2019 Berkshire System Summit Key Takeaways

Focus is the most important factor to success

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The 2019 Berkshire System Summit was held at the University of Nebraska at Omaha. I highly recommend it to everyone who's attending future annual Berkshire Hathaway meetings. This year's speakers included Don Wurster CEO, National Indemnity; Bob Batt, retired EVP, Nebraska Furniure Mart, Tony Nicely, Chairman, GEICO; Bill Roberts, CEO, GEICO; and Ron Olson, legal counsel, Munger, Tolles & Olson and Berkshire Hathaway Director.

There are three key takeaways when I synthesize the notes I took from all of them.

Focus is the most important factor to success

Both Warren Buffett and Bill Gates have attributed their success to relentlessly focusing on one specific passion or problem. This applies to most of Berkshire's subsidiaries too.

There are three aspects of focus based on my understanding.

First, focus means sticking to a core competency that has been developed over time and sticking to the geographic areas where a business can have sustainable competitive advantages. National Indemnity focuses on niche insurance markets in the U.S. Geico focuses on automobile insurance in the U.S market. Nebraska Furniture Mart focuses on furniture, appliances and electronics in three geographic areas. All of them are also focused and passionate about providing the best value for their customers.

Second, focus means constantly figuring out a way or ways to do it better than anybody else and adding more economic value to the customers than anybody else. Geico and Nebraska Furniture Mart are exemplary in providing the best value for their customers with the best quality services and products.

And third, focus means continuously cultivating and maintaining a remarkable culture and a spotless reputation to deserve the trust and respect from all participants in the ecosystem. Every Berkshire manager tries their best to avoid doing anything that would embarrass Berkshire in any way. This goes along with Warren Buffett's "newspaper test." At Berkshire's subsidiaries, it's a moral duty to conduct business in an ethical, meritocratic and win-win way.

The importance of being consistent

When asked about the Berkshire system, Tony Nicely said that one thing he learned early on about the system is that it doesn't change. Warren Buffett has been the same person all his adult life. Bob Batt and Don Wurster echoed Nicely's observation. Many aspects of Berkshire Hathaway have remained the same for decades, for instance:

- The chairman spends most of his time reading.
- Its small headquarters.
- Managers are left alone.
- They always stick to their circle of competency.

What they meant is that the key ingredients, or the overriding principles of the system don't change. But when things change, the system is also flexible enough to adapt to the changing environment.

To me, the things that don't change are the building blocks of the system. These building blocks were small advantages in the beginning but as they keep compounding, over time they become huge non-replicable competitive advantages. In other words, Berkshire's moat widens every day because the compounding power of the key building blocks. This is very powerful.

Berkshire will still be Berkshire after Buffett

After attending the Berkshire System Summit, it suddenly dawned on me that while investors mostly associate Berkshire with Buffett and Munger, Berkshire is much more than that – it's a collection of wonderful businesses, the best capital allocators and the best operators in the world. Yes, Buffett and Munger are the best capital allocators but without the best operators such as Tony Nicely, Mrs. Blumkin, Ajit Jain and Greg Abel, Berkshire would not have achieved what it has achieved today. All publicly traded companies would be lucky to have any of the Berkshire managers as their jockeys. In fact, I would happily own Nebraska Furniture Mart or Geico if they were publicly traded companies because they are wonderful businesses with wonderful management teams.

As the operating businesses becomes a larger part Berkshire's owner's earnings, Berkshire's operating managers will play a larger role in growing Berkshire's intrinsic value and capital allocation, while still crucial to Berkshire's intrinsic value today, might decline in terms of significance in the future.

Don Wurster, CEO, National Indemnity; 2019 Berkshire System Summit

How Don Wurster views the Berkshire system

Background Information of Don Wurster and National Indemnity :

National Indemnity was founded in 1940. The company provides commercial insurance products. It offers commercial auto insurance products, which provide coverage for business auto, commercial trucks and truckers, passenger transport, and specialty operations; garage insurance that provide coverage for dealers, and service and repair shops; motor truck cargo insurance that provides coverage for loading and unloading, refrigeration breakdown, and earned freight operations; and prize and indemnification and special events insurance products.

National Indemnity also provides general liability insurance, which provides coverage for construction, manufacturing and distribution, transportation, miscellaneous, and stores and rental operations, as well as installation, service, and repair operations. It offers its products through retail and contracted general agents in the United States.

Don Wurster serves as the President of National Indemnity Company and Berkshire Hathaway Life Insurance Company of Nebraska. According to a WSJ study, since 1973 Don Wurster was mentioned 35 times in 17 annual letters to shareholders by Warren Buffett.

How do you define the Berkshire System?

It's a unique culture. The Chairman spends most of his time reading. It's small headquarters. Managers are left alone. There's a lot of responsibilities at Berkshire.

National Indemnity is the oldest surviving separate business of Berkshire Hathaway. But GEICO's Tony Nicely is the one who really exemplifies the Berkshire culture. He will talk to everyone in the company. Everyone feels a personal touch with Tony. He listens to customer calls. He knows every aspect of the organization.

At the end of the day, Berkshire managers are motivated to not let down the shareholders.

Sticking to circle of competency within Berkshire Hathaway:

At National Indemnity, you are not encouraged to write policies which you don't understand the risks involved. You should know what your circle of competency is and if National Indemnity employees venture outside of their circle of competency, that's when problems happen. Sometimes National Indemnity will try to experiment with things and make best judgement and recalibrate. But at the end of the day, National Indemnity won't venture into other businesses simply because the market they are in is too tough or there's too much competition. Within Berkshire, you are not forced to do things which you don't understand.

How Warren Buffett differentiates himself within Berkshire:

Warren Buffett may not be the smartest people within Berkshire Hathaway. Warren differentiates himself in wisdom, experiences, temperament, and not letting ego get in the way. He is by far the wisest person at Berkshire. He's also willing to accept adversity. When he's wrong he admits he's wrong. It's ok to make mistakes at Berkshire as long as you learn from your mistakes.

What skillset does Ajit Jain have but Warren Buffett doesn't have:

Ajit's ability to try new opportunities and to take advantages of them. And if things don't work out Ajit can move on to other things. Ajit is more adventurous than Warren Buffett and very good at trying new things more actively. He also has more energy to go out there and go executing on things.

But Buffett knows that he's not the best or interested in day to day management of the subsidiaries. And he is wise enough know it's best find somebody with the skillset to do that.

National Indemnity hiring policy:

When hiring, Wurster ask his manager to presume that if the person they are trying to hire will stay for the next 10 years. If they look at the past 10 years and they'll see there were a lot different things that have happened and the next 10 years will be equally uncertain. The question they should ask is will they be feeling good about the person they are about to hire 10 years from now and feel good about it? That should be the motivation when hiring someone.

Use of decision trees at National Indemnity:

National Indemnity uses decision trees and try to quantify the uncertainties or risks in an intelligent way. National Indemnity uses decision tools to evaluate individual clients and policies. That's part of the culture. You have to always think about the probabilities. A good book on decision book Wurster recommend is *The Undoing Project* by Michael Lewis.

Bob Batt, retired Executive VP, Nebraska Furniture Mart, 2019 Berkshire System Summit

Bob Batt is the former executive vice president of Nebraska Furniture Mart and the grandson of Rose Blumkin. He began working for the company at age 14.

Brief introduction of the history of Nebraska Furniture Mart

After the depression, things got really tough. Blumkin had an idea to make money - selling furniture from her basement. Everyone in the family worked in the business and they all worked hard, even on weekends. The goal had always been to sell cheaper furniture. After founding, the business got bigger and bigger. During the 1940s, Blumkin came up with the idea of being all-inclusive, meaning the company would sell not just furniture, but also appliances and electronics, whereas most other furniture stores only sold furniture. One thing Nebraska Furniture Mark found out early is most decisions about home furnishings are made by women, so they tried very hard to cater to what they wanted.

The company moved to an uptown location after World War II. After dominating the Nebraska market, it opened another store in Kansas City in 2003. Then, the company scouted places all over the country and settled on Dallas for the next store.

Biggest change in the business

The sourcing of products was the biggest change. Most of the sourcing was done in North Carolina, South Carolina, Virginia and Michigan. Today, most is from China. Globalization is here to stay. Batt went to China directly and formed buying groups with local retailers, getting a good selection and good price.

Why retailers fail

Sometimes retailers do things based on ego and forgot who their clients are. Nebraska Furniture Mart never forgot that customers are always number one. Batt's favorite quote from Sam Walton is: "If you don't take care of your customers, somebody else will." It's true in all businesses. The worst example is Sears (SHLDQ). The ego of the CEO ruined the company even before Eddie Lambert took over. It lost focus.

When people go to department stores, research shows the number one thing they want is a clean restroom. The second thing they want is a clean environment and updated interiors (walls, etc). Sears flunked in both and so did J.C. Penney (JCP). Nebraska Furniture Mart tried to dominate in every section of the business it operates in. You always have to look out for what's going on, what other guys are doing.

Why Dallas? How did you go about choosing the location in Dallas?

Dallas has millions of people. There's no market dominator. It's a very fragmented market.

Nebraska Furniture Mart's team went to 10 states and surveyed the economies of local cities and locations. Originally, St. Louis was the top choice, but local government wasn't receptive and they didn't understand the concept of furniture.

Batt said the main consideration in terms of location is "we don't want our customers to be hassled to come to see us." As such, the location needs to have major intersections and roadways that you can get in and out easily. In Dallas, the company looked at a few locations, but traffic problems couldn't accommodate the flow. Finally, they found a piece of land with nothing built on it and good traffic flow. The company also did a lot of negotiation with local government so it could build new intersections and new overpasses. It's easy to get into and there is plenty of free parking.

But that's not enough. Retailers have to remove all the barriers to why people don't want to come. So, Nebraska Furniture Mart went around the world to look for the best practices. It found there are two things people don't like - waiting to pay money and waiting to pick up their products. So the company developed systems for faster payment processing and picking up merchandise. The company's representatives also studied at Disney University on how to deal with crowds, how to keep them happy and how to keep them entertained. They transferred what they learned from Disney to Nebraska Furniture Mart.

The company also had to make sure it's extremely safe with security cameras and security guards. As a result of implementing these strategies, Nebraska Furniture Mark grabbed market share right away.

Negotiations between Blumkin and Buffett

Twenty years before the purchase, author Adam Smith was driving around Omaha with Buffett and they drove past the Nebraska Furniture Mart. Smith said it looked like an interesting place and asked Buffett why he hadn't bought it. Buffett said, "Someday I might."

When Buffett decided to pursue buying the company, Blumkin was getting older and wanted continuity. The deal was a handshake deal. Blumkin told Buffett how much she was willing to sell for and he told her what price he wanted to pay, and they agreed on it. There was no audit, no inventory taking and no checking on the bank balance. The deal was closed in a few minutes.

The family's involvement after being acquired by Berkshire

One thing the family learned about Berkshire is its protocols. One protocol is don't ask about things that don't concern you. Focus on the mission of what the company does - selling goods and services. Never ask about anything outside of Nebraska Furniture Mart. Their job at Berkshire is to generate cash flow so its parent company can make better use of the cash.

What changed after NFM was acquired? Were you thinking about buying other businesses?

The retailer has no interest in growing faster than it already has. The limit to its growth is the talent pool - managers, truck drivers etc. When it opened the Kansas City store, 25% of the Omaha staff moved there. The same thing happened with the Dallas store. The company has to be careful in not growing for the sake of growth because its duty is not to cause Berkshire any headaches or embarrassment.

How much of your focus is on foreign markets versus U.S. How has the current trade dispute affected your business?

The trade war does no one any good. It will hurt both sides. They'd rather do good things. What Batt has learned in China is if you keep everyone working and producing and they have the basics of food, shelter and clothing and a chance at a decent life, they'll never go to war with the U.S. Trading with China will benefit American consumers and American businesses.

What other retailers do you admire?

Batt said you have to admire Walmart (WMT). He also admires Amazon (AMZN) after it started paying sales taxes. IKEA is a great company. One thing Batt doesn't like about IKEA is when you go in, there's one door and you have to go through their maze and come out from the exit. They try to control your behavior and what you see and do. The do-it-yourself model can be a turn-off for people who are not very good at tools, but they have a lot of things that work.

Within Berkshire there are other furniture retailers. Do they share best practices?

All four furniture retailers are very different. They always learn from each other every day.

How do you make people feel special?

You spend a lot of time and effort in understanding their needs. You make it friendly for them and deal with what they want. At Nebraska Furniture Mart, they always ask customers whether the products meet their needs, design, color and price points. They remodeled the store to make it nicer, friendly and keep it up to date.

In terms of staff, Nebraska Furniture Mark has sales people who have worked for the company for more than 60 years. It always hires refugees because they make the best workers no matter where they are from because they are happy to be in America. The company hired them when they were young and they are still there. They started from the bottom level and moved all the way up. There's a great continuity in the team at every level.

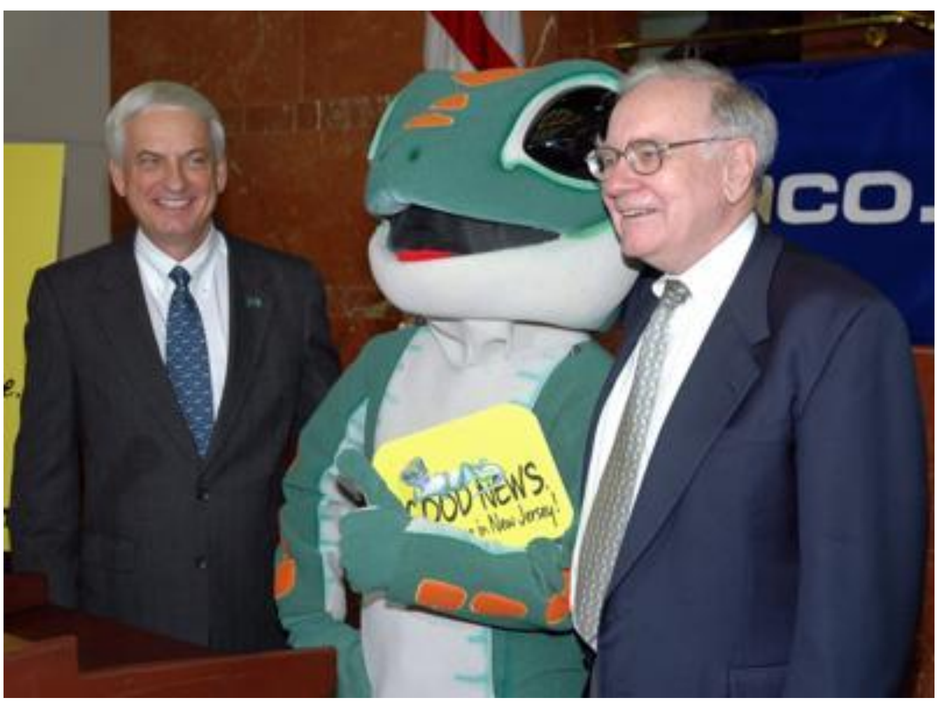
Blumkin had a favorite quote: "Nothing is forever." Things change and you have to have a continuity plan. Berkshire and its subsidiaries are very heavy in its continuity and succession plan.

Tony Nicely, Chairman, GEICO; 2019 Berkshire System Summit

Don Wurster, CEO of National Indemnity spoke very highly of Geico's Tony Nicely, saying he really exemplifies the culture at Berkshire Hathaway.

Background information

Olza M. Nicely, also known as Tony, was the executive chairman of Government Employees Insurance Company Inc. (Geico) from 1993 to 2018 and its CEO from 1992 to 2018. He served as president of Geico from 1989 and as its executive vice president from 1987 to 1989 and senior vice president from 1985 to 1987.



How do you define the Berkshire System?

One thing Nicely learned early on about the system is that it doesn't change. Buffett is the same person. Lorimer Davidson introduced Buffett to the concept of float and how insurance works, but his system of managing hasn't changed whether it's a public company or a private company, a large company or a small one.

Buffett is so easy to work with, such a cheerleader and a great mentor. If you listen carefully, you'll notice he gives a lot of great advice.

The difference between being a public company and being a part of the Berkshire family

It's quite a wonderful difference. One of the best things that ever happened to Geico was when Buffett decided he would like to acquire the rest of the company that he didn't already own for Berkshire Hathaway. He initially made a significant investment in Geico during the darkest days in the middle 1976 and kept adding to the investment.

Buffett also called Lou Simpson and Sam Butler to see if they were interested in having Geico 100% owned by Berkshire Hathaway. Buffett then called Nicely in 1995 and asked him to think about whether it made sense for Berkshire to acquire Geico, saying he only wanted to do it if Nicely thought it was a good idea.

In 1995, Nicely had been CEO for two years. He realized that by being a public company, Geico could never do what would be possible if it were a private company. Simpson and Nicely weren't interested in short-term and quarterly results, so only when investors insisted on coming in and seeing the company's numbers did they agree to talk to outside investors.

As a result, Nicely told Buffett it made a lot of sense for Geico to be part of the Berkshire family. He had only two concerns. One would be the fiduciary duties of the CEO and the rest of the directors and that the minority shareholders would get a fair price. The other concern was to come up with something to replace Geico's employee stock ownership program.

Subsequently, Berkshire came up with a profit-sharing program for Geico in which anybody who had been with the company for more than a year would be able to share the profit based on two things that can be tracked easily – unit growth and profits on all businesses more than one year old.

Even when Geico was a public company, Nicely said he always resisted meeting with the press any more than he had to. Today, he only speaks for educational purposes outside of Berkshire Hathaway.

Brand recognition

Back in the days GEICO never disclosed more than what was required to be disclosed. Since insurance is an extremely competitive business, the company would like to be stealthy.

Back in the late 1980s or early 1990s, Nicely and Buffett were driving and played the game of words of association. Buffett said “hamburgers” and Nicely said “McDonald's.” Then Buffett said “chewing gum” and Nicely said “Wrigley's.” And then Buffett said, “Wouldn’t it be nice if someday if someone says car insurance and the response is Geico?”

In 1993 and early 1994, there was a study of Geico’s name or brand recognition and they found it was about 3% to 4%. Today, most people have heard of Geico.

Why hasn’t GEICO expanded into other lines of the insurance business or other countries?

The financial collapse of Geico in 1975 and 1976 was a serious blow to the business. It took the company almost two decades to rebound from the low and regain associates and customers.

What Nicely has learned is that if you can do something really significant that’s worth doing and better than anybody else, chances are you are going to gain more economic value for both the consumers and the people associated with it than trying to do multiple things. There are few companies that have proven they can do any one thing better than anybody else, let alone multiple things.

That’s why Geico hasn’t expanded to other countries. It has looked at the U.K, Germany, Canada, China and South America, but the U.S still offers more potential for the next few billion-dollar investments than any other regions at the moment. Last year, the company moved up to a little over 13% of the market share, so there’s still a lot of room to grow in the U.S. Today, the market is almost $250 billion because of inflation, the cost of liabilities, the cost of medical payments and the cost of automobile repair. The severity of an accident will continue to grow. What will happen to the number of automobiles on the road is still in question, but right now it is still growing.

Geico stayed away from life insurance. It got into the life insurance business twice, but the return was not very good. So it sold the business twice. Geico also doesn’t do health insurance as it tries to stay inside of its circle of competency.

The hardest thing about managing Geico

Laying people off, through no fault of their own, during the financial collapse because most of those people had been with Geico for a long time. Also letting down the shareholders back when it was a public company.

How involved is Buffett with Geico?

Perhaps due to Buffett's love of the insurance business, he probably has more contact with Geico than any other subsidiary. Every year, Geico holds an annual review and planning session for the future. Buffett has attended all the meetings since 1996 and has only missed two meetings. He also started to bring more directors to the Geico meeting.

What metrics were considered in terms of succession plan?

Bill Roberts is the current CEO of Geico. He's been involved with the company in all departments and with all the associates. He's knowledgeable about the business. Roberts continues to grow within the organization as well. It was Buffett's decision on who to appoint as the new CEO, but Nicely suggested Roberts.

How does Berkshire keep top talent without offering the typical executive incentive packages of stock options?

Nicely told the story of how his father never made more than $25,000 a year and his grandfather never made more than $15,000. They never left the state and they left no debts. But they left the total respect of all the rural community Nicely grew up in. His father and grandfather had greatly impacted him.

Geico has a different culture that's not replicable. It's worked for Geico, and Nicely hopes it doesn't change.

In terms of what metrics are used to determine compensation, it's nearly the same for all employees at Geico – growth and profitability because they want everybody thinking together. It's a balanced approach because if you want too much profitability then you might sacrifice growth and if you pursue too much growth then profitability might be at risk.

The impact of self-driving cars:

The technology is coming, but it's more complicated than people think. The infrastructure, the laws and regulations are both very complicated. How fool-proof will the self-driving cars be? Can you have zero defects in the complicated software? Safety is a big concern.

In 1977 or 1978, nearly 78,000 people a year were killed in car accidents on the highways. Because of safer cars, better law enforcement and a few other factors, the number of people who died from highway accidents declined to 32,000 a few years go. Today the number went back up to about 40,000. More distracted driving and more marijuana consumption might have contributed to the rise of the death rate. But it's not just the death rate that matters to auto insurance. It's also the injuries that have become more severe and the economic damages that have become more expensive due to more expensive vehicles and more electronics on the vehicles. So inflation has really hit the property and casualty insurance industry, particularly on automobiles.

Nicely thinks it will take longer than people think to have 20% fewer vehicles on the road. The average age of the vehicles in the U.S. fleet has increased to more than 11 years. It's not a very high turnover rate. Newer cars with all the safety features are much more expensive to purchase than used cars.

Berkshire after Buffett:

Warren Buffett has done such a fantastic job in picking the people that think like him and Charlie Munger. Nicely doesn't think there will be much change. He can't imagine what Berkshire will look like without Buffett, but he thinks it will do just fine.

You will not find another Buffett. But you want someone who's smart, well-versed, familiar with the culture of Berkshire Hathaway, and in synch with Buffett's methods of doing businesses. Both Ajit Jain and Greg Abel will make great successors.

Trend of Geico's customer acquisition cost:

The cost of customer acquisition has declined due to the rise of the internet. It has saved Geico a lot of money, and Geico has been able to finance all its branding and advertising from the improved efficiency.

More than 70% of Geico's quotes come from electronic sources today, and it will only increase from here because people don't like to be bothered. There are very few people who still like to talk on the phone today, and the number will get smaller in the future. Geico always tries to make it easier and more convenient for consumers to self-purchase policies and do self-service as well.

Geico was founded in 1936 on the principle of being the low-cost provider by providing cheap but great coverage. That's Geico's franchise, and Geico needs to be the most efficient company in acquiring and maintaining customers. The future looks very good for Geico. Yes, a lot of people still like purchasing through agents, and more policies are sold through agents than through direct response, but direct response has been gaining share over time. It’s a like an iceberg moving slowly.

Why hasn’t Geico done much with telematics?

Telematics was offered to Geico in the 1990s, but Geico hasn’t done much with it. Geico’s concern was whether customers are okay with knowing that there’s a device in their cars that will collect their personal data during the lifespan of the car ownership. But now most people realize that the new cars are designed to have all the personal data that can be tracked by the smartphones. So Geico’s starting to use telematics on a test basis. The reason why telematics may become a bigger issue going forward is that a lot of people think that somehow empirical data cannot predict the future; only current data can. The predictors could be age, sex, marital status or past driving records. It would be great if past or current driving habits won’t change in the future. But if you know you are being tracked by a device to get a rate, you may drive a bit more defensively during the period you are being tracked and then switch to a more aggressive driving style once the period is over.

Also, many regulators would like to control how insurance companies price the policies. Some regulators even want everybody to pay the same. It will be very bad for America if that happens.

China’s auto insurance market:

China is the largest auto market in the world. But it is still tightly controlled, and the regulation is not adequate at this point. It will change. At the current time, Geico’s investments are best in the U.S. where it knows the market and can predict its results much better than any other countries.

Whether regulators may regulate insurance companies the way they regulate the big banks:

The P&C insurance industry has a pristine record. During the financial crisis, only AIG (AIG) got into big trouble, and it was not in the insurance business that almost broke AIG. It was the investment business. There hasn’t been a major investment company failure in a long time. Because of the guarantee system that’s been set up, even though it’s on a state level, policy holders have been paid. The P&C insurance businesses have done extremely well as fiduciaries for customers in the U.S. The largest insurance companies have paid their claims.

How does an auto insurance business differentiate itself from competitors?

The auto insurance business is a commodity business, and the first thing people want to know is price. So you have to be extremely efficient to have very good prices, or you have to go to a niche market where price is not an issue.

Geico was founded in 1936. Back then Geico had no name recognition and had to say no to half of the people who applied to get quotes from it because it was primarily a preferred-risk company.

It was only in the 1980s and early 1990s that enough information could be collected to be able to price appropriately as a direct-response insurer, and Geico has to do something differently. The regulators didn't allow the insurance company to price discriminate, so Geico has to create many different companies so that it can have more pricing points. Then it's all about building the brand for people to shop at Geico because Geico knows that for every three potential customers who call, at least one of them will sign up for a policy. And as long as Geico can get at least one of three callers to sign up, it's worth the advertising spend and building the brand. But you have to have staying power, and you have to ignore quarterly earnings. Geico can differentiate among its competitors because Buffett doesn't care about quarterly earnings. Buffett tells Nicely to spend all the money Geico needs on advertising to grow the company as long as Nicely can see the long-term value. Berkshire can handle the lumpiness of the results.

Uniqueness of Geico's advertising:

Geico spends a few billion dollars on advertising each year. It's difficult to break through if you are creating ads based on consensus. Geico doesn't do any focus groups; doesn't pre-test the ads. Geico has worked with the same advertising agency for 25 years. Geico has always had a point of emphasis whether it's price or service. For 25 years, Geico has used humor to break through because it wants everyone to like Geico and not be afraid of Geico. It has worked for 25 years, and they stick to the strategy. And Geico never put political ads that might offend any particular group.

About the author:

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A global value investor constantly seeking to acquire worldly wisdom. My investment philosophy has been inspired by Warren Buffett, Charlie Munger, Howard Marks, Chuck Akre, Li Lu, Zhang Lei and Peter Lynch.