DV01 FUNDS MANAGEMENT

Greg Madden visits Omaha

Recently as an alumnus of Macquarie University, I was fortunate to attend (at my own expense) the Macquarie Graduate School of Management's US Study Tour. Extensive reading and research was required prior to attendance; however the tour, conducted over ten days, enabled us to meet with notable investors such as:

Warren Buffett	Seth Klarman
Mario Gabelli	Joel Greenblatt
Bruce Greenberg	Bruce Greenwald
Mitch Julius	Charlie Dreifus

Whilst for many an opportunity to personally discuss issues with Warren Buffett was the tour highlight, the other abovementioned investors were, without doubt, equally impressive. I have attached a summary of Mr Buffett's comments. For those desiring a more in depth summary of the others' worldly views please feel free to call into the office for a coffee.

In discussions with Buffett, he pointed out that around October of 2008 consumption in the United States fell off a cliff. Buffett indicated that consumption patterns changed dramatically and literally overnight, despite 98 percent of America continuing to be at low risk of losing their job. Berkshire Hathaway's high-end jewellery business had the largest drop in demand, whilst more moderately priced jewellery businesses declined less so. Berkshire also owns Geico, a large discount general insurance business. Geico advertises that 15 minutes can save you 15%. In October the number of hits for people wanting to save $100 increased significantly and their website was flooded by people who had previously not bothered to make the change for a $100 saving. In addition, Buffett cited annual car sales, falling from 15 million to 9 million, as an indicator of dramatically changing spending patterns, which he felt may continue for some time.

Buffett was asked what his teacher and former employer Ben Graham, [1] would think about today's financial environment. Buffett suggested Graham would have lost significantly less money than he did last year, but that in preceding periods Graham wouldn't have made as much. In general, Buffett concluded, that Graham probably wouldn't have said anything differently than what he wrote in his book the *Intelligent Investor* and that "everything you needed to know to be a successful investor is outlined in Chapters 8 and 20 of that book".

[1] Ben Graham and the investment strategies he developed were a product of the Great Depression. By the early 1930's Graham's fund had lost 70 per cent from its peak, however he persisted and by 1935 he had eventually made back all of these losses. When Graham retired in 1956 his portfolio had gained 14.7% annually versus 12.2% for the stock market. These returns were one of the best long-term track records in Wall Street history.

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Buffett emphasised that capitalism works. He said that in the 1980's Japan looked very strong and management gurus wrote books predicting their systems would overtake the US. This was not the case and in fact, since that time, US exports, as a percent of GDP, have risen from 5% to 12%. Buffett also relishes the new ideas capitalism throws up. As an example, he cites an invite in 1995, by Bill Gates to attend a Microsoft meeting into the possibilities of the internet. Whilst at the meeting neither he nor his business partner, Charlie Munger, envisioned that people would be buying insurance from Geico over the internet. In addition, he emphasised not even Gates predicted that search engines would be as successful as they are now. Buffett says that the great thing about capitalism is that with a reasonably free market and a rule of law, capitalism continues to produce ideas that people can't foresee.

Buffett acknowledges that he has made mistakes along the way. As both greed and fear are contagious, humans naturally take on the behaviour of people they associate with. Buffett, himself, is not immune from some of those behavioural mistakes and says if you can't stand those mistakes your shouldn't be in the game. The way to overcome such behavioural biases is to continue looking for big discrepancies between value and price, because he does not believe that one can pick times to enter and exit market. At one stage last year when demand for Oil was running at 86 million barrels per day the world was at productive capacity for oil. There have been examples of this in the past. Such statistics led Buffett to make an investment in Conoco Phillips, which he now regrets.

Buffett's preferred method of investing is to read the Annual Report first before even looking at the share price he knows immediately whether he is getting value or not. Whilst Buffett believes more technical theories such as George Soros's Reflexivity, do occur, where the market gravitates to areas where people put high probability on, Buffett, himself, doesn't worry about such fears and in particular considers such extreme views as areas of extreme investment.

He says that listed shares are one of the few markets that take advantage of this fear. When markets are in a negative feedback loop, as they are now, they create huge opportunities. Whilst people are scared there are certain things that are unlikely to change. He cites Coca-Cola as a business that will continue to do well. Consumers will not stop drinking 64 ounces of fluid a day and, in the USA, 25% of that consumption will be in carbonated drinks. When Buffett first met Bill Gates, Gates told him that computers would change everything. Buffet asked him whether it would change the chewing gum people choose? Gates said no, and Buffett replied that he would keep buying companies that produce chewing gum.

On the issue of debt he says that if people are smart they don't need to borrow and if they are dumb they shouldn't be borrowing to invest.

Global warming appears to be a reality and it makes sense for people to use fewer hydrocarbons, however in the absence of government generated incentives people will continue to produce and consume carbon-emitting products. Buffett said tax incentives are required for using alternatives such as wind. It has encouraged him to make an investment in a chinese electric car company called BYD. BYD is an acronym for Build Your Dreams and he laughed that only in China would they name a company after its English acronym. He believes that battery technology will improve in the future and battery driven cars such as BYD will become a reality.

In terms of investing in emerging markets Buffett says that the private market will go to where it generates the best returns. Put simply he does not see great levels of investment in poorer emerging countries such as Africa, without profitable incentives. He cited a tool plant being built by ISCOR in China, a company he bought 80% of for $4 BN. ISCOR produces tiny cutting tools and is a large purchaser of titanium from China. Such investments in China make sense, since it is prudent to be close to where your clients are.

On his personal Investment style, Berkshire is now so big that it really requires big investments. Buffett referred to a decision several years back to buy either Yukos or Petrochina. Both companies were statistically cheap, but he chose the Chinese investment, as he was concerned about the political risk of investing in Russia, some month later Yukos's CEO and controlling shareholder Mikhail Khordorkovsky was jailed. Buffett believes that he will continue to look at investments outside the US; however it is not necessity as the US market is large and deep enough that it can throw up sufficient opportunities without looking overseas.

My own question to the Oracle, related to his highly publicised marking to market of sold derivatives in Berkshires accounts and which he complained about in his annual report. Not only did he confirm that he did not have to post margin requirements under these derivatives, he pointed out that even the potential derivative obligations owed to the now bankrupted Lehman Brothers cannot be accelerated by Bankruptcy courts. He went on to point out that you must think about the consequences of an investment and other peoples actions with a recent example; When he invested his $5 Billion in Goldman Sachs late last year, he escrowed their Managing Directors from selling their shares not only in the event of bankruptcy but also divorce.

When asked what he felt were the most effective of CEO traits, Buffett said that it doesn’t necessarily correlate well with either IQ or grades in school, but put simply, effective communication (both written and oral). He said there is no sense in having a great idea without being able to communicate it. Clearly this is an area that the hedge fund community and DV01 have been remiss on recently and I intend to rectify. Buffett believes that now is a great time to be entering into the investment business. He says that it's important not to worry too much about people’s fears of losing money, as that fear will pervade through one’s investment style and ultimately one needs an independent temperament which is more important than a high IQ.

Regards,

Gregory Madden