Pabrai Investment Funds
2014 Annual Meeting Transcript

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Note: This is the transcript of the September 13, 2014 meeting held in Aliso Viejo, California and the September 20, 2014 meeting held in Rosemont, Illinois. Mohnish's presentation style is extemporaneous; hence, there were some differences in the two presentations. Transcripts of both meetings were merged to produce this single document. The transcript has been edited for readability.

The transcript should be read in conjunction with the Annual Meeting presentation slides (the password to the video is "Warren"). They can be viewed at:

http://vimeo.com/106862214

Welcome:

The presentation is the same format as we have had in the previous year with one change. I will first go through the Pabrai Funds performance and where we are today. We always go through a postmortem of exited holdings - stocks that we don't own anymore but why we bought them and what transpired. The new section this year is an introduction to Dhandho Holdings which was set up less than a year ago, and an update on where we are with Dhandho. Lastly, we will go through the Q&A which is always my favorite part - to talk about what you have on your mind.

Slide 6 - 9

We have three funds which collectively have about $700 million in assets. Fund 2 is our oldest fund. Fund 1 blended into Fund 2 and it finished 15 years at the end of June, so this was a nice milestone.

After almost 14 years, PIF2 is up almost 7 times over that period - significantly better than the indices. If you had put in $100,000 in October of 2000, it would be worth almost $800,000 now. This is almost 4 times better than the indices would have done over that period. From the beginning of PIF1, which is from July 1st 1999 until now, it's worth 11 times more than the investment made at that time versus the Dow which has almost been flat with an annual return of about 5 %.

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Fund 3 is our off-shore fund. If it were up to me, I would have only one fund but we have to put investors in different buckets to comply with the rules. I concentrate on the numbers on the right of the PIF3 data and those numbers are more than acceptable.

Fund 3 is 12 1/2 years old. It started in February 2000 and it's up about 5 times. $100,000 invested in February 2000 is worth about $500,000 now. It's about double what the best index has done over that period. This data is through the end of July.

In the 1, 3, 5 year and life of the fund, the 1 and 3 year periods were lagging the index. For 5 years and beyond, we are doing better than the index. I prefer to focus on the number on the far right and look at the long term and where we are headed.

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PIF 4 is the fund for qualified investors and it is the newest fund. It is a little over 10 years old. This fund has matched the index and done a little bit better, but not meaningfully better. PIF4 has had a 10 % annualized return. If you look at the last 11 years, a large portion (almost 7 years) of the 11 years is characterized by the financial crisis and subsequent comeback from the financial crisis. Over the long term, I expect the fund to do better.

For PIF4, $100,000 invested in 2003 is worth about $280,000 and the best indices' performance is about the same. The fund trailed the indices in the 1 and 3 year comparison, but performed slightly better in the 5 year comparison.

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With Dhandho Holdings in the mix, we have, as of June 30th, about $840 million under management - $150 million in Dhandho and $690 in Pabrai Funds - plenty of assets to manage.

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There isn't a whole lot to report for an update on the last couple of months, but if you look at the July 1 to August 31st period, we're up about 1.2 % but year to date we are behind the indices. The funds are up about 3% and the indices are up significantly above. This is ok because I feel very good about the composition of the assets of what we own. I think it is significantly undervalued and, in the long term, we will do fine with the portfolio.

Slide 20

The expense ratios right now are the lowest they have ever been. The frictional cost of investing in the funds in terms of the accounting, administrative, tax prep and audit cost is between 4 and 8 bases points for the funds. It used to be 5 to 10 bases points and has come down because the assets have gone up from appreciation. These expense ratios are the lowest that I am aware of amongst the entire mutual fund and hedge fund industries.

I am very proud that we have a low frictional cost because that is half the battle if you want to beat the market. The second half of the battle is to come up with superior investing. The frictional cost is a big part of the equation that I try to spend time on.

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John Bogle, who has done great work on the long term performance of professional managers and mutual funds, says that it is almost like a law of nature that 80 to 85 percent of active managers will lag the indices after fees. Assuming you had no frictional cost and you had 10,000 mutual and hedge funds as the market, you would end up with half the assets out performing and half the assets under performing. But, that is without cost. If you add the cost in, then you get to 85% underperforming. The market out performance is the exception versus the rule and even when you get to out performance, the 15% is just one in 200 managers which is .05% of all active mangers that will beat the index by more than 3% a year. Significant out performance is truly a rarity and an exception, and we will continue to beat the indices in the long term. I don't know by how much we will beat the indices but, by the nature of what we do, it is likely in the long term to do better. The short term is unpredictable where we end up.

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This is the only slide that comes close to a sales pitch, but there is really no sales pitch because the funds are mostly closed and the US funds haven't been open for quite a while. The off shore fund is open for investors. It's only open because we have one investor who is a large portion of the fund and even though I like them, I would prefer that they were a smaller portion. We have kept PIF3 open so that we get a more balanced type of investor base in that fund.

We have no management fees. If you had management fees like a 2 and 20 structure that is typical of the industry, I would collect $14 million a year in fees. For those of you who were paying attention, we went 6 ½ years without collecting fees. I am still healthy and doing fine. So, it is clear that you don't need the fees to survive.

The Pabrai Family is the second largest investor in the funds. Clearly, a large portion of my families economics come from our ownership in the funds versus fees we may collect. Our interests are very much aligned because I care about the return of that capital versus the return on capital.

Our fees are subject to high water marks so we have to deliver at least 6% a year. Investors only pay for performance in terms of one-fourth above that 6%. From the middle of 2007 to 2013, a little over 6 years, we collected no fees. This was fair, because we had a huge draw down and then we came back up. More recently, we have had some fees. In the November 2013 to March 2014 timeframe, we had about $2.5 million in fees.

Finally, we have no leverage. We have no margins. We don't short any stocks. We have no derivatives so it's pretty much vanilla, long only investing. It's a great group of investors for Pabrai Funds - about 400 mostly entrepreneurial first generation wealth families. It is a great group and we have more than enough capital to manage. I am not looking to raise more assets and it's a blissful existence.

We're going to play two commercials for you.

Ad: Fiat 500L Commercial

Ad: Citibank Thank you Card Commercial

We will have two more ads coming towards the end. Another Fiat ad will be shown later, and if you pay attention, you will see that the house is the same and it's also shot in Italy. The car is the same and one of the actors is the same. I love Fiat management for the way they shoot ads because they are not wasting any money on their ads.

Now we will go through postmortem. Normally, I like to talk about investments where we lost money and spend more time on those, as well as talk about investments where we made money. Over the last few years, we've had very few losers. I have already talked about them in the Annual Report, and even amongst the losers, it's been very little in terms of actual dollars lost.

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We had a recent exit where we made money. I will go through and talk a little bit about Chesapeake Energy. We first bought Chesapeake in July of 2012 and we held it for about 2 years. We started with a smaller position and then, later, we built up more so it was a 22 month kind of blended period that we held the position. We invested about $60 million at the time and we cashed out about $96 million. We had a 59% gain over that period - that's including a spin off. It spun out a company in the middle and it ended up at a 29% annualized gain.

Slide 25-27

Chesapeake was a company that was very controversial especially around the time when we made the investment.

There were a lot of headlines around Aubrey McClendon who was the CEO and eventually he was ousted. Buying Chesapeake was very much a cloned idea. As you might know, we don't have any original ideas - everything is cloned. Before I invested in Chesapeake, Carl Icahn already had a representative on the board and he had a significant stock position. Aubrey McClendon is the founder and he was the CEO at the time. He had always leveraged his Chesapeake holdings so he could own more stock and have high returns. Whatever shares he held in his brokerage account, he had pretty much maxed the amount of leverage which his brokers would allow. He forgot to listen to Warren Buffett and Charles Munger who say that any number multiplied by zero is a zero.

Chesapeake stock took a big tumble and Aubrey got a bunch of margin calls and his entire position got sold. He was left with virtually no position in Chesapeake. Since he controlled the board and all his buddies were on the board, they came up with a new package for him which was quite egregious. There was a very significant amount of compensation, in the hundreds of millions. There was a big uproar in the press and then Carl Icahn took a position and came on the board through a representative. We had another entity, Longleaf Partners, which already had a position and they also agitated for change. They got a board seat and they appointed Louis

Simpson to the board. Louis Simpson had worked for Warren Buffet. He ran Geico's investment portfolio for more than 20 years. He is a great investor and a wonderful person to have on the board. All of these things had taken place before we had invested. When I looked at the business and looked at the economics of the business, I was pretty confident that the nature of the new board would not take any nonsense, and, in fact, they would systematically proceed to clean up things - which they did. If you leave aside the theatrics with Aubrey, at the core, Chesapeake was a great company.

Fracking is a game changer. The US oil production is currently at a multi decade high and Chesapeake was a very unusual company relative to other oil and gas companies. Aubrey came from the background of being in the oil industry - they call him a land man. He wasn't a geologist. He was a guy who the oil companies would hire to go and speak to farmers and land owners and acquire the mineral rights to the land.

When he built Chesapeake, he made it land man centric. Even if you look at major oil companies like Exxon or Shell, the large companies, at any given time, might have 30 or 50 people on their payroll who are land men. Aubrey, at a much smaller company, had over a thousand land men. It was huge. It was a factor of 20 or 30 times what the rest of the industry did, and they were very driven and focused. He had tremendous geology talent in the company and could discover and identify great rock, usually a few weeks or sometimes a few months ahead of the rest the industries. When the shales started to get discovered in the US which had a huge amount of hydrocarbons, Chesapeake was usually a few weeks or a few months ahead of the rest of the pack.

He used to unleash his 1000 man army into the different shale regions in the US, like the Marcellus shale or the Haynesville shale. They would go very aggressively and take up the mineral rights at very low prices - usually a few hundred dollars an acre. A few weeks or few months after that, the price would be 5 times, 10 times, 20 times what Chesapeake had paid. There were very few acquisitions that Chesapeake did that turned out to be duds, but Michigan was an area where they went in and that eventually didn't pan out. Almost everything they did in terms of acquiring great rock, they were right on. At this point in the US, the land rush is almost finished because it's pretty much picked over.

Chesapeake had very significant and very promising land holdings in these different shales. The issue the industry had at the time was that any time you signed a contract with the farmer, there were a lot of state and federal laws that dictated so you couldn't take advantage of land owners. One of those rules was this concept of "held by production". Once they signed the contract, they were under an obligation in a few years to do some minimal drilling on the land to retain title. If they didn't do that drilling, they would lose the mineral rights they had. It was kind of use it or lose it type of deal. The entire industry was under this "held by production" economic, and in the US, everybody went and acquired land for this fracking mechanism. They all had to drill whether the economic supported it or not, just to keep the leases that they had signed. With all that production, you ended up with gas prices collapsing. They collapsed to the point that you could barely cover production cost. They went down to less than $2 per thousand cubic feet (Mcf).

All of these things were playing out - you had Aubrey with his margin loan escapades, and you had this "held by production" thing going on which had temporarily depressed gas prices. Historically, there has been a ratio between the energy content between oil and gas which was always a constant. If you looked at a price of gas by Mcf, usually it was a 6-1 ratio for the price of oil. If oil is at $90 a barrel, gas should be at $15 a Mcf. That was normally the ratio, but when you had so much production coming in to the US, that ratio went out of whack. Gas went down to $2 or less per Mcf and oil stayed close to $100. If you looked at gas prices globally, for example, you looked at gas delivered as liquid petroleum gas to Japan, it was at $15 per Mcf. The ratio was maintained and because gas is difficult to transport - gas coming out from North Dakota is not at all easy to get to Japan because of infrastructure issues. These issues are being addressed, but it will take a few years to fully address them. So there is this differential in the globe of gas prices not being uniform.

We saw this happen a little bit in oil where West Texas Intermediate went to a discount versus Brent when we had a lot of production in the US which again had pipeline issues, but those are all temporary. We generally don't see the same thing in oil because oil is a lot easier to transport. All of these things were basically temporary, the "held by production" was a temporary thing because that was going to abate eventually. The board coming in to Chesapeake was also going to make changes, which they did. They pretty much clipped Aubrey's feathers and, eventually, he was ousted. He either didn't want to work under those circumstances or they let him go. They brought in a new CEO from Anadarko who was an executer. He didn't have the skills to acquire land the way Aubrey did, but that's not what the company needed at that time because that phase of the company was over.

We held the position for about 2 years, and had a nice gain. I exited because I was short of cash, and had another idea I wanted to make an investment in. I also noticed that even after the new CEO came in and even after he instilled a lot of discipline, they weren't producing a whole lot of cash. Even though gas prices have gone up a little bit and we got north of $4 per Mcf, they were spending about $5-6 billion in a year in CapEx to drill their different positions and they were getting about $5 or $6 billion. The cash flow was almost zero and I like to count the cash. My sense was that we got a nice gain, and there were other things we wanted to invest in. I decided we would exit the position.

Slide 28 - 29

The next couple of slides are a snapshot of positions we held in the past. None of these are present positions. We have gone all over the map in terms of what we have invested in. There isn't any strategic plan in Pabrai Funds that we have to have certain amounts in the US or outside of the US or in certain market caps. I look at things that make sense, that I can understand, that are undervalued, and then we make investments based on that. You see a wide range of different investments we have made over the years.

Slide 30

I'd like to recognize some of the folks that we work with. Sam Schlessinger from Dentons, our law firm, is here. We also work with Dentons with Dhandho Holdings. Michael Liccar does our administration, accounting and tax and PriceWaterhouse does the audits. We have UBS that custodies our assets. We have a few folks here from UBS. There is Ajay Desai and a few members of his team. Conyers Dill & Pearman is our law firm in the British Virgin Islands. Focus One is a consulting firm we use for SEC compliance. We are now registered with the SEC so we have additional layers of rules on placed us, including a number of things that came out in the Dodd Frank Act. We work with Focus One to make sure that we are on the right side. And, then, we have a new custodian in India, Kotak Mahindra Bank. We recently started to make some investments into India and we use Kotak for our brokerage and custody. They are a new player and we are happy with them.

Slide 31

This is the Pabrai team - all California based. From left to right, we have Lynn, Nickii, Julie, Betsy and the newest person on our team, Karen, who just joined us.

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I will go through an update on Dhandho. We have had a little less than a year of history with Dhandho. We founded the business in the fourth quarter of 2013. We raised $152 million in the first and second quarter of 2014. We reached an agreement to acquire Stonetrust Insurance. Tim Dietrich is here and he is the CEO of Stonetrust. Tim and his team are in Baton Rouge, Louisiana. Originally, we started working with Stonetrust by managing some of their float. I then had conversations with Tim and that lead to looking at the acquisition. We couldn't do that within Pabrai Funds, so we set up Dhandho.

We will also be infusing another $30 million into Stonetrust after we close the acquisition, which we hope is in the next few weeks. That will help them get a higher A.M. Best rating which should help the business, but the business is already doing very well. Everyone at Stonetrust sees the acquisition as a positive because it improves the prospects of the company long term, and it frees them up to pursue their vision. The only change we are making to Stonetrust is that I will take over managing the investment portfolio. The only change they see on their operation side is a freer hand to be even more disciplined on the way they run the business with underwriting. Overall it's a good win-win for everyone.

Slide 34

Stonetrust specializes in worker's comp insurance and they are based in Louisiana. They operate in 5 states. They just got licensed in a 6th state and they have ambitions to go into additional states. They are very focused and very good at what they do.

Slide 35

I set up Dhandho because Pabrai Funds can never acquire private businesses because of the way it is structured. Dhandho can acquire private companies. It can also make investments in stocks. It could make real estate investments. It's a more flexible platform. I had originally thought that we would buy private companies in a variety of different industries.

My thinking has evolved over the last few months as I understood more about the property casualty insurance business and the opportunities there are. The US has about $550 billion a year in PNC premiums. It is split amongst 3,000 property casualty companies and it's widely spread out. What was surprising to me is that, once you take out companies like Markel and Berkshire, the overwhelming majority really don't do a good job on the investment side. Even if they are good on the insurance side, which many of them are, they are really not good on the investment side. The insurance business is strange, because the two skill sets that you need to run a great insurance company are so different from each other.

The skills you need to run a great insurance operation have nothing do with running a great investment operation. You ideally need to have the two split. Not only do you need to have the two split on the investment side, you need to take a very non institutional approach. Buffet did this with Geico where he bet it all on one person. He hired Lou Simpson and he gave Lou Simpson carte blanche to manage Geico's portfolio as he saw fit. That type of a blanket handover in a non-institutional format is difficult and most insurance companies would not be able to get comfortable with it. They wouldn't have the skills to identify the person and, clearly, if you make the wrong choice, it has a very serious negative impact.

When I studied the P&C insurance business in more detail, I found that, even in the year 2014, it was surprising to me how much opportunity there is in the industry to improve results, especially on the investment side. I looked at many companies where the entire portfolio is sitting in T bills because they have no idea of what to do with it. We will focus on insurance and looking at private businesses, I am excited about this.

Once we close the Stonetrust acquisition, we will start working towards the public offering. We need the vehicle Dhandho to have permanent capital. The reason we need Dhandho to have permanent capital is because we have no desire to ever sell a business like Stonetrust. We would like to own it forever. We need the capital to be permanent and the way to make it permanent is to do a public offering. I hope all the shareholders who have invested in Dhandho hold on to their shares for a long time. If they don't want to, then they can use the public markets to reduce their stake as they see fit.

Ideally I would like a mix between wholly owned businesses as well as an investment portfolio. If we raise about another $100 or $150 million in the public offering, Dhandho would have ended up raising $250 to $300 million total. I would like to keep about $100 million at the holding company because that gives us some fire power in case some of the subsidiaries need capital. The rest of it, we would like to use to buy other high quality insurance operations.

Slide 36

Dhandho is going to be domiciled in Puerto Rico. We already have an office in San Juan, Puerto Rico. Puerto Rico has yet to hit bottom. The economy has been falling and, maybe this year or next year, it will hit bottom. It is very much part of the US, which is important to me. I am not interested in having Dhandho based outside the US. Puerto Rico is not a US state, it's a US territory.

In 2012, they passed Act 20, which gives very strong incentives for a business like Dhandho to be based in San Juan. It doesn't affect a company like Stonetrust that's based in Louisiana. Stonetrust pays US income taxes, and pays Louisiana state tax and it is going to continue doing that. At the holding company level, when we have the $100 million portfolio, the corporate tax on that will go down to 4%. When we buy and sell stocks at the holding company level, it would function like an IRA. We would not be paying 40+% corporate taxes. It makes it hard to run an investment portfolio with two levels of taxation so there is a strong incentive to not do that. That incentive lasts for 20 years and then there is another 10 year extension. That's quite a period.

Puerto Rico has very well educated, bilingual work force. In my visits there, I never encountered anyone who didn't speak English. Once we have Dhandho public, you will, unfortunately, have to come to San Juan for the annual meeting. And, unfortunately, you get a tax write off when you come there. So I hope you guys show up for our meeting in San Juan.

We are likely to have a small staff. We have one person on board, Fahad Missmar, our EVP of Finance. We have an offer out to another person and, hopefully, she is coming on board in a few weeks. We will never have more than a handful of people, because Dhandho doesn't have a whole lot of operations. Its operations are in the people underneath.

We will have the last two commercials and like I said pay attention in the Fiat commercial to the actor and the car and the house.

Ad: Chevy Silverado

Ad: Fiat 500L Commercial

Q&A

Q: I would like to know what, if any, type of analysis you made in connection with Chesapeake and the natural gas export terminals that are going to be coming online?

A: There is quite a bit of activity with the export terminals. We haven't seen a whole lot in terms of finished projects yet. In the next few years, that will change. One of the big drivers behind the investment in Chesapeake is that historically there has been a 6:1 ratio of pricing in energy equivalent gas versus oil. If you are at $4 in Mcf, you should be at about $24 a barrel for oil. If oil is at $100, then you should be at about $15-$17 in Mcf for natural gas. Today we have a wide distortion, at least in the United States where you have $3-$4 price for gas and you have about a $100 price for oil. The 6:1 ratio is not there.

Eventually, over time, it will converge, but if you go to a place like Japan, liquid natural gas coming into Japan is priced at about $15. When you get to places that are importing liquefied natural gas, that 6:1 ratio is very much intact. In the United States, you have a situation where there is what they call stranded natural gas. In many of the fields, they are burning off the gas and flaring it off, because they have no easy way to transport it. Natural gas has one of those difficulties where it is not as easy to transport as oil. But those are engineering problems that are being worked on. The U.S also had a lot of lobbying against exporting liquefied natural gas. Because the chemical companies want to have that low price, they have strong lobbies trying to get Congress not to allow it. The whole process of taking gas coming from a well, the process of converting and liquefying it, and then transporting it across oceans is not cheap. Part of that differential is because that conversion and transportation cost is significant. Even when you factor that in, natural gas prices ought to be higher if you had free flow. We don't have free flow today, especially going out of the U.S.

The second issue is that the infrastructure, even within the U.S., is stretched. Trying to get the natural gas to Cushing, Oklahoma, and places where it didn't get disseminated out is also not easy because suddenly you have production in places where the infrastructure doesn't exist. When I was investing in Chesapeake, I took a 5 or 10 year view at the time. I liked the fact that we had this differential and I liked the fact that these were engineering problems that were being worked on. We had tail winds if those things materialized and came about. In the period that we held the stock, there wasn't that much movement towards that long term Utopian state but we still made out. In the long run, natural gas will do better than where it is at today. Especially in our view, overlay all the issues Europe has with Russia and getting Russian energy is another dimension that has been added. That actually puts more pressure on the U.S government to allow more free flow of energy outside the U.S. It helps our foreign policy.

Q: I am wondering whether you are investing part of the Dhandho Holdings $150 million in public companies while you are waiting for the private companies to show up. If yes, great. If no, why?

A: We set up Dhandho with elements of the way SPACs (Special Purpose Acquisition Companies) raise money. There are these companies that go public. Special purpose acquisition companies are called blank check companies. People invest in the companies but they don't know where the money will get invested, and what assets they would buy. Usually when SPACs are set up, they have a sunset. They'll say, for example, if in two years we don't do a deal, we will return your money. At Dhandho, we took the same approach. We said that we had this first acquisition in mind and, if we weren't able to close the acquisition or a significant acquisition within 2 years, we will return the funds to the shareholder.

Due to that restriction, Dhandho cannot invest in anything until our first transaction is completed. I don't like that situation but it makes sense, because we didn't want to have a bunch of different tiny investments then have the possibility of a decline in the markets without having our first acquisition done. This would create a situation where investor funds are not what they were. As a fiduciary custodian of the assets, we do have frictional costs we are incurring in terms of the acquisition, but it's a small portion of the pie. After we close the first acquisition, we can do other different types of acquisitions. There will be lower returns on your Dhandho investment for the first couple of years because we have these restrictions. After the first couple of years, once we have a public vehicle, we have the first couple of acquisitions, and we have the ship rolling along then we should be back on track.

Q: Whether a stock pays a dividend or not - how does that enter your analysis?

A: It's not a very meaningful portion of what I am looking at. What we are really looking at is owner and look-thru earnings. It's sometimes interesting if we have a very high dividend yield. That can sometimes distort investor prospective. I look at the whole picture. What is the company? At what price can I buy the entire business? What types of earnings can it generate? Are they issuing dividends or is there an inefficiency because we have the dual tax? I prefer that they are doing buybacks over dividends. I look more favorably if a company is doing significant buybacks. That actually adds something to the equation for me. The dividends particularly are not of interest. It is of some interest if that company has absolutely no place to put the money and we can look at that, but it's not a big part of the equation.

Q: You talked about the regulatory requirements for what you can and cannot invest in, if you are in the insurance company. Could talk a bit more on how much has to be in fixed income and how much can you put in stock when it is for the float?

A: Insurance in the United States is regulated at the state level. It depends on the state in which the company is domiciled. Each state has its own statutes on what is allowed and not allowed. Some states have very extensive statutes and others are minimal. In general, a good rule of thumb for most states that I have looked at, is to look at the ones where there are deals. The

general way the states approach it is they split the total assets of the insurance company into two buckets, surplus and float. The surplus is the book value of the capital and in general is open to be invested in equities in most states. Float is much more restricted and typically limited to high grade fixed income. That is typically how most states divide it up. In general, that makes sense because a lot of insurance companies have an obligation going out fairly deep into the future. Their perspective is don't play around with other people's money, but you can play around with your own money. That is the general split. Then, within that split, depending on the state, they will put further restrictions on the number of stocks you need to have on the equity side or the fixed income side, how much can be in munis versus treasuries versus corporate bonds and that sort of thing.

Q: In the past, I have heard you talk about India international investments as being something you really did not want to do, principally because of a lack of transparency and corruption and other issues. I just heard you mention that you have apparently taken some positions in India. Can you talk a little about what has caused you to change your mind about buying stocks internationally?

A: We have not had issues with making international investments. We have had lots of investments in companies outside the U.S. throughout the history of the funds. There are some geographies that I get very concerned about. I don't think we would ever do anything in Russia or Zimbabwe. There are a few places that I am not willing to go. The Indian market has lots and lots of public companies. Probably a similar number of public companies as in the U.S. A large number of those are very small, but they typically tend to be family controlled. Lots of Indian public companies will have majority control by the promoter family and lots of those companies have governance issues. That is more like private equity or even venture investing. You really have to understand the players and spend time with them, which is very difficult to do if you are not in India or not there full-time. Those are typically reasons why, in the past, I have not had much interest in making investments in India, simply because we are not set up to do that level of analysis, intelligence, and so on.

Our investments in India are difficult to talk about because I don't like to talk about investments we have made. We don't have much and I think we own four stocks in India. None of them are of that flavor of family control, so none of them have a promoter family that has control. One of them that was reported publicly is a company called South Indian Bank. South Indian Bank is a private bank in India and they are dominant in one of the states, Kerala, and they have branches throughout. Unlike the United States, in India, it is extremely hard to start a de novo bank. To get a license to start a bank is almost non-existent. In the last 10 years, they may have issued two banking licenses versus in the U.S., we have 1,000 banks. For example, in India the total number of banking licenses issued are well under 100 with it closer to 60 or so. There are elements of a kind of controlled market and you have a situation where 60% of the country still does not have a bank account. Our investments in India are a little bit different than what would be the normal amongst the 5,000 or so public companies. I can talk more about it once we have some exits, which hopefully will not happen for a while.

Q: You have had lunch with Warren Buffett on one or two occasions because you paid the money to win the prize or whatever. I wonder, what did you ask him and what did he say?

A: I have only had lunch with Warren once since the price tags are high for each lunch. Charlie Munger has been easier because he does not charge for lunch or dinner. That has been wonderful. My family and Guy Spier and his wife were with me and we were with Warren for about three hours. He actually told us that there was no time limit to the lunch and that he was pretty much free for as long as we were free. I had exit interviewed everyone after the lunch and I made notes which I have never made public. We discussed 54 different questions or topics over that three hour period. One question asked was, "If you could have lunch with anyone in history, who would you choose to have lunch with"? His answer to that question was he would like to have lunch with Isaac Newton. His reasoning was that he believed that Newton was the smartest human who ever lived. Then he went on to say that Ben Franklin was probably the wisest, but Newton was the smartest. He said if you ask Charlie the same question, he would probably say he wants to have lunch with Ben Franklin. Then he said scratch that answer out. I want to have lunch with Sophia Loren. We covered a number of different topics and questions across a wide spectrum. Some related to investing and some related to life. There is so much in the public domain about Buffett and Munger.

The lunch highlighted for me what was truly important. It was front and center in the way Warren Buffett thinks and one of the things that was very clear was the concept of inner score card versus an outer score card is very central to Buffett. It was one of the most important principles by which he lives. He said, "Would you like to be the greatest lover in the world, but known as the worst?" or "The worst lover in the world, but known as the greatest?" He said that if you know how to answer that question then you know you are all set. For Warren, the way he measures himself is completely driven by an inner score card. He, in many measures, does not care what the world thinks or how the world would react to certain events. He pretty much marches to his own drum and you can see that in his life. For example, at the time he had his wife and, very publicly, he also had a mistress. It really did not matter to him what anyone thought about it, because to him that arrangement made sense. I think one time when someone questioned him about it, he was somewhat irritated with the question. He said there are three people affected by that arrangement and none of them have a problem with it. That is his way of looking at things.

The inner score card versus the outer score card is something that both Guy and I and our families took home from that lunch. In fact, we tried, as much as we could, to bring it into our lives because it is very powerful construct by which to live. If you free yourself from always thinking about how the world will look at things and focus more on how you measure the actions that you are taking, you will be much more successful.

Q: Along the lines of Warren Buffett, he also said his two best investments were his marriage licenses. When Susan passed away, he had her best friend, which he was essentially dating at the time, to comfort him. First question is related to Guy - maybe you can't answer this question because it is a current investment - but, he made a presentation a few days ago at the VIC on Posco, which you have presented on in the past and it looks like you hold it now. That is my first

question, any comments you want to make on that? The re-entering? I know you have said several times you do re-enter positions over time and it looks like you have done it again.

A: I don't have a whole lot to say about Posco because we own it. If you go back quite a ways, probably five or six decades, Nippon Steel in Japan was probably the very best steel maker on the planet. They had processes for making steel. If you think of the steel business, you think of a conversion from a raw material to a finished product. That conversion process could be thought of as a commodity. The engineering and chemistry is well known. In most different operations, it would be hard to get a competitive advantage, but Nippon Steel had an advantage with its processes. When Korea was completely under developed as a country, there was a collaboration with the Japanese. Nippon Steel came in, and basically tried to help them develop. In Korea, at that time, there was a very clear sense that they had to have significant expertise in steel making if they were going to build an industrialized society. It was one of the first times ever, in the history of the world, that you had a country get into the steel making business with absolutely no raw materials in the sense that none of the iron ore is native to Korea and none of the materials or coking coal or other things that you need is native to Korea.

What happened is that we had this major revolution in seaborne transport that had taken place. Seaborne transport now is extremely cheap and very reliable. Korea was able to bypass the fact that they did not have home controlled raw materials. They could bring in raw materials from anywhere at a very small add on cost to the cost of the material at that port. They started with the help from Nippon but then, eventually, Posco developed processes. In the case of Posco, when they convert, they have a meaningful advantage over the rest of the industry. If you study all the major steelmakers, Mittal and all the others and look at what happens to their profitability over the cycle, Posco has never lost money, whereas every other steel maker lost money when the cycle is down. Posco's profits go down, but they never lost money.

They never lost money because they had an advantage in the conversion. They got an advantage when the government helped them set up those ports and that infrastructure, plus you have other intangibles with the Korean culture and workforce. We can talk more about Posco in a few years. I found it fascinating when I studied it earlier. But, once again, if you go back and study just the origins of Nippon Steel and the origins of Posco in the 50s and 60s and 70s and then the whole steel industry, it is an amazing study

Q: Second question, David Iben of Kopernik Investors has mentioned this and you mentioned this before about Russia. There are obviously some deep bargains and I think Buffett has said that he actually would be looking at Russia. There are many issues in the Russian situation such as gas problems, low earnings, market share, etc. so I wanted to get what your thoughts overall on the Russian situation and are you looking for opportunities there?

A: The valuations are extremely compelling, but I have a lot of discomfort with trusting the system and the people. There are 100 different ways to make money. You don't need to make it every which way. I don't like to go into areas where there is that type of discomfort. We can do quite well without ever going there. We are almost certainly missing out on opportunities, but

that's never bothered me in the past. In many ways, Russia is outside my circle of competence and I am not able to handicap some of those factors, so I just leave it alone.

Q: Tell me about how your process has changed over the past decade - your selection and determination process for investments.

A: The most significant change that may have happened over the last decade would be two things:

1) I learned that it is better to be a cloner than to come up with my own ideas. I tend to do better when other people have already done some work and then I pick off that list. So long live cloning.

2) The second is that, in the last 10 years, we have had the addition of the pre-investment checklist and that is one of those things that carries a lot of weight without a lot of baggage. When we look at investments and we run checklists, it does not take that much time because the checklist is already there. It highlights things and, many times, it stops us from doing things. For example, we have a question on the checklist - is the company based in Russia in big bold letters and/or Zimbabwe and then we take a pass on those.

Those are the two major changes that I can think of. The good thing with the investment business is, unlike playing sports or basketball, all knowledge is cumulative and any investor is going to get better over time because of experience and having seen and studied more things. You just understand more things over time. The fact that we had invested in Posco earlier, the second time I am looking at it makes it that much faster. The fact that I made oil and gas investments earlier, when we look at Chesapeake, it makes it faster. The knowledge builds, it is cumulative and they interplay with other things. What makes it so much fun is the ability to keep adding to your knowledge base and understanding how the world works. It makes it go a little bit easier each time you look at things.

Q: I understand, after the financial crisis, you decided to do away with the 10 by 10 sizing and you have a new approach to the positioning. Could you tell us a little bit about how you do it now and why do you believe that the new approach is safer now in terms of a downturn?

A: In the financial crisis, we had very significant draw downs. The funds were down 65% from top to bottom. Thankfully, we are back up to previous highs and it did not take that much time. In that shell shocked phase, when we significantly underperformed the market, we took zeros. At some positions, we took almost a complete loss of 90% and, when we run a concentrated portfolio, it seriously hurts. I was looking for answers of what is wrong with our process and what needs to change or should change. This was coupled with a period where we were swimming in opportunities in late 2008, early 2009. You could throw darts at anything and you would have a 3X in a few years.

There were lots and lots of opportunities to invest and so I moved from being concentrated to being less concentrated. My thinking was when we take a zero on 2% versus a zero on 10%, it hurts less. We can find so many 2%s so why do we even need to go to 10%. That was true in Q1 of 2009. I could build a 50 stock portfolio that would do extremely well with those prices. That is not the case in most of the investing times over the lifetime that I will be investing. As I looked back on the decision to go from concentrated to not so concentrated, I could not justify, from an intellectual perspective, that having strong underpinnings. It was just a point in time that I was shell shocked and there were a lot of opportunities.

We need to move the pendulum back more towards where it makes sense and when we take bets, we want to be more careful. We are still going to have losers. The checklist came in and we got a reinforcement on cloning. Even though it is a short period so far, it has worked out fairly well. Pabrai Funds will typically run when we make a bet of 10% of assets.

For example, when I run assets for my foundation, Dakshana Foundation, I am very willing to put everything in one stock. We do not make any investments with donations made by other people because they are expecting their funds to sit in either fixed income or money market and we leave that alone. It is only the money that my family contributes. This idea comes straight from Charlie. If you are running a non-profit, you should take a high risk approach with your giving, so you have a chance to truly change the trajectory of the world. You should take a concentrated approach to your investing so, again, you have the chance of having the most resources to do the most good. Charlie's perspective is that if you get an outcome which is a zero, in the giving you could end up with a zero. You may end up with a zero in investing, but you may end up with a zero in the giving. His perspective is, in a charitable foundation, what you are best off doing is extreme concentration if you have high conviction on the investing and extreme concentration on the giving - both.

We do not apply that in Pabrai Funds. Of course, when we go into the insurance company, we are not going to be able to run even a 10 by 10 portfolio. Typically, most states will want to see 20-25 stocks in the equity portfolio so it will be run differently. The different buckets I have are run differently. When I manage money that my kids have, they typically do not have more than 4 stocks because, again, we are willing to live with the consequences and it is not terminal if we have a problem. That is my take on concentration. Pabrai Funds will stick to its 8 or 10 stocks making up 70 or 80% assets and the others will be the lower concentration or greater concentrations depending on the nuance with that asset.

Q: What publications or books would you recommend for getting to understand the insurance industry better and what do you think that your long term cost of float will end up being?

A: The long term cost of float means of the company we are buying?

Q: Yes.

A: I am hoping that we will do better over the next 10 to 15 years and will end up with a 95% or better combined ratio. We may do better than that or we may be below 90%, but if we end up with 95%, I am quite happy with that.

In terms of learning the insurance business, the one book that is good is called The Davis Dynasty. Chris Davis and his family have been in the insurance business for many decades. Certainly, the Berkshire reports are excellent. Specifically, if you looked at Larry Cunningham's book where he has rearranged the letters of Warren Buffett by topic, you can go directly into the insurance topic. That is a good way to look at it.

The 2004 Annual Report of Berkshire Hathaway is a fantastic guide. That should be read by every insurance company, underwriter and CEO. I asked Tim to give it to all the employees at Stonetrust. Buffet has a very good 5 page write up in that report on the anatomy of a great insurance company.

There were a couple of books that came out on AIG and Greenberg, and those would also be good ones to look at. Beyond that, you can study the Markel, Fairfax and Berkshires of the world and their annual reports and their filings. Those are good resources.

The good news in the industry is that, because of all the regulations, every insurance company, no matter how small, has to do these quarterly and annual yellow book filings. These filings are public and you can learn a lot about a company by going through those filings. They are like the SEC filings and have a standard format. You can go through it pretty quickly. There is a paid insurance industry database called SNL which is a subscription database that has a lot of data on insurance companies. We can quickly look at 10 year or 20 year combined ratios and different metrics. Those are some of the resources I would suggest on the insurance side.

Q: Buffet, Munger and you talk a lot about staying within your circle of competence when investing. You talk a lot about cloning (long live cloning). To what extent do you go closer to your edge of the circle of competence when there is a strong cloning factor in effect, sort of piggybacking off other value investors you respect, piggybacking off their circle of competence?

A: Warren Buffett says, the size of your circle of competence is really not relevant but knowing its edges is paramount. I try to ask that question many times when I am looking at a business. Am I within or outside the circle and, if I am within, am I getting to the edge or towards the center? I try to answer it as honestly as I can.

I usually have conversations with one other investor and a lot of the discussion is about whether we truly understand the two or three main factors that drive the business. It is a struggle and I always try to use a no brainer test where I should be able to write down within a paragraph exactly why a particular investment will work out and what are the factors that will drive the result. I write that paragraph and keep it. If I cannot articulate in that type of a format, then I leave it alone. The key thing for investors is to make sure you are operating within your circle. There is no easy answer and you just have to keep asking yourself the question repeatedly, till you get to the point where you are comfortable with the answer.

Q: I was wondering if you could touch back on a question that was brought up earlier regarding Dhandho and the regulatory environment around the surplus versus float and how that asset allocation can work and, specifically, if the $30 million dollar infusion into Stonetrust is then considered as surplus which then you could manage?

A: Yes, that is surplus.

Q: And that would be manageable prior to the IPO, is that correct? So as soon as ownership happens?

A: Yes, the $30 million is going into capital and it is surplus. The regulators want us to start managing the investment portfolio the way we want to. They do not want us to put it on hold because it is a critical piece. I have told them that my starting point is going to be to sell almost everything in the portfolio and start over. I do not want to manage things that I had no hand in buying. We will probably be more sensitive on the fixed income side. Louisiana has some tax incentives for investments that are domiciled in Louisiana. We have some fixed income investments which are in the state of Louisiana and I am more inclined to leave those alone. Things that are outside of the state, equities or otherwise, we would start over.

Q: Regarding the tax applicability, is that the Puerto Rican base or is it taxed?

A: Stonetrust will be taxed in Louisiana the way that it has always been taxed. There is no change in that front.

Q: One final question, regarding Dhandho and its IPO. I was wondering if you could comment on the potential natural conflict that occurs given that Pabrai Funds will be purchasing some of the IPO. Whether you would like to see high amount of capital raise? Whether you will wait until the price declines some? How do you plan to manage that?

A: I would like Pabrai Funds to have a stake in Dhandho. That would be desirable. Pabrai Funds will make an independent decision on whether it makes sense or not, depending on price. If things are euphoric, that means that there is a lot of demand and pricing is probably above where Pabrai Funds would be interested so we probably would not do anything. If things are not so euphoric, then we would have more interest. It depends on where the cards end up. I am wearing multiple hats, but when I look at what Pabrai Funds invests in, I am obviously only focused on what is in the best interest of Pabrai Funds.

In any case, with Dhandho, I prefer that the stock not trade at the highest possible level that it could. I prefer it to trade close to its underlying intrinsic value so that whoever is entering or exiting can enter at a fair price and they are exiting at fair price. If they held the stock for some period of time, their returns would match the growth in the intrinsic value over that time. I do not have direct control over that, but to the extent that I can signal and help drive that, I would try to do that.

Q: If a person at my age is thinking of becoming an investor, what are the main things I need to do to prepare for that?

A: How old are you?

Q: 12

A: Well I was 2 ½ times your age when I got to that question, so you have a very solid head start. You are here at the meeting and it is a good place for you to hangout. Are you having a good time? Have you been to Omaha or planning to go to Omaha next year? Make sure your dad takes you to Omaha. I would say that you are on the right path. Do you have a brokerage account and how much is in that account? Alright, $30k and how is it invested?

Q: Well, there are five stocks and my dad does it for me.

A: What are the five stocks?

Q: There is Fairfax, Berkshire, Wells Fargo and Bank of America.

A: That's 4 stocks. Do you want to have more stocks or just 4 is enough? Do you know about the companies?

Q: Not too much cause my dad just does it, but he is informing me about it a lot.

A: What about like buying Apple? Do you have an iPhone?

Q: Yes.

A: So why not buy the things that you use? Have you seen the iWatch?

Q: Yes.

A: Do you like the iWatch?

Q: Yes, it's cool.

A: Are you going to get one?

Q: Probably not.

A: What about the iPhone 6?

Q: Probably not.

A: I would say you are so far along. One of the first things that I tell people is that, if you want to learn about investing, then you are to open an account and make real investments because that is when it becomes real. One other suggestion is the stocks that you buy in the future for your portfolio, you make the decision. You can consult with your dad, but you do not need to agree with him even if he tells you that you should not buy it. You can say that is fine, thanks for the advice, but I will make my own decision. First of all make your own decisions in the future. When you buy the stocks, do the work just like you and your dad did before you bought the stock. Try to understand the business and find out what Wells Fargo does or what Bank of America does.

After you understand the business, then have discussions with your dad and others about the economics of the business. How much could you buy the whole business for? How much cash does it produce in earnings? It is the same economics as the lemonade stand. If you put up a lemonade stand and buying everything cost you $25, and at the end of the day, you end up with $60, that is a good business. If you end up with $20, that is not such a good business. Focus on that and then your dad can direct you towards books that may make sense. One book I would suggest is The Little Book That Beats the Market. Have you read that book?

Q: No.

A: It is at home already?

Q: Yes.

A: That is actually a good book and maybe you can start reading it. Joel Greenblatt wrote that book for a person your age so that you could understand it. Start reading the annual reports for Wells Fargo, Bank of America, or Fairfax and, whatever you do not understand, ask questions or go to Google and ask questions. These are the things that will get you off to a significant head start. Warren Buffett said to think as if you were told you could have any car in the world, but the rule was that you could never change that car, and the car you decided to get today would be the car you would have to keep for your whole life and you could not sell it. If that were the case, would you maintain the car if it needed repairs and keep it in good shape because it has to last 100 years?

He says that it is the same thing with your brain - you have one brain and you do not get to replace it and it has to last your whole lifetime. The best thing you can do is to keep feeding it more and more information and synthesizing more information into that brain. The earlier you start doing that, the greater your advantage. If you start at the age of 12, you have a huge advantage, because from 12 to 19 your brain is actually perfectly set up to specialize and that is the period of greatest creativity. By the time you go to college, it's all over. All these other guys never got the chance so they are all useless, but you can really do exceptionally well. Although the kid in front of you might get started earlier. Does he have any stocks?

Q: He was fortunate enough to be born on January 12, 2009. He had 3 stocks at that time and he still does. They are Wells Fargo, Bank of America and USG.

A: Did you collaborate with him?

Q: Oh no. We are shameless cloners.

A: Alright, those are great holdings and thank you for the questions.

Q: Two questions for you. Do you see these two vehicles combining at some stage? The second question might be easy or harder. Stonetrust combined ratio historically. Can you comment on it?

A: Stonetrust combined ratio is public record and you can pull it up. The company has gone through quite a bit of change and growth. This year, for example, they will do about $70 million in premiums. If you went back 5 years, it would be about $20 million and 10 years ago, it was about $10 million, so there was a significant change. Tim Dietrich made a very significant management change in his team around 2010. If you look at it historically, Stonetrust had a very acceptable combined ratio. You will find some years where the ratio is above 100%. Tim is the kind of guy where that truly bothers him in a significant way. He is always looking for two things. First, that he is over reserved. He never wants to be under reserved and wants to strengthen the reserves. The second is to focus on a straight underwriting basis that is already profitable. If you look over the cycle, you see that it has been much more robust over the past years.

There are no such plans to do anything with the two vehicles. I love Pabrai Funds. It does well and it serves a particular purpose. With Dhandho, I am having a lot of fun. There is tremendous learning and a lot of interest there. The asset base is going to end up different from Pabrai Funds. There may be some overlap in the public portfolio, but beyond that it we will end up quite differently. We are going to either own or completely own significant pieces of these relatively small companies that are still quite entrepreneurial and still have quite a bit of room to grow and expand. It is wonderful to have a front row seat with these CEOs. The surprising thing to me is how undermanaged the insurance industry is. Being able to take some of these companies, who will remain separate, and move them a little further along would be fantastic.

Q: With respect to Dhandho, you mentioned there has been some changes in your thinking. First, you were thinking of acquiring companies outside insurance and has that changed? Could you embellish on that a little bit and maybe end with that one paragraph version that you articulate on how and why a Dhandho shareholder value will be built and the intrinsic value will increase?

A: It is very easy to articulate. When you are looking at private acquisitions, the big difference between private acquisitions and public equities is a negotiated transaction versus the non-negotiated transaction. When I buy stocks in the public markets, I am dealing with unintelligent sellers for the most part, or sometimes sellers that are very influenced by psychology on market nuances. For example, in 2009, everything went down dramatically.

If you tried to buy private companies, you would typically be dealing with an intelligent seller, unless they were facing some personal stress or something, and they are unlikely to give you a stellar deal because they understand what the asset is worth. Unless there is something unusual going on, we typically will be paying full price.

First of all, I am especially interested in the private business buys. I am interested in buying only high quality businesses. High quality businesses and high quality people is absolutely a mandate. When you limit yourself to private companies run by exceptional people with great core business attributes, the odds that you can get a phenomenal deal are close to zero and is very unusual. In the equity markets with 5,000 companies, quarterly earnings and all this short-term focus, you can get lots of mispricing in equity markets. You can take advantage of that much less so in private transactions.

The silver bullet that Dhandho can bring into the private markets when we do insurance deals is that we can change the earnings quite significantly. There are so many insurance companies that I look at where the entire portfolio is in treasury bills and they are earning a half percent on it. A year or two after we acquire it, we would redeploy that capital and the cash flow we would generate just from that investment piece, forget the insurance piece, would be different.

The second area where we can add value is we can reinforce to management that they really have no pressure to take in premiums unless they are getting adequately compensated. We can also reinforce to management that we can carry the overhead of running the business for many years, which they may not have had the resources to carry. A lot of insurance companies today get tempted to take money in the door just because it keeps the engine running, even though the premiums are inadequate. For example, my message to Stonetrust has been, you should never write a policy where you are not getting fairly compensated for the risk you are taking. Whereas, sometimes when you have soft markets in insurance, a lot of companies are willing to do that. These are the two things that can add value in an insurance transaction.

If you were to buy a McDonald's franchise, some "N" company that has 10 McDonald's. The odds that we can get a deal or pay anything other than full price are close to zero. The odds that we can add any value or ability to do anything with the business is also close to zero. I don't want to get involved in the management of the business or tell them how to run the business. In the insurance industry, it is beautiful because I am not involved in any way in the operations. I am very deeply involved in the investments. They don't want to manage the investments and they love to give that away. Almost every business we have talked to has absolutely no issues with us taking over the investments. What we tell them on the way the policies ought to be written is music to their ears. It makes the company better to be under Dhandho, than operating on its own, because they have an umbrella which protects them.

There was another thing that was very surprising to me in 2014. I thought that after 50 years of Berkshire shareholder letters, all these insurance companies would have been in the industry reading this and following it. What I found is that none of them followed it.

This is like everything else, humans hate to clone and that's why we are here. It dawned on me that, even in this sphere, there is no cloning going on. They are not cloning Fairfax, Markel or Berkshire. They see those, but they don't touch them. I see this as a wide-open field where we can easily go in and add value. We are also looking at the size level and Berkshire and Fairfax are not interested in the same sizes. I haven't found it competitive so far at the sub $100M level that we are looking at in terms of many people looking at those types of businesses. If you were to look at a person who owns 10 McDonald's, everyone under the sun would be interested in that type of asset.

Q: I am very new to value investing. The question I have is how to read an annual report? Let's say I pick up a company like Google and an annual report is 100 pages long. How should a new investor think about reading an annual report or what is the protocol that I need to use to read the report?

A: If you look at the particular example of Google, their S-1 document that came out before they went public had a phenomenal write-up by Sergey and Larry on what they intended to do and how they intended to do it. A company like Google is a good example because even the founders could not tell you what the revenues, cash flows or earnings would be 5 or 10 years from now. What you need in terms of making investments is to have some assessment of those types of metrics or at least a floor on those types of metrics. What you want to get to in most annual reports is the regulatory requirements. This will give you the history of its audits on the revenues, the cash flows, the assets, the book values and where the business has been in the past. That is quite useful in any investment that you are going to make.

From there, if you believe the business is in your circle of competence, then, by definition, you understand the business and you ought to be able to make some extrapolation of a range of outcomes in the future. If the conservative end of the outcome makes it look attractive in terms of your return expectation, then you can proceed. If not, then move on. The metrics is really what you can get out of the 10Qs and 10Ks and you can get some good discussion on risk factors that are worth reading. Seth Klarman is a great investor who owns a bunch of horses and one of his horses is called Read the Footnotes. I always want to be at the race track when Read the Footnotes is coming in and the announcer going a million miles an hour and saying, Read the Footnotes. So, Read the Footnotes!

This is what I would suggest and the direction you want to take. In the case of Google, Larry and Sergey made an extraordinary effort communicating to their future shareholders what their game plan was and how they thought about the business. Google doesn't shy away from making very long-term bets and they clearly laid that out. They also laid out that they were not focused on quarterly or annual earnings that were not of much relevance. They did want to make sure the company was always soundly financed so they could pursue their long-term goals. They never laid out that they had certain profit goals every year. Other businesses are more precise on that because of the nature of the business.

Q: Our friend, Charlie Munger, always says show me the incentives and I will show you the results. With the acquisition of Stonetrust, how do you set up the incentives of Stonetrust executive management to make sure incentives are aligned appropriately?

A: Our modus operandi is delegation to the point of abdication. I have not looked at the compensation plan that Tim has for everyone under him. He tried to pull me in to work with him on that and I told him I wanted to have nothing to do with it. I do have a general idea of how people are paid, but I told him that it was completely his decision on how he decided to compensate his team, who he wanted on his team, who he wanted to hire, who he wanted to fire. That was all in his domain. I don't know who is paid what.

I care very deeply about how he is paid and how he is compensated. We have a very simple formula for him because I want to make sure that it's very clear to him in 2 seconds exactly how he is compensated. He has a base salary which has not changed from the way it was before the acquisition. It's a reasonable base for a CEO of a company of that size and he gets to keep 10% of underwriting profits. Every year, we have these filings which makes it clear what the underwriting profits are and 1/10th of that goes to Tim. He can do whatever he wants for his team.

One thing to keep in mind about humans is that humans do not work for money. Contrary to popular belief and opinion, humans work for a cause and they work for something they believe in. I feel that people want to make sure they are fairly compensated, but someone like Tim has no reason to come in to work every day. He has more than enough money to never work again in his life. We have no handcuffs on him because I do not want him to come to work because there is a handcuff. I want him to come to work because he wants to come to work. In fact, in any deal, we have no handcuffs and will never do that. I told Tim that my bet is that 20 years from now, he would go mad on the golf course every day and he would want to be in the thick of the action with his business. I expect him to be around for a long time. Our discussion on comp took less than a minute. I proposed it to him, told him this is how we would do it and he said that's fine. We never discussed it again after that.

Q: Could you speak a little bit more on the restrictions of maintaining compliance with that 4% tax rating in Puerto Rico? What do you have to do over time to keep that rate in terms of your operations?

A: The way that works is that the government awards you a decree. It's not automatic that when you start operations, you get 4%. It's meant for companies that go to Puerto Rico for export services. Things that are not for doing business in Puerto Rico but for businesses outside Puerto Rico so they are being attracted to the island genuinely creating economic activity in the island. Once you show the government that you meet that criteria, they issue you a decree. The decree is durable, so it doesn't matter who is in power or which party changes.

It is set up to last for 20 years with a further extension for another 10 years, so it is not forever. We would at least have that deal for 20 years and, probably, we would have it for 30 years. That is how that is set up. I don't think we could run a bunch of McDonald's franchises in San Juan

and get the 4% rate. We are telling them exactly the activities we are going to be doing and they are putting that in the decree so, as long as the activities stay within those domains, we are fine.

For example, let's say, after we sign the decree and get going, we bought a Puerto Rican insurance company. That company would be outside the decree so the operations, cash flows, and earnings would be subject to normal Puerto Rico taxes. It would only be the portion of the business that fits in with what the decree says.

We are telling the government that we have a holding company and the holding company is going to have passive investments. Those passive investments are really there so we could invest those into active companies later, but also to provide resilience to the underlying portfolio company. When we have a company like Stonetrust, I want to make sure the holding company has capital to weather any storms that Stonetrust hits in the future. The focus of the Puerto Rican holding company is to make passive investments and possible active investments from that pool of capital. As long as we do that and the activities are along those lines, we will get the benefit of the 4% tax rate. That is an example of how it works. It's actually a tremendous advantage, especially for money management oriented businesses to relocate. For the type of structure we have, it fits in well and that is why we are looking at that.

Q: Would you be willing to talk about what caused you to exit your investment in Harvest Natural Resources 3-4 years ago?

A: We had a discussion a while back on Harvest, which is mainly an oil company. When I made the investment, their primary asset was a concession they had in the great country of Venezuela. They used to be called Benton Oil and Mr. Benton made a tremendous deal with the government when they were on their knees. They got a tremendous concession with great terms. Throughout the time until I made the investment, Harvest was always paid in US dollars in a US bank account and they had great cash flows.

Two things happened. One is that the Venezuela government unilaterally decided to change the rules because they had a lot of currency problems. It still kept the economics quite attractive, but then the company basically diversified into a number of other fields, most of which ended up being duds and didn't go anywhere. When I looked at the entire investment and the trajectory where this was headed with serious concerns about where Venezuela was going, we had the option of getting out at a gain. Overall, we would have had a much larger gain if we had gotten out earlier so we decided to exit that position. There is a more detailed discussion on Harvest in some of our earlier annual reports that may give you more insights.

Q: I would be curious to hear about the Interactive Brokers decision and what was your thought process when you made that investment and then sold it?

A: Interactive Brokers is a discount broker and a very unusual company run by a Hungarian guy, Thomas Peterffy. He is a genius level guy on technology and he has pushed the envelope quite a bit on the technology front. Interactive Brokers, on a number of fronts, has done a lot better with

the degree of services. In fact, it has pulled the rest of the industry along because it forced them to make changes. For example, they have been ahead of almost anyone else in terms of allowing the individual investor to access a wide range of exchanges on a single platform at low prices. He has also put in a lot of automation. He does control most of the company, even though it's a public company, and my recollection is that he has an overwhelming share of 80%.

When we bought, it wasn't as cheap as I would have liked it and it had taken a little bit of a stumble. It was not a very big position because we couldn't get enough of the stock at the prices we wanted. We held it, but then we had a more compelling opportunity show up and we had a small gain. I compared what we were looking at and what we owned. I don't remember what we replaced it with, but we switched out of it. We had a small gain and that was the end of our adventure with Interactive Brokers. We didn't make a lot of money and it wasn't a large position. I liked the business but I was not excited about the price we were getting. There is always the question about Peterffy and what he will do long term with his stake. We were basically, in effect, going to be tagging along with whatever his decisions he made.

Q: How do you see yourself dividing your time between Pabrai, Dhandho and Stonetrust?

A: The answer on Stonetrust is zero because Tim is running Stonetrust. We will be managing the investment portfolio of Stonetrust and that has a lot of overlap with what we do at Pabrai Funds. The difference is there is a fixed income component and a portion of the assets have to be in US government bonds and municipal bonds. On the equity side, it will be more diversified than what we might do in Pabrai Funds.

I have learned a lot in the last year about the property casualty business. That knowledge has applicability in the public markets when we look at the opportunities. In general, there is interplay between all three in terms of how we do things. I have not found it to be a challenge or a problem to manage all of them so far.

If you look at it from the asset size, we run a $700 million portfolio. Stonetrust will have about $110 million or so in assets, so it will be about $810 million. We will have another $100 million at the parent, so we might be at $700 million to a billion in assets when we have other companies.

As we acquire more insurance companies, this very high degree of commonality that's going to end up in terms of the way the portfolio is structured will be "if you're buying for one, you're buying for all". I don't see the investment management really being that much different than what we are doing today.

On the operations of Dhandho, these are really at the subsidiary level. This is the way that the CEOs and companies run themselves. You can say delegation to the point of abdication. Tim has carte blanche to run the company just like he has been running it in the past and the other CEO's will be the same way. We are there at a board level to support but I told him if he needs my help, we are both in trouble. I think we should be fine and if I felt we were overwhelmed in any way, then I would make changes accordingly.

Q: Since we are talking about Dhandho, is Dhandho open for business as far as buying additional operating companies and if so, what would be the criteria as far as size and type?

A: We have been looking at and we will continue to look at businesses to buy. My preference in general is biased towards property casualty insurance, but I am open to looking at anything. We put our acquisition criteria, which was plagiarized from Berkshire Hathaway, on the Dhandho website.

Basically, we are looking at property casualty companies. We are looking at companies which earn premiums between $10 million and $100 million. There are about 300 property casualty companies in the US in that size range. I have looked at many of them and have had conversations with many of them. If we can do something in that industry and in that range, that is our sweet spot. Any type of acquisition in the $10 to $100 million range, in terms of purchase price, is of interest and we will look at that as well.

Q: When you identify a prospective investment, can you walk us through how you evaluate its intrinsic value using a Discounted Cash Flow (DCF), mental Gordon Growth Method, your gut or something else?

A: For most companies that I look at, I usually stop looking at them within maybe 30 seconds after I start and it's usually for one of two reasons. Either it is outside the circle of competence or the evaluation doesn't instantly jump out as compelling. Those are the two basic reasons why we take a pass relatively quickly.

In general, I haven't run spreadsheets and I find that, if there is a need to run a spreadsheet, that is a red flag to take a pass. Let's say you had a company that had a billion a year in cash flow and the company's cash flows were almost guaranteed to come in. Say, it's a coke bottler and the cash flows are not going to grow but they were going to stay at a billion a year for as long as you could see, maybe 10 years or more. A business like that, if it had no excess capital, is worth $10 billion or 10 times cash flow. The $10 billion number really hasn't changed over the last two decades since I have been doing this. This company would be interesting if it were available for $5 billion or less. If I could find it at 5 times cash flow and the cash flow is stable, that would be interesting.

If you take the same business and say it is growing at 5-10% or more per year, then you can bump up the 10 times cash flow number to maybe get up to 15 times. I don't think I would go much more than 15, or maybe 17. You can look at half of that as the price that we would be willing to pay - 7 or 8 times earnings, growing at 10% a year and pretty stable. That would be of interest. So to that extent, if we do a DCF, that's the DCF we look at.

Q: You have mentioned that Dhandho now has about $150 million, $35 million was used for the Stonetrust acquisition, $30 million more to inject new capital in Stonetrust. What is your thought about the remaining amount? You mentioned that some amount is coming in with the IPO and you are looking for acquisitions. Are you thinking of investing directly in equities as a portion of that or are you only going to be investing the amounts that Tim sends to you for investment?

A: Tim is probably not sending me money for a while and I think the reason he is not sending me money is because he has a great gig going. He is going to be using all that capital to grow. They actually have a great business and, in insurance, it's hard to tell. The best we can tell right now is that they think they can maintain discipline which is underwriting combined ratios in the 90-95% range and they can still grow the business 10-15% a year. As long as he can do that, the very best use we have of the capital he generates is for him to keep it. The ROI on that is phenomenal if you are generating 93% combined ratios.

This year, they will probably end up doing about $70 million in earned premiums. They might do close to $80 million next year. If you take a $70 million number and you take 90 % of that, you are at $63 million. If they end up with $65 or $66 million as the cost of bringing in that $70 million, a large portion of that is not paid out immediately so that turns into float which we get to invest. The economics of that become very compelling especially as they grow. If you run the numbers, they grow for a while and then it's a wonderful business. This is my ideal situation - where the businesses we acquire are like Stonetrust or better. They ask us for capital and they don't send capital back.

If you think about the $150 million we raised and say another $100 or $150 million we might raise in the IPO, we could end up with $250 to $300 million total raised. Ideally, what I would like with that $300 million or $250 million is for about $100 million of that sitting in the holding company invested in a concentrated manner in half a dozen stocks and the rest of it sitting in wholly owned subsidiaries. Ideally, in PNC insurance like Stonetrust. If they need more capital, we are happy to provide it.

If we end up with the decree being granted to us in Puerto Rico, then the gains on the $100 million get taxed at 4%, which is quite attractive. The rest of the 2, 3, or 4 subsidiaries we end up with will just do their thing. When it gets to the point where they are drowning in capital, then we will bring some back. That is how we intend to do it.

Q: *Are you managing the flow for Stonetrust right now. Are you investing the flow?*

A: Not right now because we have not closed on the acquisition. Tim would like us to close before they send us the money and the regulators would really like that. We need to close first. We will give them $65 million and then will get $110 million to manage.

Q: I want to ask you two questions. The first is related to the investment process. When you look at an investment, how much weight do you put on quality versus evaluation? I think the

ideal situation is to have a great business available at attractive prices, but it doesn't make a career because you have to wait maybe 3 or 4 years to make a trade. Some people run the value strategy where they don't think about quality that much. In fact, they think quality is dragging their performance. What are your thoughts on evaluation versus quality?

And my second question is related to your past holdings. When I look at some of your past holdings like POSCO, BYD or Fortescue Metals, it seems like they are not really high quality businesses. When you look at Asia, do you look at it differently from the US and what kind of opportunities are you seeing today in Asia?

A: Charlie Munger might disagree with you about whether BYD and POSCO are high quality. The ideal situation is to make an investment in a great business that is growing and where the capital it generates can fully be redeployed. That is the ideal situation. The ideal situation is Stonetrust Insurance because they are not sending us capital and they can redeploy the capital. Quite frankly, one of the reasons why the insurance business is attractive to me is that you can think of it as a black box. The premiums come in on one end and claims and expenses go out the other end. To the extent that you can make that black box efficient, which is deploy technology, etc., then it can churn really well. If you look at a business like Stonetrust with 68 people, the $65 or $70 million they will do this year is very efficient in terms of what that black box consumes to do all these things. For me, the ideal situation on the public equity side is to invest in businesses which generate high returns on capital. This means they are great businesses and they have the ability to use all the capital that they generate. And to buy those businesses really cheap, which is not easy to do.

If we look at a business like Coke or AmEx, those are good businesses but they are not able to use the capital that they generate. Most of that is excess capital coming out of those businesses. You have to find a place to put it to work or give it back to shareholders. The truly great businesses that can use everything for a long time are rare. In an ideal world, my number one interest is to invest in businesses that are growing, can use their capital and can grow for a long time. If we can't find that, then we go to the second choice, which are the AmExs or the Cokes of the world. They are great businesses, but they don't use the capital. The capital comes back and, hopefully, they have a good capital allocator at the helm. When we can't find those, then we go to all of the above, which are the special situations and mispriced companies.

I disagree with the fact that BYD and POSCO are not great companies. I think they are exceptional companies. Fortescue is a little different. In Australia, tens of millions of years ago, a major meteor came in and created a major iron ore deposit in the Pilbara region. That region is so rich in iron ore that they don't have to mine it. It is surface mining and they can just scoop up the dirt which has a high iron ore content. There is no exploration cost and no real mining. The only Capex you have on that is to get the iron ore which is in the middle of nowhere to a port, which is what Fortescue did so well. They got it to a port and from that port, it goes to China and it leads to civilization and growth in China. If you have a concession that gives you rights to that soil in the Pilbara region and you built the infrastructure to get it to a port, those are the elements of a great business.

You can't do that in China because the meteor did not come in over there. In iron ore mining, you have just a few regions in the world. You have Brazil and Australia, which controls 80% of the seaborne iron ore trade. If you own these low cost mines in those geographies, those are fantastic assets to own. We were able to invest in Fortescue at a time when it was mispriced during the financial crisis. Of course, some of the actions of the manager subsequently made me do a double take. We don't own the position now, but we did well with it.

Q: I have a couple of questions. My first question - can you talk about your sourcing process and how many names are you typically looking at in a given year? I know the hit rate is obviously extremely low, but I am just curious how low that hit rate is?

My second question - if you were to take Business A as being a phenomenal business with a mediocre management team that you felt did not allocate capital well, but they did an OK job and compared it to Business B, which was a good business that you felt had a phenomenal management team and could allocate capital well even if that meant doing so not just on the asset side, but on the liability side and buying back stock and delevering if they needed to or levering up if they wanted to. Which business would you prefer in that situation?

A: The sourcing process is very scientific. We are shameless cloners. There is a guy in Zurich, John Mihaljevic, and he puts out The Manual of Ideas which you can buy for $1,000 a year. John makes it very easy to be a cloner because he puts all these picks of different managers in his book. There is another website called Dataroma, which is free. Dataroma gives you a very quick summary of the activity level of all the well-known value players and I sift through those lists every quarter - Berkshire Hathaway is in there, as well as Louis Simpson and other players. Of course, The Manual of Ideas gives me a broader dataset than Dataroma. We might have some things that pop up from places like the Corner of Berkshire & Fairfax.

We have a few sources along those lines and, once we look at a business that some smart guys already bought into, I look at how large a portion of their portfolio it is. I focus on the ones where they have committed one of their larger positions in the fund and it is one of their top ideas. Then, I see whether it is within the circle of competence and if it's cheap. Most things fail one or the other. Either I can or can't understand it, or I don't think it is in the circle of competence, or it is not cheap. Or more than one of these factors. If it gets through the first few filters, then we drill down and go through the process seeing whether it makes sense or not.

Your second question is difficult to answer in the absence of price. I can answer it in the abstract. If you overlay price on top, then that makes it more useful. Clearly, I would prefer a great business, great manager, one that is able to use all the capital they generate and can keep doing that. Behind that will be a great business, great managers that can use the capital; and then great business, not such great manager, and then we just go down the line. Not such a great business, not such a great manager, but still out to achieve and we will probably still make out. We have made investments in all of those and I learned over time that I am better off being more on the top than at the bottom end. If sometimes you have looked at things with PE's 1 or 2, then we can lower our standards quite a bit if those numbers make sense.

Q: You mentioned that Buffett had hired Louis Simpson for GEICO, so my question is, why did he not do it himself, and would you ever consider hiring somebody else to run money for an operation like that?

A: I am not sure, but at the time Louis Simpson came to GEICO, it may have been majority owned and it was not owned by Berkshire. This was right after Jack Byrne had taken over and GEICO had a lot of problems. Jack Byrne was trying to ride the ship and wanted to run the portfolio himself. Buffett pushed him to hire someone else and he kept resisting and Buffett kept pushing. Finally, Jack Byrne found a guy and wanted Buffett to meet him. Buffett met Louis Simpson and said, he is the guy.

When Louis came in, GEICO was not wholly owned and then when GEICO became wholly owned, Buffett thought of Louis as a succession plan. His perspective was that if something happened to him or if there was a transition at Berkshire, Louis would be the one who could take over the entire Berkshire portfolio.

In my case, we spend a little bit of time thinking about succession, but not a whole lot. The succession issue for Pabrai Funds is really simple, it gets wound down. We have a board that would come in and do a systemic wind down and then return the assets. On the Dhandho side, we have got it set up, if I am dead or mentally disabled, which I hope neither happens soon, that my friend, Guy Spier, would basically come in and take over the reins of the ship.

Again, Dhandho really does not have a whole lot of operations. It has these wholly owned subsidiaries that are mostly on autopilot and it has a portfolio, which should be relatively concentrated. If at some point, we end up with a position in a company and we find someone who could manage that portfolio, we would look at that, but there is no such plan right now.

Q: Given your investment philosophy, what would you define as your universe of sectors or subsectors or what would be outside of your universe of subsectors?

A: As you have seen in the slide, we have invested in a wide range of different industries. I tend to stay away from industries with rapid change, so we are unlikely to have investments in tech companies, biotech investments, pharma, and those types of investments. We have had one Indian pharmaceutical company, but it was really a generics company that was really good at generics. I am not interested in investments in Russia or Zimbabwe, so we stay away from that. Beyond that, if it is understandable and if it’s something that I am familiar with or think I can get familiar with, then we will look at it. If it is complex or has rapid change, then I generally just leave it alone and move from there.

Q: I wanted to ask a little bit about the float, both within Stonetrust and within Dhandho as you do more PNC insurance acquisitions. Do you have a target leverage ratio in mind? The reason I bring this up is when you look at Berkshire in the early years of Buffett taking over National Indemnity, you see that he was able to get very high leverage ratios using the float. He was able

to get ratios as high as 7-8 times because the regulators would allow him to do that. Over the years, the regulators have clamped down on the leverage ratio that you're allowed to use your float to fund your equity positions. How do you feel about that and what do you think about the target leverage ratio using your float?

A: If you look at National Indemnity in the early days in 1967 or 1968, it did not have a high leverage ratio. The good thing with the insurance business is that you can pull up all of these filings. Going back to the 1960s in Nebraska, it was not online, so Tim helped me find a consultant who actually pulled those for us and sent it to us with a PDF from a Laserfiche. I am not sure how the regulations have changed, but, in general, the way they stand today depends on the state. It is regulated at the state level, so each state does its own thing. The simple rule of thumb most states use is that typically they want the float invested conservatively in fixed income type instruments and they are okay with the surplus or the book value being invested in equities in a diversified fashion. I'm shortening the statute, but that typically is how they like to see it split up and that has not changed in quite a while. The states have had those regulations in the books for some time.

In the case of Berkshire, many of their insurance companies are very heavily overcapitalized. Some of them, for example, have five times the capital that they need for the business they are writing. They may have $500 million in surplus and they are writing $100 million a year in premiums. They are very heavily overcapitalized and part of the reason is they aren't getting the pricing they think they should get and they could write a lot more. If you look at National Indemnity, and the 2004 Annual Report for Berkshire, it lays out a 20-year history. It does not go back to the 1960s, but it goes back from 1984 to 2004. The ratio of the premiums written to the surplus is very conservative, mainly because they weren't getting pricing that they were happy with.

In the later years, they started getting it and then they started writing. In general, with insurance, you can't go crazy. It is regulated and the regulators, rightfully so, want you to be conservative. In the case with Stonetrust, because they are doing workers comp, you could have a person in their 20s become quadriplegic and they may have a payout for 60 years or more on that claim. It is very important that we run our affairs in a manner that the individual has no questions that the payouts are going to come. My bent in managing insurance assets would be very different from managing Pabrai Funds. It is a different animal.

Q: In Dhandho, you are going to do acquisitions. Are you going to have an internal acquisition team or are you going to totally depend on external people to review these when you are looking at them? My second question I have is for Pabrai. Are you looking at your portfolio in a way of a certain beta that you're looking for and does that play into your decision making?

A: When we do acquisitions, we are looking at the whole team. I don't work with Greek alphabets, so I stay away from them. I could not even tell you what our beta is. The moment you start going into Greek alphabets, you lose me. We try to look at businesses that are undervalued and I don't want to have all the businesses in the same industry. I want it split out into a few different industries.

Beyond that, I have never thought of volatility as a measure of risk. The investment business tends to think there is some correlation between volatility and risk and I don't think that is true. We are not concerned with price fluctuations and to the extent that the price drops, we can take advantage of that and can buy more of the same thing. Beyond that, I am almost resigned to the fact that almost everything we buy will drop in price, sometimes, significantly, after we buy it. Somehow the stock knows that I bought it and then reacts accordingly. That is how we approach that.

Q: How do you handle your loss making trades? How do you manage the implication of possibly risking a bigger drawdown that you are comfortable with versus doubling down on a bet that you thought was undervalued and double that price?

Secondly, I just wanted your take on activist school of investing. I have been following closely the Herbalife bet that Bill Ackman has made with Bill Ackman and Carl Icahn having a go at each other on CNBC. I just wanted to know what you think about activist school of investing and its evolution over the last couple of decades with technology?

A: As for the drawdowns drop in prices, we have position limits on how much we are willing to put into a position. I look at those position limits from a cost basis, so we don't look at it based on the current price. We are unwilling to commit more than 10% of assets to one position. If we are fully invested at 10% and we get a drop in price, we are not going to buy more. As I just mentioned, we assume the drop in price will happen because everything I buy drops in price after I buy it, so we are not too concerned about that.

I don't look at it as a stock, I look at it as a business, as if we own the whole business. Unless there is a permanent change for the negative in the business, the quoted price is not relevant. I am always looking at what the business is worth and what we paid for it. In the interim, if it goes up or down, that is not relevant to us. We are concerned with our buy price and our sell price. We are not concerned with what happens between those two points.

Regarding activist investing, we don't do it and we will never go there mainly because I am too lazy to do that. I don't have the energy Ackman has and it would take me two years to put together those slide presentations that he puts together. Bill is a smart guy and he is a very charitable guy. He does phenomenal work, but sometimes it can be worthwhile to put that effort in a different direction.

When you are shorting a stock, as Bill found out, your maximum upside is a double if the stock goes to zero and your maximum downside is bankruptcy. Why would you ever want to take a bet like that and why would you want to take those type of odds? The nature of the business world is that the average public company CEO is an honorable guy and a guy you would be happy to have your daughter marry. He is a guy or a girl who is basically trying to add value to the business. These are normal traits of a typical public company CEO. There is a natural bias towards building value and when you short a shock, you are going against that natural bias.

I have no idea what happened with Herbalife. Charlie Munger mentioned that for those people who are selling magic potions, you should be careful about them. I am skeptical about Herbalife from that vantage point. It does not mean that you should take a position just because you don't like the magic potions or the price of those magic potions. It might end up doing a lot of good for humanity. Buffett says that 99% of the things he looks at goes into the "too hard pile". It would have been good to put Herbalife in the "too hard pile" You don't need to opine on everything.

Q: In the last 15 years, you have done exceedingly well in so many different areas from entrepreneurship, investment, philanthropy and education. What drives you for the next 15 years and are those inspirational forces the same today as they were 15 years ago?

A: The last 15 years were really good for building character because the funds lived through two tumultuous periods. We had the dot com crash right after we started in 2000 and, in fact, we were a beneficiary. The funds were up in 1999, 2000, and 2001. We made quite a bit of money because we never invested in those high fliers. Of course, we got hit with the financial crisis where we did take a big drawdown.

The last 15 years have been tumultuous and it was a tough 15 years for an investment manager. I always tell my friends that you need to show up with a large pot of cash on January 1st, 2016, ride that bull till 2033, and then get off. Make sure that when we get to January 1st, 2016, you have that pot of cash ready to go. I am not completely joking about that because there are people who historically look at the US market and there has been these 17-year cycles. During the time between 1965 and 1982, the Dow was flat at 875 in this 17-year period. There was lots of GDP growth and, in fact, that was the period when the US did quite well. We had issues, stagflation on a few things, a few wars and we had the oil embargo. The economy grew between those periods, but the Dow went nowhere.

Then from 1982 to 1999, we went from under 1,000 to over 12,000 so it widely overshot the GDP growth. If you look at it from 1999 till December 31, 2015 or 2016 and that 17-year period (given that we are almost ending 2014), we were almost flat from 1999. We were at 16,000 or 17,000 and we were at 12,000 or 13,000 then. We will see how it plays out. There is some rhythm to the market, so it is possible that we may end up with 15,000 or something in those two end points and it doesn't look like a whole lot of gain. Even if we end up with 17,000, when you look at the analyzed returns over that 17-year period, it is very low.

Hopefully, if it plays out the way it should in 2016 to 2033, it may be a replay of the 1982 to 1999 years and you may get wide exuberance in 2033. Then you get off that bull. It is not outside of reason to think that it may happen. As we are looking at the world today, people underestimate how great the United States is. They underestimate the core strengths that the US has. It has so many tailwinds working for it and those tailwinds do not exist in Europe or Japan. They don't exist in large parts of Asia, even though Asia has other tailwinds, but it has a lot of headwinds as well. In the end, we may end up seeing amazing things in the decades ahead.

We have some people here today and maybe I can ask these engineers from Google who are working on all kinds of stuff that they won't talk to me about, but maybe they will tell you about it. Maybe they can give their perspective on what the world will look like in 2033?

Google Guest: I have no clue.

A: But you already have it in the lab.

Google Guest: Yes, there is a lot of exciting stuff going on. We are testing driverless cars. In humanity, we have lots of data and we are using the data to help people in the developing world. The resources to knowledge and information have grown up to an accessibility that they have never seen before. The pace of development can only be expected to accelerate and this is sort of my personal opinion.

Anish: My name is Anish and I also work with both of them at Google. I am working on Google fiber. This is the 1 gigabyte internet that we want to bring into the US. We don't know what we can create once that 1 gigabyte internet is available over here. It is not in the Silicon Valley, but when the internet first came in, people did not think that anyone would need 1 Mbps or 5 Mbps. People used to laugh at people who talked about those kind of speeds and today those kind of speeds choke many peoples internet. We are working on driverless cars that will be unique. I will be able to tell my son that he does not need to get a license because he will be sitting in a driverless car. Or when I grew old, I probably will be able to live in my house longer because there will be a driverless car. We have contact lenses that can detect glucose levels and that is very good. There are a lot of things, but I am only speaking about what is public and what we can talk about. Google is investing a lot in itself, of all the money that it generates, and there are some extremely exciting technologies that are all over the place.

A: Do you think we will be in a better place in 2033 than today?

Anish: Definitely. The rule of Silicon Valley is that 1 in 10 investments pan out. The investments happening in Silicon Valley right now, not just Google, but all around, are completely amazing. Even if 5% of those span out, we will be in a completely different world by 2033.

A: We may get more polarization of wealth in these years because of the nature of the direction and maybe the government will take action to counter that. We are definitely moving forward in the world. You can already see it in the US, where the unemployment rate amongst people without a college education is quite high. Whereas, if you look at a company like Google, they cannot find the people they need. They are continuously looking for people and they can't find them. We will get to more of that polarization, but I am very bullish on the United States and I think the United States in many ways will be the emerging market because of all these core strengths it has.

We will also see a huge growth in Asia and in China. In spite of all these kinds of yellow spots we see around the world, the long term is good. My take on the next 15 years is hopefully life

will get a lot easier because we won't have these mega-collapses and mega issues going on. So put me down as a bull and, especially so after another two years go by.

Q: Mohnish, I want to thank you very much on a personal basis for making me feel like I wasn't the only one who worked for free the last 5 years. I have been reading your filings for Dakshana and I really admire the work that you have done there and in New York. Every manager has a plan for reforming education in the US. Could you take a minute and tell me what you have learned or is the IIT system so unique that something like that would not be adaptable domestically?

A: I will borrow from Charlie Munger and Whitney Tilson who asked Charlie a question a few years back and he said, "If you were Emperor for a day of the United States and you could make one change, what change would you make?"

Charlie did not even waste two seconds and he said I would abolish K-12 private schools. That one change would go such a long ways towards fixing the US education system. You can take the perspective where you take every K-12 school which is private and assume the students who are in the program today will continue as is until they finish. The school would continue under private ownership because there is no ownership change. They become charter schools.

There are only two ways in which a private school today can admit kids. They can either admit kids in the neighborhood, like a public school does without any barriers, or they can admit them based on academics or other quantitative factors, which are very transparent. Once you admit a kid, you get paid by the government based on your enrollment. Basically, every student ends up with a voucher and every student picks where they want to go to school. If the public schools are not delivering value, they don't get the budget and they are closed down.

If we ever got to the point where some President enacted that as a law and Congress supported it, it would go such a long way towards fixing the education system. The US already has the best college education system on the planet. It is exceptional and it is expensive. If I were to have a silver bullet that could cure much of the ills in the education of the US, this is where I would focus if there is no opt out. My kids go to public schools, but they go to public schools in areas where the parents are fully engaged. These schools perform as well or better than private schools. Many of you live in areas where the public schools are exceptional.

Once you get opt outs in a meaningful way, where people who live in these geographies and cities don't send their kids to the public schools in the cities, this is when you start going downhill. Buffett says, once a school starts going down, the good public school is like virginity - you can preserve it, but you cannot restore it. It is very difficult. We have seen this happen in Chicago and New York, and other places where there have been valiant efforts to reform public schools. It's very hard to do, because you have opt out. Once you have opt out, you don't get the right parents engaged and then you are not going to solve the problems. That's how you would have to approach it, because that would address the teacher's union problem and other issues. It will cause a lot of turmoil and a lot of strikes, but then at the other end, we would come out

looking great. We will be back to having a great public school system, but I don't think it is on the agenda for Congress in the near future.

Q: Building on that question, there has been a lot of talk about the undergraduate value for education in the U.S. Peter Thiel is talking about funding people to drop out of college and start their own businesses. Do you fundamentally think that the Dakshana program works because there is value that the IIT's deliver? If so, how does that get replicated in the U.S.? They are talking about the complete disruption of the undergraduate education system in the U.S. now.

A: When I went through undergrad, over four years as an out-of-state student at a state school, the cost was $9,000 a year and the all in cost was $36,000. When I started working, my starting salary was $31,000. Today if you go to a state school you are looking at about $150,000 or more in state. If you go out-of-state, in a state school, you are probably looking at over $200,000, or close to $230,000. The starting salary is not even two times what my starting salary was. You might get $55,000 when you start, so the salaries have not moved anywhere near the way the costs have moved. The cost of education has really sky rocketed and this is where most people question the value of the education. After I spent $250,000, I may not even have a job. It is a very significant sum and hopefully technology will give us the answer.

In India, the IIT System is still an expensive system. If you look at the all-in cost for the government per student, per year including what the students are paying, it is about $11,000 a year and close to $50,000 for four years, and that is Indian costs. If you were to compare that, the IITs are really not cheap compared to the US once you do some adjustments for exchange rates and cost of living.

Hopefully, the answer comes out of leveraging technology, because otherwise it is basically on an unsustainable path. What we are doing at Dakshana in India is not like that. There are some non-profits in the U.S that do this and QuestBridge is one of them. What QuestBridge does is they identify very high quality individuals in the inner cities who would have great difficulties attending college. They prepare them for college entrance with all their applications and then QuestBridge submits their application to schools that have agreed to work with QuestBridge. When a school like Harvard, or Stanford accepts a QuestBridge student, they may get a 100% scholarship. They pay for everything, including the air ticket from where they are coming. There are a few programs like that in the US. The bigger question is the cost and hopefully technology delivers the answer but we will see. Dakshana doesn't have the answer to that for the US.

Q: Your behavior is a seeming paradox. On the one hand, the Pabrai Funds have been closed for five or six years now and you don't want to accept money. You have admitted in several reports that you just can't find any good new ideas now.

On the other hand, with Dhandho and with Stonetrust, you are raising more capital and getting more capital under your control which you want to invest and you seem to be saying that there are other good ideas out there where you can invest this capital.

Could you clarify that and, as an ancillary question, are you afraid that having all this new additional capital will force you to invest it or force you to make less than optimal investment decisions?

A: It is actually different buckets and different asset classes. The impetus to form Dhandho was that we couldn't make an investment like Stonetrust within Pabrai Funds because it is a completely different vehicle and it is not set up to do that. At the same time, I liked the business and I liked that class.

In the last year, I felt it has become clear to me that there are a small sliver of humans who understand value investing and have cloned Warren Buffet on the investing side. The number who have actually done it on the wholly owned subsidiary, or insurance, on operations, or as a manager, is almost nonexistent and surprising. My take was it would be a shame not to at least try it, because it seemed attainable and it didn't seem that complicated. Now I find that, after a year, the number of insurance companies that are under managed is extreme. A lot of them are small enough that we can work with them and some of them are run by incredible entrepreneurs. I have run into a few businesses that I was extremely impressed with and, in fact, I am hoping that we can make these things happen. We will work on that.

Also, what I am hoping to do when Dhandho goes public is that Pabrai Funds will participate in the IPO. It could not invest in Dhandho so far because it is a private vehicle. At the time we go public, we will try to invest $70 or $75 million into Dhandho so that the Pabrai investors get exposure to that asset class. The only caveat to that is we will only do that if the pricing is reasonable. If the valuation is within rational ranges, then we will do that. If there is a euphoria and we are coming out three times book value, then we would not want to participate and we would wait for a time when it was more sensible. We will try to give the Pabrai investors access to that, but I don't really see this as a conflict in a sense that there are opportunities in the private markets in that space.

There aren't a lot of opportunities outside of insurance in the private market. You tend to pay full price and deal with intelligent sellers who will tend to time sales to fit everything being perfect for them unless you find some unusual distress situation. What happens in insurance is that even when we pay full price, we can add so much value and it can truly be a win-win. In the case of Stonetrust, that's the case. We are not in any valuation metric or getting a bargain. We are paying full price and I think it will work out to be a fine situation and which is why we have pursued this avenue.

Q: Part of your criteria for new insurance companies is that you would like to buy a property and causality insurer. Berkshire, Markel and Fairfax seem to be doing the same thing and focusing on that space. What is the drive there and what is so unique about that?

A: The uniqueness is that the stuff we are interested in is too small for them and they wouldn't be interested. These multibillion corporations aren't really set up to buy a $30 million company. You get the flexibility on the investments and the other non P&C businesses are more restrictive

in what you can do in the investments. Tim finds the same thing on the business side. One of the things they can do is zig-zag a lot faster and better in and out of different markets and different deals based on the economics, versus the larger carriers who move slower. This is the reason we are doing that.

Q: In Dhandho, do you plan to list the book value every year? And my second question is how do you plan to instill the discipline of underwriting insurance at profitable prices and avoiding the markets when it is below cost?

A: Regarding the book value, when we go public we will have all kinds of filings required so there will be a lot of transparency on that front. I would like to communicate these types of metrics to the shareholders. The idea is to communicate in a manner where, if our situations were reversed, I would be happy. As a benchmark I would use, “Am I getting the information I would want, if I were an investor”.

In regards to the underwriting discipline, with insurance companies it is almost impossible and very hard to change the underwriting in the operating culture. We are not looking for fixer uppers. We are not looking for things to buy at one third of book value and then do surgery and fix it. I am looking for businesses that already understand the core and the DNA about how important it is to run a sound operation from the underwriting, claims, and the operations of how they treat the people.

The second is that to the extent that incentives matter, I don't think that incentives matter that much. A person like Tim is much more driven by purpose than dollars. Besides his base salary, 100% of Tim’s compensation is driven by underwriting profit and he gets a tenth of the underwriting profit the company makes. When Tim and I talked about that, it took us less than thirty seconds to arrive at an agreement. To the extent that incentives drive behavior, there is no incentive that Tim has which is tied to growth or to factors outside his control. For example, we could do a phenomenal job on the investments and that would have no impact on his compensation because it has nothing to do with what he is responsible for. The area that he is responsible for is very much going directly to him, and I hope he makes huge bonuses.

Q: I have a couple of very quick questions for you. One is about China. What are your thoughts about China? Do you see opportunities that perhaps existed in the U.S. market back in the fifties and sixties? And the second one is around companies like John Deere which has more secular, sort of tailwinds - population, demographics and so forth. How do you look at companies like that right now?

A: China is mostly outside the circle of competence and, for most Chinese companies, I wouldn’t be able to proclaim that I understand their business or their drivers. One thing to keep in mind is that China has grown a lot in the last decade, but the equity markets have not been friendly to the investors. We see a situation where there is lots of GDP growth, but no great results for the equity investor and the two are not tied together. There are plenty of fortunes that

will be created in China and plenty of businesses that you could invest in. It is not apparent to me that I will be able to understand those or invest in those.

John Deere, I haven't looked at lately but it is a fantastic business. By no means is it undervalued and it is nowhere near those numbers. In general, the last few ideas we have had, have all been outside the US except for something we found recently, but we are not able to buy a whole lot. For quite a while, I have not found things in size in the United States. The U.S. markets aren't exuberantly undervalued. You may have pockets of that in some tech stocks, but by and large, it is not undervalued. It may be fairly to slightly overvalued and there is not a whole lot of opportunity. A company like John Deere is not under distress. I haven't looked at valuations lately, but I would be surprised if it is trading at anything below its historic multiples. We need to find great businesses at great prices and right now there is not a whole lot of that, at least in the US.

Thank you for coming.