market that we can address? What's our penetration? What's our frequency? And so in Africa, in beer where we have three investments, Guinness, i.e. **Diageo** [DEO], **Heineken** [Amsterdam: HEIO] and SAB, the market's 400 million barrels of beer and only 100 million of those are bottled, taxed, refrigerated and modern branded beer. The rest is still traditional, which is homemade, untaxed, unbranded and unhealthy in many instances.

That conversion process takes place alongside of the growth in GDP. As the GDP grows, more people are brought into commerce, commerce increases consumers' disposable income and they want to buy something with that badge that promotes their standing. That's a pretty effective conversion to rely upon in our businesses. We simply have to make sure they invest enough to be at the table when the preferences move from traditional to new.

In China, there are 550 million cases of hard liquor sold a year. Only four million are Western. We have three investments that compete for that four million, **Pernod Ricard** [Paris: RI], Diageo and **Brown-Forman** [BF/A].

In general, the rise of Chinese travel means that as the consumer goes around the world, 43 million will travel this year from China in sort of culture travel which is what I call it, as they come back from Paris they'll have a little taste for Martell, a little taste for Hennessy, a little taste for Chivas, maybe a little taste for Johnnie Walker because of the memory of the experience. They'll take that with them and over time, as that multiplies, we have the possibility of going from eight-tenths of 1% to 2% of the whole market. That's a doubling.

If you double, it puts an enormous amount of pressure on the supply channel because a 1% move in China is 6% or 7% of the scotch market or something. And so on the margin, you could see pricing impacts and profit impacts that are quite considerable. That's just white space. It's a question of how you get that conversion going.

In **Mastercard's** [MA] case, which is a fairly big position, you have 85% of the commerce done in non-U.S. markets still done through cash. In many instances, the governments incent the move towards credit cards or payment

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devices because of the ability it gives government to police the unregulated, tax evasion that takes place in many countries. If you migrate towards credit or debit cards, you have an audit trail that drives compliance.

Governments are very interested in working with Mastercard to develop disbursement cards because it's extremely difficult to get cash into the hands of 750 million needy Indians who live in the rural districts. Mastercard and their competitors are in dialogue with the government to figure out a way to have this biometrically secured payment device, which can receive the funds they're entitled to without the risk of theft of fraud or corruption – a very big market.

Across our product portfolio, we see that type of opportunity. Our management team's job is just to go about rolling out steps to convert. Most of those steps are structural and most of those don't cover their costs early on, so we need to make sure that when we talk to our managements, they're willing to lose enough money to make as many long term.

MOI: I want to pick up just in the case of the hard liquor in China, you've been investing abroad mostly in global brands and the success has come from these global brands, and picking them, identifying them at the right stages and so on. In China, I'm curious there's been some out of favor within the local hard liquor, the **Moutai** [Shanghai: 600519], I remember you talking previously about that brand. Is that an opportunity for you?

"Mastercard and their competitors are in dialogue with the [Indian] government to figure out a way to have this biometrically secured payment device, which can receive the funds they're entitled to without the risk of theft of fraud or corruption – a very big market."

Russo: It's a great brand. It's possible. But I would say we have a lot of opportunity in that market even with the businesses whose managements I know and really can see, and regularly interact with. Moutai would not be that management. It's difficult. I've had experience over the years trying to visit with and getting to know and what motivates managements of companies like Moutai. It's quite frankly very hard to come away with a sense of what they most care about. I put a very high discount on my capacity to know.

The share is traded for a mid-teens multiple now so they're not nearly so demanding in terms of valuation. I've seen the brand in the marketplace and though early on I would have said that it was sort of at-risk local products that the western market will quickly deal with when prosperity arrives, I don't feel that way now that I've spent more time with the market. Moutai segmented high end products are really deep with brand equity and history, and culture.

It's not going to be an easy conversion, as I once thought it might be because a lot of Moutai, the vast bulk of it is very cheap and very effective. But the opportunity is still quite interesting. For example, many of our companies look at the traditional Moutai consumer occasion, which is with meals as the possibility for their business. In the beer industry, there's a huge belief that they could get some conversion from Moutai at meals to beer. Other spirits companies are thinking about ways to supplant western spirits, sometimes prepackaged with soft drinks, say Coke and Jack Daniels or something as a category to help move Moutai out of the lunch room or the dinner table. We'll see if that works.

But the other thing is I would say Nestle bought a very large local confectionary company in the second half of 2011 when the Chinese market collapsed from the western pressures fearing China's real estate collapse, the stock market plunged. At that time, Nestle came in and made an offer for the nation's dominant confectionary company. And one, without any rival bidders

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because there's nobody else interested in investing in China when the market didn't reward that because of the collapse.

Nestle prevailed and people I know in the U.S. who owned a stake in that company felt very badly handled because they believe that the business was as well-positioned as it is, it would lead to future returns. The family that controlled the company, it was 40%, a Taiwanese family, was delighted to partner with Nestle because Nestle brought production technology and insights, and SAP systems and marketing systems and all the rest, they could take the business to a new layer. But the public shareholders among which were counted many North American investors were dealt out of the equation.

The counterpart Nestle also will profit from it. But I would have felt bad if I were a Hsu Fu Chi shareholder to be left at the dance like that. I have no idea in those cultures how to protect against that. That would be one of the things I would fear, but there's definitely no reason why Moutai shouldn't be looked at.

MOI: Related to that, you mentioned the case of China where uncertainty in the market leads to investors taking a pause but that may for value investors be exactly the time to strike. And Warren Buffett in the letter talks about those CEOs who cried uncertainty when faced with capital allocation decisions during this financial crisis, and in contrast, Berkshire had that confidence and is now being rewarded in instances. When it comes to international markets, really one of these things that one often hears, I just don't feel comfortable with this uncertainty. Is that really for you then the biggest source of opportunity once you identify that it is a right business, the management's comfortable, to get the right price in these uncertainties that are out there?

"In the case of Cartier in China, what will be ten years later—it'll be a mainstream luxury that will be bought by millions of people who have prospered..."

Russo: It comes through in waves. We recently saw a result of a recent reported period from China showing growth that was slightly slower, gold prices reacted sharply down and this isn't the time of political reform promised for China. There's a new leader and the new leader's articulating a new sense about, and it surfaces in the area of gift-giving and ostentatious living.

Well, you just couldn't design a more near-term objectionable moment for **Richemont** [Swiss: CFR] and for Pernod Ricard, and for Diageo. Richemont particularly, you think about gold prices plunged, they sell gold watches to Chinese consumers who may be pulling back because the GDP is slowing in China and who may fear wearing a watch if the government actually is going to censure them for ostentatiousness.

Those factors just gang up on a company like Richemont for the near term. And then you have to ask yourself the question that Charlie Munger said keeps him out of trouble as an investor. He says this at the annual meeting, the thing that keeps him on a steady keel is whenever something is pitched his way, he says: and then what?

In the case of Cartier, for example, in China "and then what" will be ten years later, it'll be a mainstream luxury that will be bought by millions of people who have prospered and probably no longer are sensitive or vulnerable to pullbacks in government officials' ability to receive gifts of precious items as part of the structure of the economy. If you presume that that goes away as it may under the current regime, it's an unlikely thing but if it did, it's still quite possible that Cartier will have a very good business. It'll be a broader and more stable business probably. That's the "and then what" in my view about that investment.

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MOI: We talked about the U.S.-centric nature of the annual report and the letter. What do you think investors who are investing internationally, what is really the one thing that they can learn from the annual letter? What are the most helpful comments in the letter for you as an international investor?

Russo: Everything about Berkshire is about reducing the number of activities, thinking longer about what you expect, keeping your horizon clear and uncluttered despite near term noise, and then recognizing the real value of the capacity to suffer.

"Within Berkshire, the fact he held $50 billion in cash for four or five years meant that the profits that he could have shown if he went out the yield curve and brought in 4% or 5% more income, it's $2.5 billion of unreported profits. He stayed the course and, of course, the returns that we received as a result of that were much, much higher because he was willing to suffer."

Within Berkshire, the fact he held $50 billion in cash for four or five years meant that the profits that he could have shown if he went out the yield curve and brought in 4% or 5% more income, it's $2.5 billion of unreported profits. He stayed the course and, of course, the returns that we received as a result of that were much, much higher because he was willing to suffer. Berkshire has stood for investors the base case for the benefits that come from taking fewer moves, thinking deeper before you move and then making sure that when you do act, you do so with tailwinds and then with the benefit of managements who are really evidenced as owner-minded, because if you lose on that last point everything else won't matter.

Owner-mindedness is really such a critical thing and for us at least it's been expressed through our attempt to find family-controlled companies like Berkshire where you know that the investments are being made for future wealth and unreported profits. And so that really surfaces from the annual report and that applies across the globe. The willingness to do anything and the ability to do nothing, which is at the heart of what makes Berkshire so strong, is something that very few other people can emulate. He has stable capital, he has a 40% shareholder he sees every morning in the mirror, and he gets high approval ratings from his main shareholder everyday. It's very rare. That's a very rare occasion.

MOI: We've seen that in Asia, especially with some even successful local managements that have created quite nice businesses, but then gotten distracted with property development let's say. Have you observed in international markets that there is a learning such as at Berkshire with some of these local managers or does really a Nestle have to come in and in a way teach that? Is there any self-learning at Moutai or at these types of businesses?

Russo: There's no doubt that the lessons of Berkshire are infiltrating business decisions around the world, slowly, but they get lost in translation. Thinking Brazil of Eike Batista who was just three years ago narrowing in on Warren's wealth gap and doing so through a blinding stream of transactions, taking pieces of companies public, buying them back, taking other pieces public, buying them back, participating in all of the businesses that seemed to have the investor sentiment behind them, really playing off of investor sentiment to personally profit.

Doing it entirely opposite of how Berkshire sets forth to build its wealth. And then to watch in the last twelve months the whole enterprise come unglued shows you that saying that you're going to be the next Warren Buffett and acting in a way that's quite speculative doesn't make you Warren Buffett. It probably doesn't get you where you want to end up which is permanently well-heeled. In this case, the leverage has come back to really dismember that person - for the time being.

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It's a long race and we'll see how it all plays out but it's exceptions like that. The fact though is that Berkshire will have probably have 5,000 investors from abroad at this year's annual meeting, up from 50, twenty-five years ago. And Berkshire, for a long time, in this notion about patriotism and domestic capital, for about ten years Warren and Charlie held a separate session with the increasing numbers of foreign investors who came to Berkshire. They did so with one idea, which was to say to those people to go home and tell anybody who has a great business who wants to sell it that they should think first and only of Berkshire. They had an army at work for them.

After all of that, we haven't surfaced many deals. And so, it's possibly that investment in that communication not surfacing any outcome that may end up being part of the reason why Berkshire's a bit frustrated with their international efforts. They invested deeply in time and in effort to get the message out that if you want to put your business permanently secure in a place that shares values, Berkshire is the partner of choice. It hasn't really surfaced much yet, it's a long term awareness-building investment that they've made.

MOI: It's interesting even in what's going on in Europe, one would think that would be a perfect time for something like that to surface from a family business in Europe. Why do you think then that has not happened?

Russo: I don't have a good answer. Berkshire's made some strategic partnerships and some strategic investments in the insurance business, which by the way I failed to say is an area we spoke earlier about where Berkshire will commit capital. They will commit capital to insurance. However, it's episodic and they will be without anything for vast periods of time, so that you really can't depend upon consuming your capital like those other businesses that we've discussed. But there haven't been all that many great businesses that have sold over this period of time so there hasn't been the activity.

I could think of only one which was in the industrial machinery business which would have been a potential interest, I thought. A German company that a Chinese competitor acquired almost out of bankruptcy because they lost so much money trying to enter the Chinese market, and because the western construction market collapsed so hard that the business was ravaged and the Chinese competitor bought it, that would have been something I could have considered Berkshire buying. It also wasn't that big a transaction. They're looking for big elephants or whales, I'm not sure what he calls them these days, but he's looking for big deals.

MOI: Do you think in the context of the succession uncertainty, do you think it would be helpful for the next person-in-charge if Warren Buffett had made a deal in Europe, had made a large deal in other parts of the world to help the next Warren Buffett in-charge to have a bit of a platform, an "in" within the market?

Russo: It's a good question. Some of the steps that Berkshire is doing now are estate planning in nature, corporate estate planning. Very large commitments of capital, something like IBM in some ways help the successor because that $12.5 billion is taken care of with a mandate, sort of all put to bed, and let's get out to the next block of capital, Well, there's $12 billion going out to Heinz. That's taken care of, at least for a while, the preferreds will come back, which is too bad as I've said because the next person will have to redeploy that money. But at least, out it goes.

"Some of the steps that Berkshire is doing now are estate planning in nature, corporate estate planning. Very large commitments of capital, something like IBM in some ways help the successor because that $12.5 billion is taken care of with a mandate, sort of all put to bed, and let's get out to the next block of capital, Well, there's $12 billion going out to Heinz. That's taken care of, at least for a while…"

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I actually think the share repurchase does a little bit of that by making the balance sheet a little more agile, by getting some money out. Having done it before Warren passes from the scene means that his successor doesn't have to explain why under his watch they use share buybacks and under Warren's it never did. The fact that they did a billion plus buyback recently is extremely important for the successor to have credibility when he says: buybacks are important, in fact Warren did the big one, and the first big one. Rather than having to convince the shareholders that the opportunity set remains unblemished, though I'm going to buy back a lot of stock and Warren never did. That's a big deal.

I was surprised at the annual letter about the discussion about the dividend, because I would have actually thought that in the context of where the shares will end up after they're deposited at the Gates Foundation, that the Gates Foundation's mandate of spending 5% would have led to a dividend from Berkshire. Instead, Berkshire talks about the model that they gave, the utility of selling 4.5% of your position on a regular basis, suggesting that that's how they think that the future holding, even in the Gates Foundation, will get their spending mandate met.

"Berkshire doesn't want a dividend so long as Warren's alive because he doesn't want funds coming to him personally, taxably. I'm not sure why the dividend discussion doesn't at least accommodate the possibility that all bets are off when the funds are held by the Gates Foundation, because a foundation has very different needs for cash."

Clearly, Berkshire doesn't want a dividend so long as Warren's alive because he doesn't want funds coming to him personally, taxably. I'm not sure why the dividend discussion doesn't at least accommodate the possibility that all bets are off when the funds are held by the Gates Foundation, because a foundation has very different needs for cash. And a distribution from the company of cash lessens the load of his successors to have to redeploy cash, if they happened to lack the same kind of brilliance that Warren's evidenced for all these years. So it just seems like it was a surprising conversation to me about how they thought about dividends.

MOI: What are perhaps the two or three key things you're looking to get out of the annual meeting as an investor in Berkshire? What's foremost on your mind to learn about?

Russo: It's going to be of any further insights about succession, both at the board level. I was delighted to see that Meryl Witmer was appointed to the board as she's a fabulous investor and a young board member, and comes with a really vast network from Wall Street. To learn about how the board's evolving would be kind of interesting.

Hopefully, field a few more questions about deployment of capital going forward in the two areas that I was surprised weren't more deeply described in the annual which is dividends and share repurchase. To have some discussions around this notion of the regulatory environment that is at play in Berkshire's three largest categories – insurance, rail and utilities – will be interesting. And to celebrate hopefully good news about Berkshire's chairman's health as the result of last year's scare. Those are the things that I hope we get a look at.

MOI: Tom, thank you so much for your insights into Berkshire and beyond.

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