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Stock Strategist

Ideas That Will Make You Money
by Pat Dorsey, CFA | 05-17-06 | 06:00 AM

Even though he's been Warren Buffett's partner at Berkshire Hathaway BRK.B for more than 30 years, Charlie Munger runs a very distant second to the Oracle of Omaha in name recognition. That's a shame for a couple of reasons.

First, Munger has had an enormous influence on what we all now think of as the core Buffett investment philosophy of buying wonderful companies at fair prices. Prior to meeting Munger, Buffett hewed closely to the price-conscious and quality-agnostic approach of mentor Ben Graham, and it's fair to say that Berkshire's ownership of companies like See's Candy, Coca-Cola KO , and (more recently) Anheuser-Busch BUD can be traced to Munger's influence. (We also own Coke and Budweiser in our Tortoise model portfolio.)

Second, Munger is just as smart as Buffett and arguably more candid in his public comments. I think Buffett's fame forces him to be somewhat more guarded when speaking to audiences, and his notoriety also means that he's frequently asked the same questions at Berkshire annual meetings and elsewhere. Munger, by contrast, is rather blunt.

Just as Buffett and Munger hold court each year in Omaha at the Berkshire Hathaway annual meeting, Munger does a solo act answering questions during the annual meeting of his own firm, Wesco Financial WSC . (Wesco is 80% owned by Berkshire.) It's a great chance to hear Munger's unadulterated thoughts, and a few of my colleagues and I traveled to Pasadena, Calif., last week to see what Charlie had to say. He didn't disappoint, and I've summarized the highlights below.

On the IQ of the 'Smart Money'

Munger does not normally make any comments of his own before the question-and-answer session, but he did this year because, "so many of you [attendees] have come so far." He reminded the crowd that, "if there's any efficiency at all, asset classes converge in the long run," and used that comment as a launching point to talk about the dangers of chasing performance and listening to self-interested experts charging high fees. After noting that alternative asset classes--such as commodities and real estate--have done very well over the past few years, he pointed out that many institutional investors have only recently been allocating more assets to these areas.

Munger drew a parallel between this trend and what happened with venture capital investing several years ago. "Places like Harvard and Yale [endowments] were early into venture capital, so they got access to the best managers. Envy then rippled through the world of investment management, and firms rose up to satisfy the demand. Everyone piled in during the late 1990s, and promptly lost half their money. Something like that will happen again in other areas."

The key point here is that chasing the asset class that's been the most hot most recently rarely works out well for investors. It generally works out very well, however, for the consultants and investment managers selling the "product" that's been created to satisfy investors' demand. As Munger put it at the meeting, "How can anyone be so uncynical about human nature?"

Many managers and investment professionals will create and hawk whatever will sell, regardless of whether it's right for investors. Remember all those Internet funds launched near the top of the Nasdaq? Or all the recent launches of emerging-markets and precious-metals funds? Caveat emptor.

On Asset Prices

Munger: "Every asset class I see is priced on a fairly rich basis.... Junk bonds seem to me to be pretty junky. The easy bargains are picked over because people like you are willing to come so far to hear about value investing. Of course, if a thing is despised enough, you can run a Geiger counter over it and make it go click."

He then related the story of someone he knew who'd started a fund to invest in companies in sub-Saharan Africa, illustrating that even such an out-of-the-way corner of the world was being picked over. Munger also recalled a comment made by Buffett at the Berkshire annual meeting concerning how cheap Korean stocks had become during that country's financial meltdown in 2002: "There were flour mills trading at 2 times earnings. Warren thought he was young again."

The underlying message here is simple to understand, but difficult to carry out: Investing in what's out of favor or overlooked will generally bring a better return than buying whatever happens to be in the headlines. It's a message that's made Munger and Buffett very wealthy, and it's a central theme of Morningstar's investing philosophy.

On Opportunity Costs

Buffett often talks about how much more money Berkshire could have made if he had acted on certain opportunities rather than "thumb sucking," as he has put it. Munger hit on a similar theme a couple of times during the Wesco meeting.

"The proper thing to do is look back and think what huge opportunities we all missed," he said. "We didn't scan enough areas looking for opportunities."

Then later in the meeting: "You can miss a lot. As long as you get some, and don't make monstrous mistakes, you'll do fine. But you should constantly review mistakes of omission." Munger related the story of fund manager Chris Davis' wall of shame--on which he posts the certificates of stocks that represent his worst losses--and mentioned that everyone should have a "wall of shame squared," reviewing all the things "you could have done if you'd been a bit more rational."

I couldn't agree more. As Munger put it simply, "You will be a better investor if you do this."

On Everything Else

As usual, Munger's answers to questions from the audience were rife with great quotes. Here are a few that I managed to scribble down, with context appended where it's necessary.

"There's always a lot of nonsense that's conventional."

On the way the accounting profession has handled accounting for derivatives: "I don't think giving up is the right word. They've sold out."

When asked for some financial detail on Iscar, the Israel-based metalworking company recently purchased by Berkshire: "That's a very intelligent question, so I will give you a very intelligent answer. I'm not going to tell you."

"I don't know how we'll fix corporate compensation. When people rise high in life, they have a duty to act as an example. Look at judges and generals, for example. The culture's horribly awry, and I don't know how to fix it."

"There will be some repeat of LTCM somewhere. You can count on it."

"The harder you work on something, the more confidence you have in it. But you might be working on something you aren't good at."

When asked whether he considers buying businesses outright and managing them more honorable than managing a portfolio of equities: "Hell, yes. It's a more engaged life. Why must people constantly flip just to add an extra zero?"

When asked whether he has an opinion about naked short-selling: "My jihad calendar is full up."

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