Letter to Clients
March, 2016

First Rate

As you may have noticed, we took advantage of the recent period of volatility and added to our already large position in Moody's, the credit rating agency. Fortuitously, we later learned from our favorite financial columnist Matt Levine that the National Archives had released "a portion of the 'approximately 250 cubic feet of paper records and 13 terabytes of electronic records' assembled by the Financial Crisis Inquiry Commission." You might well ask why that was fortuitous. Well, we haven't had time to read it all, but it includes an interview with Warren Buffett on Moody's. We thought we'd share that interview with you and add our comments, both to elucidate our reasons for owning the stock and to highlight the differences between our thought processes and Buffett's.

MR. BONDI: Okay. What kind of due diligence did you and your staff do when you first purchased Dun and Bradstreet [which owned Moody's at the time] in 1999 and then again in 2000?

MR. BUFFETT: Yes. There is no staff. I make all the investment decisions, and I do all my own analysis. And basically it was an evaluation of both Dun and Bradstreet and Moody's, but of the economics of their business. And I never met with anybody. Dun and Bradstreet had a very good business, and Moody's had an even better business. And basically, the single-most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by a tenth of a cent, then you've got a terrible business. I've been in both, and I know the difference.

[Moody's has operating margins in the mid-40s, meaning that it is very profitable, more so than any of our other companies except Visa and Mastercard. Normally margins that attractive would invite competition, which would then reduce margins. Even in the wake of the financial crisis, though, when credit ratings agencies' reputations had suffered considerably, fledgling competitors were unable to take any meaningful share from the dominant three agencies[1], including Moody's, notwithstanding the best efforts of legislators and regulators to encourage entry into the business. Many investors still rely on ratings (see below) and apparently would rather, as they say, rely on the devil they know. Similarly, issuing companies, though they might want to "forum shop" for the most advantageous ratings, want to be able to place their securities with a minimum of fuss, thereby discouraging them from turning to ratings agencies that do not have the ready confidence of a critical mass of investors.]

[1] **That is, Moody's, Standard and Poor's, and Fitch.**

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MR. BONDI: Now, you've described the importance of quality management in your investing decisions and I know your mentor, Benjamin Graham -- I happen to have read his book as well – has described the importance of management.[2] What attracted you to the management of Moody's when you made your initial investments?

MR. BUFFETT: I knew nothing about the management of Moody's. The – I've also said many times in reports and elsewhere that when a management with reputation for brilliance gets hooked up with a business with a reputation for bad economics, it's the reputation of the business that remains intact. If you've got a good enough business, if you have a monopoly newspaper, if you have a network television station -- I'm talking of the past -- you know, your idiot nephew could run it. And if you've got a really good business, it doesn't make any difference. I mean, it makes some difference maybe in capital allocation or something of the sort, but the extraordinary business does not require good management.

MR. BONDI: What interaction --

MR. BUFFETT: I'm not making any reference to Moody's management, I don't really know them. But it really – you know, if you own the only newspaper in town, up until the last five years or so, you have pricing power and you didn't have to go to the office.

MR. BONDI: And do you have any opinions, sir, of how well management of Moody's has performed?

MR. BUFFETT: It's hard to evaluate when you have a business that has that much pricing power. I mean, they have done very well in terms of huge returns on tangible assets, almost infinite. And they have – they have grown along with the business that generally the capital markets became more active and all that. So in the end – and then raised prices – we're both – we're a customer of Moody's, too, so I see this from both sides, and – we're an unwilling customer, but we're a customer nevertheless. And what I see as a customer is reflected in what's happened in their financial record.

[We like good businesses such as Moody's. We also believe that good management matters. It matters with regard to capital allocation and it matters with regard to the day-to-day execution of strategy. We've met several times with Ray McDaniel (CEO of Moody's) and Linda Huber (CFO). We believe them to be thoughtful and disciplined, and that their thoughtfulness and discipline are to at least some extent responsible for Moody's results in recent years. For analogous reasons, we <u>don't</u> own McGraw-Hill Financial, which owns S&P, the other large U.S. credit rating agency. In comparison to Moody's, it has executed less well and allocated capital less well historically. To us, the world seems full of companies that have a pretty good underlying business but that are sufficiently mismanaged such that the shareholders don't receive the benefits of the good business. American Express (another long-time Berkshire Hathaway holding) is an example that comes to mind. We don't like the lower returns that bad management tends to produce, even in a good business. We like even less the additional "tail risks" that come with companies with bad management—that is, the critical mistakes that bad management can make in a time of crisis.]

[2] **This is inside baseball, but Ben Graham, widely seen as the inventor of value investing, was famously indifferent to either business or management quality, and based his investment approach almost entirely on whether the price of a security was inexpensive relative to the assets on the company's balance sheet.**

MR. BONDI: And I've seen in many places where you've been referred to as a passive investor in Moody's. Is that a fair characterization, and what sort of interactions and communications have you had with the board and with management at Moody's?

MR. BUFFETT: At the very start, there was a fellow named Cliff Alexander who was the chairman of Dun and Bradstreet while they were breaking it up. He met me – I met him in connection with something else, years earlier; and so we had a lunch at one time. But he wasn't really an operating manager. He was there sort of to see – oversee the breakup of the situation. Since we really own stock in both Dun and Bradstreet and Moody's when they got split up, I've never been in Moody's office, I don't think I've ever initiated a call to them. I would say that three or four times as part of a general road show, their CEO and the investor relations person would stop by and – and they think they have to do that. I have no interest in it basically, and I never requested a meeting. It just – it was part of what they thought investor relations were all about. And we don't believe much in that.

MR. BONDI: What about any board members? Have you pressed for the election of any board member to Moody's --

MR. BUFFETT: No, no --

MR. BONDI: -- board?

MR. BUFFETT: -- I have no interest in it.

MR. BONDI: And we've talked about just verbal communications. Have you sent any letters or submitted any memos or ideas for strategy decisions at Moody's?

MR. BUFFETT: No.

MR. BONDI: In --

MR. BUFFETT: If I thought they needed me, I wouldn't have bought the stock.

[We know activist investing is very popular right now, and it can be effective, but for the most part we think it's incredibly arrogant for investment managers to believe that they have the expertise to run businesses better than executives who've been in that business for years. Look at Sears. It's better to buy businesses with the right management and with the correct alignment of incentives in the first place. Not that we won't give our opinions when asked, or when we see something happening that doesn't make sense to us at a company we otherwise like. But investing in a company and hoping it will change is (to channel Buffett) like marrying a partner with annoying habits and expecting him or her to get rid of them after the wedding.]

MR. BONDI: In 2006, Moody's began to repurchase its shares, buying back its shares that were outstanding, and they did so from 2006 to 2008, according to our records. Why didn't you sell back your shares to Moody's at that time? I know subsequent in 2009 you sold some shares, but from '06 to '09, during the buyback, did you selling your shares back, and if so, why didn't you?

MR. BUFFETT: No, I thought they had an extraordinary business, and -- you know, they still have an extraordinary business. It's now subject to a different threat, which we'll get into later, I'm sure.

[Here, Buffett is presumably referring to either the threat of punitive legislation/ regulation, or the threat of successful litigation. Regulation of ratings agencies in the U.S. was significantly enhanced by the Dodd-Frank legislation. Similar and in some ways possibly more stringent regulations are being considered in Europe. However and to date, the new regulations, while somewhat burdensome from a cost point of view, have done nothing to reduce the dominance or profitability of the "big three". If anything, the increased regulation and reporting requirements have benefitted the larger ratings agencies at the expense of the smaller ones, as the larger companies are more easily able to afford the additional expense. Regarding litigation, since the financial crisis, a lot of litigation against Moody's has been attempted but not much has been successful. Moody's has powerful advantages—their ratings express opinions about the future, so they can rely on the first amendment for protection, much as journalists can. The way around this defense is to accuse them of fraud, but, as someone told us years ago when we were investing in Salomon Brothers, "fraud [which requires a demonstration of intent] is very hard to prove". More recently, plaintiffs have alleged "negligent misrepresentation" by Moody's, but this, too, has proved a pretty high hurdle to overcome. The litigation threat hasn't entirely gone away—as we write, the Department of Justice is apparently considering whether to file suit against Moody's for ratings actions it took leading up to the financial crisis. Whether that happens should be known this year, and we have a substantial allowance for that possibility in our valuation. The good news is that the further away from the events of the financial crisis we get, the more likely new claims will be barred by the various applicable statutes of limitations.]

MR. BONDI: Uh-huh.

MR. BUFFETT: But – but I made a mistake in that it got to very lofty heights and we didn't sell – it didn't make any difference if we were selling to them or selling in the market. But there are very few businesses that had the competitive position that Moody's and Standard and Poor's had. They both have the same position, essentially. There are very few businesses like that in the world. They are -- it's a natural duopoly to some extent. Now, that may get changed, but it has historically been a natural duopoly, where anybody coming in and offering to cut their price in half had no chance of success. And there's not many businesses where someone can come in and offer to cut the price in half and somebody doesn't think about shifting. But that's the nature of the ratings business. And it's a naturally obtained one. It's assisted by the fact that the two of them became a standard for regulators and all of that, so it's been assisted by the governmental actions over time. But it's a natural duopoly.

MR. BONDI: Now, Mr. Buffett, you've been reported as saying that you don't use ratings.

MR. BUFFETT: That's right.

MR. BONDI: But the world does.

MR. BUFFETT: That's right.

MR. BONDI: And my question is --

MR. BUFFETT: But we pay for ratings, which I don't like.

MR. BONDI: My question is one of more policy and philosophy and, that is, would the American economy be better off in the long run if credit ratings were not so embedded in our regulations and if market participants relied less on credit ratings?

MR. BUFFETT: Well, I think it might be better off if everybody that invested significant sums of money did their own analysis, but that is not the way the world works. And regulators have a terrible problem in setting capital requirements, all of that sort of thing, without some kind of standards that they look to, even if those are far from perfect standards. And so I can't really judge it perfectly from the regulator's standpoint. From the investor's standpoint, I think investors should do their own analysis and we always do.

[Exactly. We don't, and wouldn't, use ratings in our analyses of securities we own or are considering owning—we've long since learned to rely on our own analyses and our own judgment. We're more than happy, though, to take advantage of the fact that many others do rely on ratings.]

MR. BONDI: Would you support the removal of references to credit ratings from regulations?

MR. BUFFETT: That's a tough question. I mean, you get into – you get into, you know, how you regulate insurance companies and banks. And we are – we're very significantly in the insurance business and we are told that we can only own triple-B and above and different -- there are all kinds of different rules in different states and even different countries, and those may serve as a crude tool to determine proper capital or to prevent buccaneers of one sort from going out and speculating in the case of banks with money that's obtained for a government guarantee, so that is not an easy question.

MR. BONDI: As I mentioned at the outset, we're investigating the causes of the financial crisis. And I would like to get your opinion as to whether credit ratings and their apparent failure to predict accurately credit quality of structured finance products, like residential mortgage-backed securities and collateralized debt obligations, did that failure, or apparent failure, cause or contribute to the financial crisis?

MR. BUFFETT: It didn't cause it, but there were a vast number of things that contributed to it. The basic cause, you know, embedded in psychology – partly in psychology and partly in reality in a growing and finally pervasive belief that house prices couldn't go down and everyone succumbed – virtually everybody succumbed to that. But that's – the only way you get a bubble is when basically a very high percentage of the population buys into some originally sound premise and – it's quite interesting how that develops – originally sound premise that becomes distorted as time passes and people forget the original sound premise and start focusing solely on the price action. So every – the media, investors, the mortgage bankers, the American public, me, my neighbor, rating agencies, Congress – you name it – people overwhelmingly came to believe that house prices could not fall significantly. And since it was biggest asset class in the country and it was the easiest class to borrow against, it created probably the biggest bubble in our history. It will be a bubble that will be remembered along with the South Sea bubble and the tulip-bulb bubble.

[Hard to argue with anything Buffett says here. While we've never been fond of the "everyone else was doing it too" defense, it is clearly difficult not to participate in a bubble when the contours of that bubble are invisible or almost invisible at the time. The important things from our perspective are the lessons that Moody's appears to have learned from the lead-up to the financial crisis. These include the need for constant vigilance, both over their internal processes and over external developments that might be giving rise to new risks, and, we think most importantly, a stated determination to position themselves, overall, as the most conservative of the major ratings agencies.]

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