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Charlie Munger at Harvard-Westlake School

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[This conversation about the financial crisis, moderated by Jim Gibson, took place at a fundraising event for the Harvard-Westlake preparatory school, where Charlie Munger is a longtime trustee.]

JIM GIBSON:
Charlie, why did so many smart people get it wrong?

CHARLIE MUNGER:
Well, that is a marvelous question and it is such a marvelous question that I have devoted a big chunk of my life to studying that exact question. It was obvious to me for some reason, at an early age, that a great many very brilliant and disciplined people made perfectly screwy decisions that were disastrous -- and that it happened, frankly, wherever I looked. I found this extremely curious, and somehow early in life I got the idea that I would never be able to play chess blindfolded against six Grandmasters and win. God just did not give Charlie Munger any such skill. But I said, 'Oh my gosh, I cannot be as asinine as all these other people if I just kind of work at it steadily for a long time,' and that is what I did.

I think part of the popularity of Berkshire Hathaway is that we look like people who have found a trick. It's not brilliance. It's just avoiding stupidity. You say it is the same thing just stated differently -- well, maybe it is the same thing just stated differently. But you understand it better if you go at it the way we do, which is to identify the main stupidities that do bright people in and then organize your patterns for thinking and developments, so you don't stumble into those stupidities. Of course, this present situation involves massive cognitive failure at a great number of places dominated by very, very bright people, and that is quite interesting.

Let's just go through the list, briefly. Academia failed. The professors at our greatest universities [have] perfectly asinine ideas -- first, about efficient market theory. One of those people influenced McKinsey [& Company] so much that McKinsey came to the Washington Post at the time it was selling at one-fifth of what it was plainly worth as a share of the total enterprise, and said, 'You can't buy [the stock] in because, under efficient market theory, it can't be worth a fifth of what people would pay for the whole company.' Of course, the kind of mind that would keep a stupid idea like this when they have a fact that would clearly refute it -- it clearly violates traditions of science and mental decency. They taught this drivel to our children for decades and, by God, a lot of people are still doing it. It was in the major textbooks in economics and people as smart as Paul Samuelson [believed it] -- and that is a significantly smart man. How do smart people get such dumb ideas and hold them so long? I'll try to come back to that theme after I've enumerated more examples.

Then these ideas from economics drifted into corporate finance, and they got the capital asset pricing model -- also pure drivel. They taught it to all of our children and the law schools picked it up. They didn't understand it, but they could repeat it like a mantra from Buddhism, and people would learn it and regurgitate it on the examinations and they'd get As and so forth. Of course, they got out into the real world and they were menaces to decency and sound thinking. That didn't bother the people at Harvard [University] or any of the people that were doing it. And you say, how can smart people do such immensely dumb things?

You don't have to make this stuff up. Life will constantly surprise you with these ridiculous examples which teach important lessons. These are seriously smart people who took up with Paul Samuelson. Alan Greenspan is a seriously smart person although not as smart as Paul Samuelson. Then they got other ideas and these spread, and the good ideas that are buried in economics by and large weren't emphasized enough. I don't know, 15 years ago or so, I rifled through the three leading textbooks in introductory economics - I'd never taken a course in the subject - and I read through them. About the 20th page of Mankiw's famous book, which succeeded Samuelson's famous book, the guy says smart people make their decisions based on opportunity costs. Well, that was the last time opportunity cost was discussed in 1,000 pages. I want to tell you that compared to the other drivel that was discussed, opportunity cost deserves more than one sentence.

Berkshire Hathaway is constantly kicking off ideas *[audio unintelligible]* in about two seconds flat. We know we've got opportunity X, which is better than the new opportunity. Why do we want to waste two seconds thinking about the new opportunity? Many of you come from places that don't do that. You've got to have one horse, one rabbit, one something or rather, and that rabbit is going to be thinking about something which would be ruled out immediately by an opportunity cost available generally to the place – but, it's a different department. You have to be diversified and so on and so on. It's easy to drift into this idea that opportunities don't matter, you've got so many different ways of doing things that are better. It isn't better.

The right way to make decisions in practical life is based on your opportunity cost. When you get married, you have to choose the best [spouse] you can find that will have you. The rest of life is the same damn way. You have to figure these things out if you want good results in life, and if you don't, well, you have to pretend that you can get good results in life. If you have enough sales ability, maybe you can get by with it.

At any rate, these ridiculous ideas came out of academia. This wasn't true in engineering and arts and science by the way. The idiotic ideas are all from the social science department and I would put economics in the social sciences department although it has some tinges of reality that remind you of arts and science.

In economics textbooks they teach you Gresham's Law: Bad money drives out good. But we don't have any bad money that amounts to anything. We don't have any coins that are worth a lot, that have precious metals that you can melt down. Nobody cares what the melt-down value of the quarter is in relationship to the dime, so Gresham's Law is a non-starter in the modern world. Bad money drives out good. But the new form of Gresham's Law is ungodly important. The new form of Gresham's Law is brought into play - in economic thought, anyway - in the savings and loans crisis, when it was perfectly obvious that bad lending drives out good. Think of how powerful that model is. Think of the disaster that it creates for everybody. You sit there in your little institution. All of the builders [are not good credits anymore], and you are in the business of lending money to builders. Unless you do the same idiotic thing [as] Joe Blow is doing down the street. Pete Johnson up the street wants to do something a little dumber and the thing just goes to a mighty tide. You've got to shrink the business that you love and maybe lay off the employees who have trusted you their careers and so forth or [make] a lot of dumb loans. At Berkshire Hathaway we try and let the place shrink. We never fire anybody, we tell them to go out and play golf. We sure as hell don't want to make any dumb loans. But that is very hard to do if you sit in a leadership position in society with people you helped recruit, you meet their wives and children and so forth. The bad loans drive out the good.

It isn't just bad loans. Bad morals drive out the good. If you want to run a check-cashing agency in [a] downtown big city, more than 100 percent of all the profit you could possibly earn can only be earned by flim-flamming people on the finance contracts. So if you aren't willing to cheat people - basically minorities - more than 100 percent of the profit can't be earned. Well, if you inherited the business or your idiot son-in-law is in it, you don't know what else to do. This is what I would call an adult problem and most people solve it in the adult fashion: They learn to tolerate the cheating. But that is not the right answer to people who want to live a larger and better life. But it is a form of Greshem's Law, the new Gresham's Law. One that is not taught in economics courses and should be. It is a really serious problem and, of course, it relates deeply to what happened to create the economic crisis. All kinds of people who you would be glad to have marry into your family compared to what you are otherwise going to get did things that were very regrettable under these pressures from the new Gresham's Law.

Well, I've done enough for economics, let's go on. Corporate finance is beneath contempt. Believing just by buying volatile stocks you make an extra 7 percentage points per annum, I mean those people still believe in the tooth fairy and yet it is taught to the children. On the other hand, the children don't have to work very hard to get there so it's a Mad Hatter's tea party -- but this is the real world as [it] exists. You have these extremely dumb things being done by these smart people. But a lot of them are under big institutional pressure like the poor bastard in the law department who has to face the new Gresham's Law. Of course, that kind of pressure is on all these other people that are doing these dumb things, many in academia. I had a friend who had a child in the economics department at Chicago, very free market orthodox economics, and [the child] didn't believe the markets were quite as perfect as they thought at the University of Chicago and he had to hide his views. There wasn't the slightest chance he could do *[audio unintelligible]* at the economics department at a really great university unless he pretended to believe twaddle. Of course, employment is full of this sort of thing. Generally, the employment relationship - the need for money - causes more terrible cognition than any other single factor. Upton Sinclair said it best of all. He said, 'It is very hard to get a man to believe non-X when his way of making a living requires him to believe X.' On a subconscious level, your brain plays tricks on you and you think [that] what is good for the true little me is what you should believe. Of course, it's very hard to deal with since it's not conscious malevolence that's causing the bad cognition -- it's the subconscious reality of the human mind.

We have psychology departments with distinguished professors, surely they can teach our young to avoid – the psychology term for this is 'self-serving bias.' Surely the psychology department is teaching our children to avoid this. Well, it's not so. The psychology department is full of people who collect psychology experiments the way a boy collects butterflies. They just like listing them and knowing the other people who collect the butterflies and so forth. Very little synthesis is done from one experiment to another, and if you ask them to synthesize - where you use the findings of psychology against the risks of reality, and through synthesis create a powerful machine that will get the right answer in a complex mess - the psychology professors are not going to help you. In fact, you'd be sort of dropped out of a psychology department if you purported to know a lot of non-psychology and integrate it beautifully with psychology. It goes back to what Whitehead said. He talked about the fatal unconnectedness of academic disciplines. Those bastards feel no duty to master the big ideas in all the disciplines and get synthesis and reality across the disciplines. They are rewarded in their own little shop for being silly and monomaniacal and with their high IQs. They do all this terrible mischief because they don't know in a functional way what they teach in Psychology 101. The psychology professors who invented and discovered a lot that is very important, they are not really helping the wider civilization all that much. We're better off having them than not having them [but] in terms of what is the best that can be in academia, it has failed us horribly. With hard science and engineering excepted - [and] I think the cognition of medicine tends to be quite good in the best places and biology also tends to be good - but boy, you get into the rest of the social sciences and you have to be very wary because there is an asininity trying to clobber you up behind every rock.

With academia failing us, now we turn to what happened with our regulators. Well, Alan Greenspan at the Federal Reserve overdosed on Ayn Rand. Basically he kind of thought anything that happened in the free market, even if it was an axe murder, had to be ok. He's a smart man and [a] good man, but he got it wrong. Generally, an over-belief in any one ideology is going to do you in if you extrapolate it too hard, and that's what happened in economics. What happened in economics that caused Alan Greenspan's cognitive failure is very simple. They reasoned correctly that a free market would be way more predictive than anything else, and they reasoned correctly that once you had a fairly advanced capitalist system – if the people that were putting up the capital could sell their pieces of ownership in the company to other people, they'd be more inclined to invest because it gave them an option to get out if they wanted to leave. It's not like buying a restaurant in the wrong place. Then they reasoned that if that was true, if you had a really free, liquid, wonderful market in securities, that would be wonderful, and the bigger and more wonderful it was, the better it was for the wider civilization.

When I was at Harvard Law School, seldom did a million shares trade in a day. Now billions of shares trade everyday, and economics professors like Alan Greenspan presumably are looking forward to trillions. Our civilization is not going to work better if we have trillions of shares traded everyday. It's the most asinine idea you could ever have to extrapolate so vigorously, and of course three or four billion shares is way too many. We have computer programs that are trading with other computer programs. We have many of the bright people who ought to be doing our engineering going to work at hedge funds and investment banks and algorithmic trading places and so on and so on. We've got this big share of the GDP – and by the way, the way GDP is calculated is peculiar. If the crime is so bad that I have to hire a night watchman, that adds to the GDP. Nobody in economics wants to look very deeply because it makes their problem messier and more complicated as you make it more correctly approaching reality.

Well, so at any rate, these people got the idea [that] unlimited trading is a big plus for civilization. It's [ironic] that the economists and most of these people worship Keynes – who thought no such thing. [Keynes] said a liquid market of securities is one of the most attractive gambling devices ever created. It has all the joy of gambling, plus it's respectable. Furthermore, instead of being a zero-sum game, where you are bound to lose the frictional cost, it's a game where you can pay the frictional cost and actually make a profit. This is one of the most seductive gambling devices ever invented by man, and some nut who took economics thinks that the bigger and better it gets, the better it is for wider civilization. You now see how well that theory has worked. We made a wonderful market test of all this wonderful academic faith in utterly free markets and marketable securities -- the more trading the better. And not only in marketable securities, but they have new securities called derivatives. In the old days, knowing that people went crazy gambling in securities, they had margin rules. You could only borrow a limited amount to speculate with. [Then] they brought in option exchanges, they brought in derivatives, they brought in the repo system -- they created the most wonderful gambling game for anybody with blood really coursing in his veins who wants to get rich quick. This is one of the most attractive things that ever came down the pike. Of course, it runs the great exodus and creates a big mess in the end. How could it not?

By and large, and it's interesting to think about, it's mostly a male game. The nuts who did most of this damage are male. You go into a trading room on Wall Street and you won't find many women barking into the phones and going to the strip clubs. There is a lot of testosterone in our present troubles, and of course, the people that get promoted logically are sort of like the people that win our athletic contests and get to be captain of the teams. Many of you were in investment management and you know how it works. Everybody wants the guy that everybody else trusts, who can't stand to lose, that everybody likes, and tends to get things done -- and I just described the captain of the team and so forth. There is a law firm in town, Latham and Watkins, that galloped past everyone else and that is all they would hire with some exceptions. They knew what they wanted and, boy, did it work for them. Of course, if you are in investment management, it's exactly the wrong personality type. Maybe you want them in the sales department, but you don't want them managing the money. It's the cranky peculiar people like those sitting here who will better serve you in making these decisions. That is another problem with life. [The] guy who invented the Peter Principle is right: You know we all get promoted in hierarchies and, of course, half the time some guy gets one category too high and of course half the time you have someone who is utterly unqualified for this spot he is sitting in and yet he has the power. He's got a big ego and everything else. What do you do about this? This is a serious problem. If you don't think this is a problem with Wall Street, look at the personality profiles of the people that headed our main investment banks. They were caricatures. Stan O'Neal or whatever his name was at Merrill --

If [Anthony] Trollope invented a character like this, you would say, 'It's too extreme. I can't get by with this one.' It would be regarded as foolish, not as effective satire. That just happened again and again and again. And you are surprised we have this big mess on our hands. Some very powerful forces have been unleashed here. Some very powerful forces of unreason have been allowed to flourish. Of course we get a big mess. We always were going to have cyclical fluctuations in capitalism. We always [were] going to have cyclical fluctuations in securities markets. But to have them magnified so greatly, and to have such exacerbation of the result by this extremely liberal use of credit –

When you talk about liberal use of credit, the derivative game was just unbelievable. The things people would agree to, thinking they were making money. For sure, they had these corporate finance types who did this work showing from the risk management department, the exposure of the firm. You want to talk about childish, high IQ childish. This is right up there. It's hard to think of anything much worse. I suppose the eighth husband of Zsa Zsa Gabor or something would be competing for similar honors of cognition.

What they did was, they said, 'Well, financial outcomes in securities markets must be plottable on a normal curve,' – [a] so-called Gaussian curve, named for probably the greatest mathematician that ever lived. Gauss must be turning over his grave now with what's happening. Of course, the math was very helpful because you could come up with numbers and results that would make people feel confident with what they were doing. There was only one trouble with the math: The assumption was wrong. Financial outcomes in securities markets are not plottable. It is not a law of God that outcomes in securities prices will fall over time on a curve and [follow] reality according to Gauss's curve. Quite the contrary, the tails are way fatter. Warren and I always knew this by doing what might be called Monte Carlo simulation in our heads, just roughly. We could just see it didn't fit, too many extreme things happened that the math didn't correctly predict, and so we just thought they were all damn fools. Of course, we never bothered to learn the math. We used to sit at Salomon when they made these presentations in the risk management crowd with all these figures, all the daily trading and the disaster, blah blah blah and so forth. We would just roll eyes at one another that grown men could be doing this. And yet we were only two when the whole culture was into this craziness. People were actually making decisions about how much risk to take, based on the application of correct math, based on an assumption that wasn't true. And by the way, people gradually knew it wasn't true. But by that time they had gotten so enculturated in the math and they were so good at it they couldn't give it up. It's like a friend of mine who said he couldn't give up the Catholic Church, he's too invested in it. You know he's 75 years old. We all get that way with our best-loved ideas, and it happens to people who get ideas about risk management. So there was just a lot of serious irrationality.

Now we turn to the accounting profession. Now you think accounting is something we can trust? Accounting is one of the glories of modern civilization. In the heyday of Venice, they really made double entry bookkeeping popular. They taught it in all the math books of that era just the way people draw arithmetic now. Anybody who was anybody in Venice knew double entry bookkeeping the way you know how to scratch your ear. This was very helpful to Venice, which at one time was the most important commercial city in the world. And so these accountants with this glorious background got into establishing their accounting principles. What did they finally come to? This is relatively new once sort of after the mess unfolded. They came up with this loon. They said if you are on the edge of extinction, your credit is utterly destroyed, you have no cash to do anything, to buy anything, but your outstanding bonds are selling at 50 percent of their face value -- you have made a profit equal to 50 percent of the face value of the bonds. It's not a profit you can eat or use because you don't have any cash with which to buy the bonds, but in terms of the financial statement, as your real [financial] health gets worse and worse your profits get higher and higher. I'm not kidding! This is accounting the way it is ordained in this country as we sit here. They are teaching this kind of stuff to our children and forcing it on our companies. It is absolutely insane.

Let's take bad debt reserving for banks. That is a really important subject in a world where Gresham's Law is going to cause a lot of terrible cognition and terrible behavior. The accountants want a system and they ordained we have to use it that says you compute your bad debt reserve actuarially -- you look at your bad debt losses in past years, and you use that in judging what your future bad debt losses will be. But, of course, if you are making a totally different kind of loan to a different kind of borrower, using the past experience is insane. It is not just slightly insane, it is really insane. Nobody would do this with his own money who had any sense -- judge his future exposure in lending based on his past exposure in making a totally different kind of loan which is obviously way safer than what he is doing now. But once the accountants chose this crazy accounting convention, then people have a wonderful opportunity to game the system. If you want your bank to look like a big earner for two or three years, just make a bunch of lousy loans that will take a while to be diagnosed as such. Your accountants will cause the loans to stay on your books accruing a lot of wonderful income and you will report it to the analysts, and the credit agencies will believe in the income, and so on and so on and so on and you'll look fine for quite a while. You can say this will eventually come home to roost? Oh no, when it starts coming home to roost, we'll just do twice as much more and that will swamp the old troubles coming home and when that gets in trouble we'll double again and if you are deposit insured you can do it *ad infinitum* as long as your accountants will let you because you are using the government's credit to attract the new money. And, of course, that credit is unlimited.

Who in the hell would have this kind of accounting that had any sense of all in a *[audio unintelligible]* civilization? It's our leading accountants, the people you'd be glad to have marry into your family. And not one of them has the least tinge of shame. They are like Upton Sinclair, they believe what they have to believe to make a living. What the accountants can't stand is the idea that if you made them do what rationality requires, make this thing realistic -- make it a reasonable judgment about what is going to be really collected in the future. What's really sound here? They sense that plaintiffs' lawyers will sue them and they really won't be able to do it. That is unendurable to them. They would rather have the figures all wrong and the figures create the kind of a mess that we've had than face reality. On a subconscious level, they just choose the accounting that makes it easy for them to do. It's like a surgeon once said [at] the Jules Stein Eye Institute [when] I asked him, 'Why are you doing a totally obsolete cataracts operation?' This guy was a genius who correctly diagnosed my left eye before it went out for good and he said, 'Charlie, it's such a wonderful operation to teach.' I'm not inventing this story. I mean, if you are really training a bunch of interns, I mean, this was a hell of a wonderful experience and you know how he stopped doing an obsolete cataracts operation at the Jules Stein Eye Institute? When the patients all voted with their feet. That is one of the glories with capitalism. If people are asinine enough, the customers will frequently bring reality to bear by voting with their feet.

Well, you see the drift of this everywhere you turn and, of course, you turn to the regulators. Imagine the SEC, they had trouble diagnosing Bernie Madoff. You have to believe in the tooth fairy to believe he was having those figures by the methods he claimed to be using. You wouldn't have gotten that one by Howard Marks for two seconds. I mean you wouldn't have finished your sentence before he noticed it couldn't be true. But people get into powerful positions in the regulatory authority who don't think like Howard Marks. And the end result is these disastrous regulatory decisions, and then of course people get co-opted. Almost everybody at the SEC is young enough, so they want to leave and go back to business and they are going to go back to the regulated business. Well, how great a regulator is that going to be?To do a lot of unpleasant things? The English system for trial lawyers is much better. If a trial lawyer is really good, and he is really smart and so forth, they put him on the bench. That way, they get rid of one important competitor so they get more briefs, they get a good judge and he stays a good judge because he never comes back into trial lawyering and he never goes into *[audio unintelligible]* stuff in England. That is a much better system of getting a trial judge than we have elsewhere, but it is rare. What we have now, a lot of our judges are like the SEC commissioners that go out and join the regulated part of the world. The conflicts of interest are just rife and the failures of cognition from their background and their professions like accounting.

I had this discussion with this woman who was head of the accounting standards authority, very high IQ women, very high-grade woman. [But] nutty as a fruitcake. She said to me, 'Charlie don't you want it consistent? If we are going to mark-up bonds the firm actually owns, why shouldn't we mark-down the bonds on the other side of the balance sheet?' Well, I said: 'Because an insane result is going to have bad practical consequences in the world.' And she said: 'We don't talk that way.' She may still be there for all I know.

At any rate, we get into these amazing results. Then, if you take our legislators on the Republican side, they have these Alan Greenspan nuts who thought, unlike Keynes, that just unlimited derivatives and market trading and use of credit had to be good because it was a fast-acting free market and free markets are good. Of course, anybody could see that it was going to implode sooner or later. It wasn't like all human experience didn't show that there would be hell to pay sooner or later. You didn't know when, but you knew a cataclysm was coming at some time. I certainly knew. And I would argue that doling out credit easily, making a lot of loans that are likely to be unpaid does more harm than good. I think what we have just been through proves that you are not helping somebody when you prop him up in some house he can't afford and make every month agony for 12 months and eventually dispossess him in front of his friends and tear down his ego and disappoint his wife. It is a really miserable experience and they don't do this in places like Switzerland. You want to own a damn house, keep earning or borrow from your folks or do something. I mean, they are not into providing loose credit for houses. They don't want a crazy boom in housing prices and they don't want -- you know they are Germanic. If we had a more Germanic culture, we wouldn't have done as many dumb things as we've done. Not that our Germans aren't acculturated into our culture in due course, but the old Germanic virtues of thrift and so on did not get into this kind of trouble.

The head of Freddie Mac who had a Ph.D. in economics came out and sat with us and said what should we do? I was young and optimistic, being 60 or whatever I was, or 75. I said: 'It's very simple. You are using so much credit and there is so much danger in what you are doing that you should make no more than 80 percent loans to people with good credit. You shouldn't do anything else. You've got a bunch of experts who you have hired to lobby everybody and to bring you information as to what the legislators want and so on and so on. You should go back there and fire them all and just say, when they ask you what you were doing, 'I'm sorry, but we are using so much leverage and the government's credit and we simply can't afford to do anything with this much leverage except to make loans to sound people on sound properties.' Well that would have been very good advice if he had followed it. For one thing, he'd probably still be employed. But, of course, can you imagine the advice this man got from his friendly investment bankers, consultants, public relations type[s], lobbyists? He bought every dumb derivative and went into every dumb thing and of course the place went totally insolvent in due course.

I think the government was totally correct, by the way, given the problems of the recent crisis, to just nationalize the whole thing. They had to and we've got the problem, but there is very little taste that I see toward really changing the whole thing of making lending an entitlement process. But boy, teaching people they don't really have to pay and a lot of the credit being given for education, a lot of it in for-profit education. [This] is very foolish credit given to people who are never going to learn much and never going to pay much. But you know people feel that people with no prospects ought to get the same type of credit as people with prospects. They don't do this in India, they don't this in China, they don't do this in Japan. I mean, this is an American phenomenon and of course, I think it does enormous damage to shovel out a lot of dumb credit, raising false hopes. I think it creates ungodly messes and it degrades human responsibility and that is a very important subject.

Another thing that is never discussed any more is my idea of one of the great philosophers of America who was Charlie Frankel. He was mugged to death in due course because, after all, he lived in Manhattan in a different time. Before he was mugged to death, he created this philosophy of responsibility. He said the system is responsible in proportion to the degree that the people who make the decisions bear the consequences. So to Charlie Frankel, you don't create a loan system where all the people who make the loans promptly dump them on somebody else through lies and twaddle, and they don't bear the responsibility when the loans are good or bad. To Frankel, that is amoral, that is an irresponsible system. That is like selling an automobile with bad brakes and you know the brakes are bad. You shouldn't do it. Well, we've just been through a period where nobody gave a damn about an irresponsible system. If you can engage in business in some lawful way and dump trouble on somebody else through God knows what techniques, the more the merrier. It finally got to be like musical chairs, except in musical chairs, you are only one chair short when the music stops. In the new form of musical chairs, everybody has a hell of a time and is sitting on his ass on the floor. Of course, that is what we created and it was perfectly obvious that something like this was bound to happen although we didn't know when. So this is very, very significant cognitive failure and it has just shot through pretty much through the whole civilization. It isn't everybody. If it were, the civilization would perish and it would deserve to.

There are people who have behaved well through this and a lot of them I can see sitting in this room. But what would you suspect with a bunch of people that are supporting a really great school? I mean, these are not the scumbags of the world. And so, all I can say is that this is very serious stuff and what we have all done together at Harvard-Westlake School is to try to create the kind of education that reduces the future nonsense. It is not easy, because very powerful forces of self-interest and subconscious powers of delusion are working against us -- and, of course, we live in a nation with different ethnic groups, different religious groups and so forth. Our civilization is a lot harder [to] manage than say, Denmark or Norway or something -- and always will be. Therefore, we should be doing it better, not worse, and of course, it is just the opposite. We have a worse problem and therefore we are governing it worse. In California, we have carefully created two types of people in the legislature: right-wing nuts and left-wing nuts who hate each other. Every 10 years they get together and each side has two or three decent halfway moderate people and they join together in throwing them out. They identify those six or eight people - 'We don't want any normal people in our legislature' - and they gerrymander them out. This is the largest state in the most important country in the world, and that is the way our legislature works. How many of us are really doing anything about it? It is something.

Well, I have probably gone on long enough about some of the problems that you can see everywhere, and surely they are deep cognitive problems that affect the very smartest people in really major institutions. They are not easy to solve. I should close with are there any hopeful signs? Well, think about that for a minute. When the Chinese government had people starving by the millions, disaster, rebellion and so forth -- their ideas weren't working, their troubles were way worse than ours. That is what caused the change in China. The failure prompted the reform. Now, fortunately, they had a system where if the guy at the top got a good idea, he could change things. In our system that is not so simple. But at any rate, failure sometimes does cause significant reform, and lord knows we've had a lot of failure. As nearly as I can tell, we aren't going to get much legislative change.

Now if you take investment banking, I would say that is the part of the investment profession that has gotten the worst hatred. People are not that mad at private equity or conventional investment management, you know, for pension funds or private individuals. But you can cut the hatred against investment bankers with a knife. Somebody like Don Graham says he hasn't seen anything like it in his 40 years in Washington. I mean, the hatred is very extreme and the criticism [that] hurts the most is the criticism that is true. The truth of the matter is that some of this hatred is deserved and some of the hatred of the commercial banks is deserved. The commercial banks got too aggressive at flim-flamming people on credit cards and then they started loaning to people aggressively because they knew the accountants would let them report the income when they knew the guy had eight cards and was kind of kiting from one card to another. Well, how smart did you have to be to know that that was dangerous? They didn't care as long as they could report the income. They didn't care about the moral failure of flim-flamming and then when they started losing money, they would just flim-flam a little more to get more revenues. Is this the way a government assisted part of the banking system should behave? It was not only folly, it was sin.

By the way, you aren't supposed to talk about sin in economics, but sin has consequences. The world is a complex place and investment banks of course got into their share of sin. Particularly in the derivative trading and in the clients they took on and the lousy stuff they sold and so forth. Everybody regrets it, and there have been apologies from investment banking which of course were deserved. But, in essence, I don't think they feel that bad about it all. They think, 'Well, we are in a tough aggressive business, we've got to get ahead, we've got to provide opportunities for the young men who come to work here. If something is legally saleable, we have to sell it. We can't let the guy on the street make more money than we do.' These are the guys that had to win the games. Angelides said to one of the investment banks, 'You were like the guy who sold a car knowing the brakes were defective and then went out and bought life insurance on the guy to whom you had sold the car.'

This is not too attractive of a human activity. Well, of course, Angelides was right. The answer was, 'Yeah, well, we've got people in different departments. The department that does the selling wants to do everything that is legal and the department that controls the risk wants to be sure -- they don't even talk to each other. There is no sin here, we are just aggressive people each trying to do his own thing the best he can.'

The other helpful thing about our present condition is that in the past we've had rascals and fools. After their era, we've had the wonderful civilization that you and I can remember. Or at least a lot of us can remember. If you go back to the age of the robber barons, it's a very interesting age. Ambrose Bierce said of Collis P. Huntington, correctly: 'He was scrupulously dishonest and had no more soul than a shark.' That was a pretty accurate description of Collis P. Huntington, but he did create the toughest section of a big transcontinental railroad that we needed. Then, if you get into the investment banking manipulators of a former age, you get into Jay Gould and Russell Sage. They were unbelievable because they controlled railroads -- not for the purpose of earning money from freight, but for the purpose of pushing the railroad down artificially as they shorted the securities and then letting it go up and dumping the securities. They were just shucking suckers by manipulating the companies they were in charge of running. Somebody in Congress accurately described those two men. He said, 'When they are talking, they are lying and when they are quiet they are stealing.' We live in the aftermath of Russell Sage and Jay Gould. They are gone, and we've since had Thomas Edison and Henry Ford. We've had a lot of wonderful achievement and investment banking had a long phase when it behaved better than it has in the recent buildup to sin and folly, and so we can hopefully believe we will go back. We don't have anybody who operates exactly like Jay Gould and Russell Sage now that they are gone. Maybe what I am decrying now will -- maybe it too will pass. Thank you.

[Floor opens to questions from the audience]

QUESTION #1: [WHY DIDN'T THE GOVERNMENT LISTEN TO THE WARNINGS ABOUT DERIVATIVES FROM BROOKSLEY BORN AND WHY ISN'T THERE MUCH REFORM?]

MUNGER:
Brooksley Born has company. When they brought in the options exchanges there was one letter saying it was a dumb idea -- and it was from Warren Buffett. They didn't pay any attention to him, either. There was a lot of us they didn't pay any attention to. These are powerful forces and in human affairs you can't expect perfection. In a miasma of prosperity and gambling with $100,000 bills floating around like confetti, you can't expect people to behave as if they were in a monastery. That is not the way the world works and you can't expect human cognition to be all that good. So you are just decrying a fact of life. Of course, I have been decrying it in the same way. But you diagnosed it correctly.

I think [you are] right when [you] suspect not much that [you] want to happen is going to happen. Maybe we have two more of these messes ahead of us before things change. Not a pleasant thought.

QUESTION #2: [IS THERE A BETTER WAY TO MOTIVATE PEOPLE WHO ARE BELOW THE EXECUTIVE LEVEL TO DO A BETTER JOB GETTING QUALITY BUSINESS AS OPPOSED TO HIGH VOLUME?]

MUNGER:
The younger people are going to adopt to whatever the ethos is that suffuses the place. If you've got a Stanley O'Neal at the top that has to win, the ethos is going to be terrible. It's just that simple. The whole ethos of the place has to change for the behavior of the place [to] change down through the chain of command. By the way, you said it was greed that has caused all this, I think you've used the wrong word. It's envy. Envy is the great driver. One investment bank can't stand some other investment bank being bigger and better. Even though the guy is making $5 million a year, he can't stand it. It's envy. And envy was in the laws of Moses, you couldn't even covet your neighbor's donkey. I mean, those old Jews really knew it would cause a lot of trouble even among sheep herders. So you put it in the whole financial system and make it sacred and feed it so you have an envy driven miasma -- well, of course it's going to be a hell of a mess. The way to avoid envy to some extent was described by Aristotle. He said, 'People will adjust better if the perceived difference in outcomes in society are perceived as just.' Therefore, everybody that wants to help society be stable should have a duty to arrange everything, including his own compensation, [to] be perceived elsewhere as just. Well, all I can say is that if Aristotle were still alive, he'd be a grumpy old man because his message hasn't fully been assimilated yet.

QUESTION #3: [IS THERE A SPECIFIC REFORM YOU WOULD URGE TO BE ADOPTED?]

MUNGER:
Well, if I were running the world. If I were the Lee Kuan Yew of the United States, believe me I would know how to fix this. But, of course, nobody has that power, and if Lee Kuan Yew -- if he had been born here, [he] wouldn't have been able to do what he did in Singapore. I think the whole idea that we need massive legalized gambling in every hamlet of the world and that our system of capital allocation ought to have the most attractive and powerful legalized gambling of all sucking in more money -- the whole idea is obscene. I would change the laws so that all these people would have to do something else but that isn't going to happen. I don't think minor tinkering is going to change it all that much. And I think minor tinkering is all you are going to get.

I knew we'd have a hell of a mess eventually. I just didn't know when it was coming. I think I know eventually we will have a hell of an inflation mess, but I can't tell you when it is coming. It could be way in the future. But I think eventually you'll have it.

QUESTION #4: [RISK OF A LONG TAIL GEOPOLITICAL EVENT?]

MUNGER:
Something we came as close to as we came recently to real crisis is deadly serious. You have to remember that Germany during the Pax Britannica was a pretty respectable place, and in that place little Albert Einstein got his entire primary education from the primary schools of the Catholic Church and it was a pretty civilized place. With enough of an economic mess and enough chaos, a bunch of civilized Germans, half of them Catholic, ended up supporting Hitler and creating a barbarism and an evil that frankly makes you shiver in your seat as you remember it. So I don't think you should assume that a prosperous decent place like the one that educated little Albert in the Catholic schools is guaranteed to stay forever no matter what happens or how big the messes get. I think these things are serious and I don't think these things automatically fix themselves. I think that the good people have to join together the way we have all joined together in helping Harvard-[Westlake] School. There are other things that should be done in the world. I don't think we live in the type of world where it is at all responsible

not to participate in trying to fix some of these things as best we can. We have serious troubles and I know of the investment professionals I see in the room -- I probably know Howard Marks as well as I know anybody and he is a very smart man and I'd be interested in knowing -- Howard, have I overstated it or is it close to right?

HOWARD MARKS:
No, I think Charlie it is close to right. I think that the problems we've had have stemmed from human failings and they are never going to change. You can adjust here and there, and you can encourage and dissuade with regulation -- but the ability, for example, for greed to overcome morals and prudence, will never change.

MUNGER:
Well, I lived in a world for a long time where the behavior was better in finance and investment management -- and in investment banking, particularly. That world could come back. I don't think the present craziness is destined to be our lot. I think if this thing hadn't been checked, if it had just gone on and on and the mess had been greater -- in Japan, when they had their mess, the asset values were about three times higher than they were here in relation to GDP so their fall back, in terms of psychological feelings of net worth – and Japan got twenty years of stasis. But that's a homogenous nation of people who believe in courtesy and obeying authority. They are ideally suited by nature for just what they've had to endure and I don't think we are at all well suited for the kind of a mess they had. I don't think we should test our situation with more stupidity that causes results like that.

Who is talking about changing accounting? Who has blamed accountants for any of this? That is real cognitive failure. These guys have really failed the rest of us and they are proud of it. It's like Nietzsche's character who had a lame leg and said he was proud of it. They are proud of their dysfunction. It is quite serious when you have troubles and the people who do things are proud of their ignorance. We are talking about that exact kind of a thing. You want a world that elevates the right kind of people. You want a world where the Lee Kuan Yews get more power and the damn fools get less. I don't know how you get there but I have to bequeath that to a new generation. I tried to do the best that I can in my own time. I am not required to go on prattling like this when it makes some people hate me. I could be sitting on the country club porch. It isn't just the fun of doing this that brings me here, it's a feeling of duty.

QUESTION #5: HOW CATACLYSMIC DO YOU VIEW THE LONGER TERM FUTURE?

MUNGER:
Well, in the longer term future, there will be terrible messes as there have been in all of the reported past history of civilization. I don't think we get to a wonderful stage where all these cataclysms are past forever. I think we were very lucky that our cataclysms weren't a lot worse. Hitler could have supported the Jews in atomic energy instead of kicking them out. I mean, we could have had all kinds of different results that could have made our problems way worse. No, I would say it's probably in the nature of human civilization that there will be terrible cataclysms and I don't think you are going to have 500 years of perfect calm. Won't matter to me. [END]

[This transcript has been edited lightly for clarity]

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