First Quarter 2015 Commentary

Volatility returned to the stock market in the first quarter, as investors dealt with a number of concerns. These included the pace of global growth, the sharp fall in the price of oil, the strengthening dollar, and uncertainty of when the Federal Reserve will begin to raise interest rates. Over the course of the quarter, the Dow Jones Industrial Average experienced the highest number of daily swings of at least 1% since the fourth quarter of 2011.

In spite of this volatility, the S&P 500 finished the quarter with a small gain, advancing 1.0%. The Dow declined in price, marking its first quarterly decline since the first quarter of 2014. Nevertheless, the price decline was small, and dividends propelled the index to a total gain of 0.3% through the end of March.

Spring Is Inkwell's Favorite Season

Spring is always an exciting time of year. Sports lovers have the Masters golf tournament and Kentucky Derby to look forward to, the snow stops falling and the temperatures start rising, and all of us can look forward to spending a little more time outdoors. We too look forward to spring, but for a different reason: it's the time when Warren Buffett releases his annual letter to Berkshire Hathaway shareholders. The letter is a 20-page tribute to capitalism and is full of investing wisdom and sage advice, sprinkled with Midwestern wit and humor.

This year's letter was particularly momentous, because it marked the 50th anniversary of Buffett's control of Berkshire. To mark the occasion, Berkshire actually produced three letters this year. The report consisted of the usual letter containing Buffett's analysis of Berkshire's performance over the prior year, plus a bonus letter each from Buffett and Charlie Munger (Buffett's long-time partner and Vice Chairman of Berkshire) reminiscing on Berkshire's golden anniversary and looking forward to the next 50 years.

The first page of the letter shows the annual percentage change in Berkshire's book value and share price over the last 50 years. The overall gain in book value from 1964 to 2014 was 19.4% per year, which works out to an incredible total gain of over 750,000%. Berkshire's stock price has done even better than that, gaining 21.6% annually. While that per-year figure is only 2.2% higher than the gain in book value, due to the miracle of compounding, the aggregate gain for Berkshire's stock price was an astounding 1,826,163%—or nearly 2.5x that of book value.

Either of those numbers absolutely dwarfs the annual gain of the overall stock market during this period: the S&P 500, including re-invested dividends, gained 9.9% per year for an aggregate gain of only a little over 11,000%. We should note that this gain for the S&P 500 does not take into account any taxes, whereas the growth in Berkshire's book value completely accounts for the billions of dollars of corporate income taxes it has paid over the last five decades.

When Buffett took control of the company in 1964, Berkshire stock was trading at just over $11 per share. At the time of this writing, shares are trading hands at a little above $200,000.

Buffett's Formula

Instead of spoiling your fun and going into all the details of the letter (which you can—and should—read for yourself), we'd like to take a step back and examine how Berkshire has been able to grow from a mediocre textile mill to one of the most valuable companies in the world. We think there are six key components to its great success:

Snowball Effect
One of the main reasons Berkshire has been so successful is simply Buffett's long-standing tenure. Fifty years at the helm of a company is a long time, and if more good decisions than bad are made, it is a good bet that the power of compounding will produce a snowball effect in the value of the company. This is especially true if, as was the case with Berkshire, the company is managed for the very long term, and not with a focus on short-term results.

Float
Berkshire's biggest business is insurance. In the insurance industry, other people's money is known as float. For example, when you pay your auto insurance premium, the insurer collects the money up front but doesn't have to pay it out as a claim until later. In the meantime, the company holds on to this "float" and is able to invest it in stocks, bonds, or other securities. This float has provided billions and billions of dollars to Berkshire and has been the ammunition Buffett has used to diversify Berkshire into a number of businesses with different economic characteristics. Float at Berkshire is currently running at close to $84 billion.

De-centralized Management
Berkshire has more than 50 subsidiaries, employing close to 350,000 employees. A typical company that size would have hundreds, if not thousands, of employees at headquarters, and it would have the typical departments such as Human Resources, Legal, Marketing, Investor Relations, etc. Berkshire Hathaway has 25 headquarters employees and not one of those departments. This de-centralized structure works well at Berkshire, since managers of the subsidiaries are basically CEOs with complete control of their operations. This autonomy is important both in attracting more businesses to the Berkshire fold and in incentivizing managers to have a long-term mindset as they seek to do the best for the parent company.

Lifelong Learning
Buffett learned about investing from Benjamin Graham. Graham espoused a philosophy of investing in low-quality companies that were trading at bargain prices. Buffett called these types of companies "cigar butts": even though they were disgusting and soggy, there was still one free puff left. While this is an entirely intelligent way to conduct an investment enterprise, the problem with this strategy is that you cannot use it to invest very large sums of money. That all changed when Buffett met Charlie Munger. Munger convinced Buffett that it was better to buy good companies at fair prices than fair companies at good prices. The Buffett/Munger multi-decade partnership has been one of mutual trust and admiration and has been one of the most successful partnerships in the history of corporate America.

Rational Capital Allocation
Capital allocation is arguably the most important job of a CEO. Should profits be used to re-invest in the business? Buy other companies? Pay dividends? Buy back stock? Deciding on these choices is a matter of opportunity cost and price paid. In our opinion, most CEOs make their capital allocation decisions by looking at what their competitors are doing and then doing the same. Buffett has shown a remarkable ability to act rationally in deciding how to best utilize Berkshire's capital, the best example of which was getting Berkshire out of the dying textile business and into the insurance industry. And while he's very good at it, he's certainly not infallible. He has made mistakes in allocating capital over the years, but they are generally few and far between.

Partnership Mentality
The most important over-riding factor in our mind, and the one that brings all the other elements together, is that Buffett sincerely treats his shareholders as if they were his partners. There is no egregious compensation at Berkshire; Buffett pays himself $100,000 a year, board members get no compensation to speak of, and there are no option grants. Bad news is communicated fast and all shareholders, big and small, are given the same information at the same time.

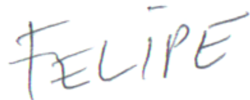
One Of a Kind

The story of Berkshire Hathaway has been one of unparalleled success. In most walks of life, especially in those dealing with money, copycats quickly surface to imitate successful enterprises. But that has not been the case with Berkshire. There are very few companies that have attempted to duplicate Berkshire's model.

So why has its model not been copied by a myriad of companies? It is an interesting question with no clear answer. While Buffett's model is simple, it might not be easy. CEOs nowadays are pressured to optimize their performance quarter in and quarter out. Sometimes what's best for a company in the long run, though, will necessitate some short-term pain, but CEOs are loathe to take on such tasks and put their sizable short-term incentive compensation at risk. Buffett also has the luxury of owning a significant amount Berkshire shares, eliminating the risk of being targeted by activists or being fired after a quarter or two of disappointing results.

Whatever the case may be, though, if we ever find a company that shows the characteristics that Buffett has employed for the last 50 years, you can be sure we will investigate it further. Investing in the "next Berkshire Hathaway" is the dream of every investor.

Sincerely,



Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC