This is Markel (MKL) CIO Tom Gayner’s Q&A Session from the 8th Annual Value Investor Conference in April 2011, in Omaha, right before the annual shareholder meeting of Berkshire Hathaway. The upcoming 9th Annual Value Investor Conference will be held May 3 – 4, 2012, again in Omaha.

**Question:** What was your biggest investment mistake?

**Tom Gayner:** Our biggest investment mistake was in the 2008 period where I was unaware of how much leverage really existed in the system. I had banks and financial institutions, and I also owned other businesses which the systemic oppression and deleveraging that took place really affected their businesses in ways that I had not foreseen. So we lost some capital, and I imagine that for most people in the investment business that that's true. There are the few exceptions that we all know about because those who won gains in 2008 tend to be very public with their statements about their wins. So that was really a painful episode, a painful time of learning, and really what it taught me about was just how powerful leverage is. It's one of those things we thought that for a long time that good judgment comes from experience, which comes from bad judgment, so despite of listeners who thought I said before 2008, I'd have been a lot better off. We always talked about judgment like that - if you're smart, you don't need it, and if you're dumb, it'll kill you. So you can hear that, to some extent, literally it went in one ear and out the other. But having been through the painful experience now of 2008 and seeing the effects of leveraging and using too much of it, that's the biggest investment mistake that I've ever made. I've made a lot of other smaller mistakes, but that's what life is, it's a series of learning about you and generally speaking you learn more about things that don't work out than things that do.

**Question:** When you look at the insurance business and the implications for pricing and how you price insurance and what the dynamics are, how do you price in an environment where there are zero-percent interest rates? You generally have historical context for data, but you haven't seen this in a long period of time.

**Gayner:** Well I think that zero percent interest rates are basically driving people crazy. It's certainly not a policy decision that the market would produce, and it certainly has gone on a lot longer than I thought it would have. The paradox for the insurance business is that – well, let's just stipulate, and say for example, that interest rates are at zero or close to zero. Well what that should mean, frankly, is that the inherent profitability and what you charge for insurance should go up, because when you're setting an insurance price and thinking about the economics of the insurance business, you assume some investment income usually, whether explicitly or implicitly, and it factors into your pricing decision. And similarly, even if you're not doing it, everyone else who you're competing with in the industry to some extent is. So if interest rates are low, what you should do is for the same unit of risk and insurance, you should charge more for it, because you need to make an underwriting profit as opposed to assuming you're getting
investment income from it. Now what has happened in the last couple of years, and this is where zero-percent interest rates have had a systemic effect, is that the amount of capital that people think they have and the amount of capital that people are trying to get some sort of return on, is psychologically probably even more than what they really have. So the supply and demand factors – insurance like any other business uses capital to be out there and make itself a legitimate player in the market place – that supply has caused insurance prices to be low. So while naturally, you would think insurance prices should be going up, as a practical matter over the last couple years, in the face of zero-percent interest rates, they've gone down. What we do specifically is say that those sort of macroeconomic factors are things over which we have no control, and we shouldn't really spend a massive amount of your time, I think, personally, over things over which we have no control over whatsoever. Well what do we have control over? We have some control over what we think the ultimate loss would be when we're willing to take an insurance risk, and where our expenses in running the business are. So our discipline internally, I think, this would be true of any well-run insurance company, is to not take risk for which you don’t think you’re going to make an underwriting profit, and you just have to wait for this unusual inversion in the interest rate and the investment environment to pass, and ride it out.

**Question:** You talked about leveraging — in your experience, is there a yardstick for businesses, how much they should leverage? And secondly, in your letter to shareholders this year, one talks about the value of cash. Is there some rule in your experience that businesses should keep so much cash aside? A percentage or something?

**Gayner:** The question: Is there a rule of thumb for businesses, how much leverage they should have, and second is a question about cash, how much cash they should have. Well, I very much hesitate to use the word rule, because that gets to a mechanical kind of thought rather than thinking. In fact, one very good friend of mine, he has his MBA from Duke, and I remember after he finished, he threw a great artifice, and obviously he spent a lot of time getting that MBA, and I remember asking him what do you want after, what I is the number one takeaway from getting a big time MBA from Duke, big time MBA. And his answer was "It depends." Those two words. It depends. Every situation you encounter, it can be looked at through "It depends." A business, generally speaking, and for instance, at Markel, not just from the insurance side but the noninsurance businesses that we own and operate, there are different levels of leverage that are appropriate for each of those businesses. For example, our industrial kinds of businesses, like the dredging business or the equipment business, we essentially operate those with no leverage, none. And the reason for that, and the people who run that business would sort of would like to use a little more leverage than what I'm comfortable using, the reason why we don't use leverage is not because it's not a good idea right now, it's just that a bad day will come. When a bad day comes, those are businesses that have a fairly cyclicality to them. You can't have leverage. Because you could be stocked out of a game in the middle of playing your hand by virtue of having someone else having control of your business. So those kinds of businesses we operate with very low leverage. By contrast, the global home park business that we own, which has very dependable cash flows, there is some leverage there, that's normal and reasonable, and there's a law of large numbers, there's thousands of people who pay rent every single month and need to every single month for a basic property. So that kind of business can, and should probably have some sort of leverage to it. So the answer is, it depends.
The other thing I'd say about leverage, and this is again, not something you'd pick up in a financial textbook, but I can remember a conversation that I had with [Shelby Davidson?], this is a name that might mean something to you in the investment world, if it doesn’t it should, this is one of the great investors out there and a great teacher. And it was in the early days at Markel Ventures, and I started to ask some things outside the insurance business. He and I were talking about it, I was asking some questions, starting to take advantage of some of his experience, and I was talking about some of the difficulties of when you're meeting a management team, and there's a business for sale, how do you know if you're dealing with a good person? A character that you can trust, a trustworthy management team running a business? And Shelby without a second of hesitation said, well if you want a good test for somebody not to be a crook, don't invest if there's a lot of leverage in their business. And I said, what do you mean? He said well think about it, crooks want to steal money, right? That's what a crook does. Well if you're using equity financing, and all equity, you're stealing your own money. Crooks don't want to do that, they want to steal other people's money. So generally speaking, you want to look at the integrity issues in a lot of businesses, and the things that are being said about Wall Street or the structures that were created and tasked around; those were hugely leveraged entities in certain situations, and it was pretty easy for a bad person to confuse the leverage that was there. So there isn't a black-and-white answer, there is no rule, other than that your common sense should guide you. Some businesses can handle some leverage, and other businesses are really a lot better off, even already with a lower rate of return of equity, by minimizing their leverage.

Question number two — in terms of cash, cash is again something that I would say is a paradox. This is something that Steve Markel and I debate, and it's a real world issue for Markel: We've been carrying probably an excess amount of cash for several years now, and Steve's been overanxious earlier to deploy that, and I've been resisting that to some degree. It's not because I like cash; I don't. It's a pathetic investment, with the yields you're not making, and it's subject to ongoing depreciation each and every day. But what cash does for me now, and the reason we probably have a little more than we normally would, is that cash creates optionality. And to the extent that you're looking at a volatile world for things that will move in price way more than they move in value, the only way that Markel Corporation would be able to respond to those opportunities is by having the cash. So it's not that I like cash, but I do like optionality and I do like the ability to move decisively and quickly when things arise. And clearly, and I didn't think of this myself, but look at Berkshire Hathaway (BRK.A)(BRK.B), it always has $10 million walking around, and the cash flow and the cash trove that they had going into 2008 served them extraordinarily well and enabled them to do things like the Goldman preferred and the GM preferred, etc. As for the rule of thumb for cash, other than I never want to be without it. So I'm willing to give up some current investment return in order to have options that cash carries with it.

[Question: What do you look at that maybe now, there may be specific overall systems?]

Gayner: I think there probably is. It's very dispersed… You talk about systemic leverage. If you think about individuals and the way that individuals perhaps and individual companies and firms and small groups of individuals have made decisions in the face of that result of 2008, a lot of people have brought the leverage way down. Look at the cash on a corporate balance sheet. Even if it is outside the U.S. because of tax reasons, corporations in general are carrying a lot of cash
and have reduced leverage fairly well. And I think through personal experience and just conversations with people, people in many cases are less leveraged than they used to be. Governments are more leveraged than they used to be. So there's distinct dispersion. During the bell curve, there are these binomial distributions, where there's way too much leverage and perhaps not enough, but it's not a normal distribution. To some degree, I couldn't help but categorize this into things that I can't control, and it would freeze you from making a reasonable action by virtue of a scenario analysis that you could play out that includes a white-out scenario, but that would wipe out everybody. So I'm willing to essentially take those scenarios off the table to invest in businesses that have [?] and no matter what pricing you use, how many zeroes we attach to a price, those businesses are actually doing something that is of value and society will continue to need no matter what, and they'll be fine. And I feel like I have a lot of control over that thought process than over what happens to the overall system. And by the way, in terms of the overall system, I'm more optimistic than a lot of people are. If you go back through history, you can always find sound logic, reason, correct arguments as to why things are just about to go down. But somehow or another, human beings are A) remarkably adaptive and B) remarkably resilient. I read this article yesterday, there was this great article in the NY Times, which is not normally noted for having positive feel-good articles, but it was about a Toyota dealership in Japan in the areas pretty darn close to where the earthquake and tsunami hit. It talked about in the dealership itself, they felt the earthquake, they went to the appropriate shelters, and as soon as the earthquake stopped, they came out to look at the damages, and boom, the wall of water from the tsunami hit, and the employees actually ended up going to the roof, and were able to wait it out. But the story was about how quickly they put the pieces back together to open that dealership for business, and how it sold six doze, 72 cars since then, and the manager in the dealership was talking about how important getting cars to the people in this area of Japan was. This was a critical thing. So they were going to do what it took to get cars to that part of the world. And on a daily basis, that happens over and over and over again in whatever circumstances. So absolutely some enduring things in the human animal to somehow or another to both create horrific problems and then being able to solve them.

**Question:** If you had sticky money for ten years, and you wanted to beat the S&P 500 with public equities, what would be the ideal amount of money? How much is too much to manage? How many stocks would you own ideally? And would you focus on small, medium, or large or a blend?

**Gayner:** I think the answer to this changes every time. I would have answered your question very differently ten years ago than I would answer it today. Let's go through your points. The first point was ten years of very stick money so you have a long-term time horizon. I am so lucky, so blessed, that's exactly that's what I have. So I'm very fortunate in that dimension I talked about with managing your client’s expectation. Fortunately, I have a fund at Markel, which is a great organization, and the people on the insurance side who are endorsing all your work, they have many deposits into the capital equity cap every year for the 20 years that I have been there, and they've never asked for a dime of it back. So you don't get a better client than that, and I'm extraordinarily blessed to be in that circumstance. With that being said, then you make the most of that opportunity that you get. In terms of beating the S&P by 5% over ten years with a large amount of money like that, I don’t know, at this point we have $2 billion total in equity investments. I would not assert to our board that I would be able to beat the S&P by 500
basis points over the next 10 years. Frankly, if I beat it by 50 or 100 S&P points, I think I've done a pretty good job. For the 20 that I've been there, we are actually ahead 350 or 450 basis points over a long period time. That started with a small amount of money, $35 million bucks, and it's $2 billion-ish now, so the dollars involved get bigger. And the degree of our performance in the last 10 years has been just as good as the first 10 years, even though the size of the money has gotten bigger. So the answer to that question about how much money is too much is completely theoretical; I don't know. And it also depends on what [?] you're operating on.

The second point I want to make about beating the S&P right now is that sometimes, I think that is easier than others to do. So for instance, going back ten years ago, I owned a lot of small-cap stuff and tiny companies. That's because, or 12 years ago, that was the era when Coke (KO), Pepsi (PEP), GE (GE), blue chips were all selling for 30-40-50 times earnings, and at that time we owned zero, none of them. And by process of elimination – well here's a joke that picks on the airline businesses because that's sort of an easy target: If you want to beat the S&P 500, here's what you do, you buy 500 stocks, and then you sell the airlines. You should do better. Probably won’t be 500 basis points, but it will get you something. So the S&P operates at a miserable 10 years basically because those companies in general, the earnings have been okay, and they've been compounding along, but the P/E multiples are overpriced. At this point, I actually think it's at the absolute better, from a relative measure, the S&P is probably due for a pretty good day. As I look at the businesses that comprise the S&P, and really let's talk about the S&P 50, the biggest 50 companies that earn 90% of the dollars, those are good businesses, global-spreading businesses, they're efficiently run, they're doing the rights sort of things with their balance sheets. Just saying as an asset allocation statement, if I'm sort of lucky the S&P 500 turns around for the next nine-ten years, I don't think that's a bad thing. In a different environment, if you remember back in the late 90s, any asset was essentially making that statement. It became wildly possible. In the investment businesses, you get in more trouble with a good idea than with a bad one. With a bad idea, you stop. With a good idea, you keep doing until it becomes a bad idea, and then it probably became a bad idea before you realized it was a bad idea. So if I was guessing, over a long period of time, I think the S&P 50 will be a pretty tough index to beat, but in general, it's kind of a good place to be. And what that implies is that generally, a lot of large companies are pretty attractive investments. That being said, the fun thing about operating in the small-cap world is that there's way more dispersion. There's way more difference between a good company and a bad company, so there are opportunities in the small cap world, and I think we'll continue to have those refined, idiosyncratic, good ideas, but it will be tough with billions upon billions of dollars as opposed to $200 to $300 million, or half of that, $500 million, that should be fun and challenging.

Question: Which idea do you like best right now and why? And secondly, how does a deal flow from Markel Bankers and firms, how does it compare with [?].

Gayner: Well in terms of the one we have the most dollars in is Berkshire. And that may be an unsatisfying answer for those of you looking for a new tip, but it has been the largest holding in our portfolio since 1990 and it continues to be so. I think the powerhouse that is Berkshire continues unabated. So I'm very comfortable with that being the largest holding that we have.

If actions speak louder than words, I should assert that it's Berkshire. If not, I should have
something else as my largest holding. Now the degree of certainty that I have that Berkshire will earn a return is pretty high. So there might be some things that are a bit more uncertain and you'd think I was happy with a higher discount rate, but I'm pretty comfortable with that as my largest holding.

Secondly, with the topic of deal flow, this ties into the question about zero percent interest rates. We did our first Markel ventures deal in 2005 when we bought AMF Bakery. And really, the only reason we got that deal was because it was headquartered in Richmond, Virginia, and we knew the person, so the idea that Markel was comfortable, familiar, there was an emotional connection that worked there that enabled us to get that. In 2006, 2007, even though we laid off strategy, working devices going into the [?], our total [?] was zero. Nothing. And that's because of the expectations of sellers and the price that they began [?]. In 2008, we did the [Dudovo?] start up [?]. Then in 2009, we transferred our [?], pulled out all that cash that we had, so that it became a very attractive idea because we could actually start checking into the flows. In 2006, 2007 people wouldn't return my calls; by 2008 we started getting emailed proposals from people who wanted to sell their businesses to Markel. That continued at a pretty good pace for 2009 and in the early days of 2010; it's deteriorated [?] because all the other guys, the private equity guys who have a lot of money, are back in the game [?]. So there is higher valuations than we've talked about in that world. The counterbalancing effect that we have is that anybody can say this is what they want to do, but now we have the track record of actually having done it and bought a company, so there are a cadre of attorneys, advisers, investment bankers that have firsthand experience with us and they know that we'll do what we say, and who people who are considering selling a business can talk to the people who have already sold a business, so there's a network and it takes place, so we're still continuing to see really where the deals are from that bet. And I think that will continue actually to persist and grow as time goes by.

**Question**: Could you maybe take us start to finish on a stock idea, how you came into it, how you researched it, how you decided to sell it, a good or a bad one?

**Gayner**: Well I tend to be a pretty slow seller. There's two reasons I would sell something, let's start with that: A) I made a mistake, it was wrong, and that usually involves some sort of character judgment I made about the management, being disappointed in some sort of tainted investing that seems inconsistent with what I wanted to see. Or secondly, and this is a little bit true right now, there are ideas that are just less compelling than a new idea that you might have and you need some money to pay for what you're buying. Generally speaking, it's not just a matter of the fact that I don't like to sell, but actually there's huge tax efficiencies for Markel for us to be able to buy and hold something for a long period of time. For instance, if you think back to the 2008 crisis environment, you could have bought a high-quality company at somewhat of a discount, or you could have bought something that was having a near death experience at a really knockdown price. Now, we spent a lot more of our time on the high quality companies selling at some discount rather than those who you wondered if they were going to make it through or not. Now at this point in time, the ones that did make through that were teetering, they've gone up a lot more than just a high-quality company continuing to chug along. I think that causes a second decision: Do you sell it or do you hold it and risk perhaps the volatile nature? And if we do sell it, then we're a full corporate taxpayer so we're going to pay 37% tax on that profit, so that means a dollar of gain I've only got 63 cents to reinvest, so the subsequent investment really has to be
good to warrant selling something. That's sort of some biases and some tax reasons why I tend to hold things for a relatively long period of time.

You look at our largest holding, Berkshire, just sort of 10 to 20 years ago, came to know more about it as time went by, so we've watched these opportunities as a matter of public record, for instance, I'll mention Walmart (WMT), which as of yet has been a relatively unrewarding investment and is something that I've been investing in for the better part of the last four years, sort of a ['?] stock. But it's not particularly mysterious what Walmart is. I look at the numbers, I look at the annual reports, I look at the quarterly updates, I see the sales going up, the share count going down, the balance sheet in great shape, the dividend going up. I see thousands of people going in every Walmart every single day, I see the global expansion, I'm aware of the risk of the political unpopularity of the company from time to time, but at the kind of prices that I started buying it, where it was 16-17 times earnings, now it's at 12ish, I continue to buy that sort of thing. There's not a whole lot of rocket science or higher math involved in deciding that it's a good investment. But in this environment, it's typical of this sort of thing. 10-12 years ago, screenings were different, because of smaller companies, that's much more idiosyncratic where a particular business is run by a particular gifted management team. And the environment will circle back around, it never goes away completely, but at the moment we have more capital allocated towards what I would call “big battle ships.”

**Question:** What's the single biggest thing that keeps you up at night and how does that affect your investment?

**Gayner:** Well the single biggest thing that keeps me up at night is that there are some systemic issues of leverage and just the kind of the way the government's behaved. And we can argue correctly that they've responded to emergency circumstances in ways that were helpful and productive at the time but sort of withdrawing from that has created its own set of challenges. And I don't know how much I can do about that, so I try to go back asleep. But that’s what I wake up at night.

**Question:** It doesn't seem like you have a lot of international companies. And second do you have any overall market evaluation techniques?

**Gayner:** The second one is quick: overall, not a whole lot. I've seen the literature, I've seen what's out there, and of course the statistics, but as John Train once said, "Investment is the art of the specific." So no matter what's going on in the overall pricing, the specific companies that appear attractive to me, I'm willing to act and purchase that. Or sell it in the opposite case, no matter what the overall market looks like.

Second thing, international. So we're in a college and academic setting, I'm going to give everybody a test, I'm going to name two companies, and they're both in the business of making a motor which moves something from point A to point B. One of them is called Honda (HMC), and one of them is called Caterpillar Tractor (CAT). And everyone has to play. So who believes that Caterpillar is the domestic company? Nobody believes Caterpillar is the domestic company? So by contrast, everyone's going to raise their hand when I say Caterpillar is the international company? "60% international!" Oh well, so you're getting ahead of the game here. So everybody
knows the name Honda. Is it a U.S. company or an international company? Well on your brokerage statements, Caterpillar is going to be listed as a domestic company. That’s silly. Caterpillar is more [described?] outside the U.S. than inside the U.S. Honda, by contrast, is North America’s largest market. But it will show up in the international revenues. It's pretty close to 50% of the revenues of the S&P 500. So what I look to is where the company actually does business. Every successful company is becoming more and more global. Even Markel which is a relatively small entity, 15 years ago the percentage of global businesses we had was near 0; today it's probably near 35% between our direct international holdings and the global businesses that we insure. And if you look at some of the Markel bankers’ numbers, in 2005 it was probably 5% international, it's probably over 30% these days, and the other half of our business was always part global, because there was 80% of the sales outside the U.S. So I disagree with your proposition that we don't have an international portfolio; I would say very much we do. But it just so happens you buy a lot of things that happen to have their influence in the U.S.

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