<u>Second Quarter 2012 Commentary</u>

"It's déjà vu all over again" —*Yogi Berra*

This past quarter seemed eerily similar to last year's third quarter, when economic worries, particularly those coming from Europe and China, dominated the news. In last fall's quarterly commentary we had this to say:

> *July through September was surely an interesting three months, with no dearth of negative news regarding economic worries in the U.S. and abroad. Let us enumerate the concerns. The U.S. fiscal deficit. Dysfunction in Washington. ... Europe's debt problems. The possibility of a double-dip recession. Slowdown in the Chinese growth machine.*

Today, we can basically say the same.

For the last few months, we have had a sort of tug of war in the equity markets. On the negative end of the rope, we have a recession in parts of Europe, uncertainty of whether Greece will remain in the euro currency union, worries about the state of many European banks, concerns about the debt situation in Spain, and the looming fiscal cliff in the U.S. On the other side of the rope, stocks are moderately cheap, with low expectations priced in. Additionally, the economic situation in the U.S., while not great by any means, is in much better shape than in many parts of the world. As a famed hedge fund manager has said, the U.S. equity market offers "the best house in a bad neighborhood."

This resulted in quite a wild finish to the quarter. On June 6 and June 12, the Dow Jones Industrial Average gained 287 points and 163 points, respectively. These gains were nearly matched by declines of 143 points and 251 points on June 11 and 21. Then, in a flurry of buying activity on the final day of the quarter, the Dow gained 278 points or 2.2%, while the S&P 500 advanced 2.5%. After all was said and done, the S&P finished the quarter with a loss of 2.75%, reversing a portion of the first quarter's strong gains. The Dow had a better showing, declining 2.51%.

Pilgrimage to Omaha

In May, we attended the annual Berkshire Hathaway shareholders' meeting in Omaha, Nebraska. Berkshire's CEO and chairman, Warren Buffett, is arguably the greatest investor in history, and we always look forward to our annual pilgrimage to the Midwest to hear his thoughts.

This year, as always, Mr. Buffett and his vice chairman Charlie Munger, held forth for about six hours, answering questions from shareholders and analysts. The discussion ranged over dozens of topics, from the largest ideas (such as the European financial crisis) to the smallest details (such as an insurance subsidiary's profit anomaly in the fourth quarter). Here is a brief description of some of the more interesting topics that were covered:

Hale and Hearty

After the 81-year old Mr. Buffett announced earlier this year that he has Stage 1 prostate cancer, shareholders have been understandably concerned. His prognosis is good, though, and he should pass through his prescribed treatment later this summer. The actuarial tables estimate that he'll be with us for at least another five years, which gives him plenty of time to continue to put our money to work.

Facebook

The Berkshire meeting took place a few weeks before the ill-fated Facebook IPO, and Mr. Buffett expressed no desire whatsoever to buy any shares. In fact, he said that he would stay away from any investment which carried with it a high salesman's commission. This would include shares of an IPO (for which the investment bankers are paid about 5%) or variable annuities (which typically charge about 7%).

Gold

Asked about another popular investment of the moment, Mr. Buffett did not express any enthusiasm for gold, either. As a commodity of little to no commercial use, gold is basically a physically attractive, though non-productive, asset. Mr. Buffett said that he would "bet his life" that productive assets (such as stocks or even farmland) would out-perform gold over the next 50 years.

Simple, yet Difficult

His remarks on Facebook and gold were part of several comments on a similar theme throughout the day; namely, investing is simple. That is not to say that investing is easy. Far from it. Investing is a constant and difficult struggle to find ways to prudently protect and grow one's capital. But the framework on which those capital allocation decisions are based is a simple and straightforward one: "If you make your buy and sell decisions based on what a business is worth, you'll make money."

Cash Cow

And what sums of money has Berkshire made recently! Currently sitting on more than $175 billion in cash and investments, with more than $10 billion streaming through the front door each year, Berkshire has lots of capital to deploy. Fortunately, there are several ready uses which were highlighted at the meeting. MidAmerican, the utility subsidiary, will be able to put up to $100 billion to work over the next ten to fifteen years. Total capital expenditures came in at just over $8 billion in 2011 and—with the railroad subsidiary Burlington Northern having to provide upkeep for its 23,000 miles of track, 13,000 bridges, 7,000 locomotives, and 79,000 cars—should probably continue to grow. Management is always on the lookout for sensibly priced investments and acquisitions. Just last year, over $10 billion was used to buy a large equity stake in IBM. And finally, about $20 billion of Berkshire's current cash holdings is earmarked to be used in a particularly novel way….

Stock Buyback
For the first time in its history, last fall Berkshire began buying back its own stock on the open market. Mr. Buffett considers his shareholders as his partners, so he views this as akin to buying out the interest of one of his partners. Though he is loath to under-compensate a former partner for his share of the business, the economics are so compelling that it would pain him even more not to purchase such a cheap investment. Berkshire will only buy back shares when they are trading at 110% or less than their book value, and Mr. Buffett indicated at the meeting that even that 110% figure "dramatically" understates Berkshire's actual value.

Berkshire Hathaway Re-Visited

We have been enthusiastically optimistic about Berkshire Hathaway shares for quite some time. Our enthusiasm was only reinforced by our trip to the shareholder meeting. To make sure that our enthusiasm is not due to psychological biases such as commitment & consistency[1] and social proof[2], we revisited our investment thesis and valuation work on Berkshire upon our return from Omaha. We again came to the conclusion that shares in the company currently offer a very attractive investment opportunity, and that is why we are happy to hold a substantial investment in Berkshire in your account.

Since Berkshire is such an important position in your portfolio, we want to share our analysis of the company, which appears below.

Company Description
Headquartered in Omaha, NE, Berkshire Hathaway (BRK) is a holding company owning subsidiaries engaged in a number of diverse businesses. These businesses include: insurance (*GEICO*, *General Re*, *Berkshire Hathaway Reinsurance Group*); railroads (*Burlington Northern Santa Fe*); utilities (*MidAmerican Energy Holdings*); manufacturing, service and retailing (*Marmon*, *McLane*, *Fruit of the Loom*, *Benjamin Moore*, *Shaw Industries*, *Lubrizol*, *NetJets*, *Nebraska Furniture Mart*, *International Dairy Queen, See's Candies*); and financial products (*Clayton Homes*, *XTRA*, *BH Finance*). The company, as part of its insurance operations, owns substantial stakes in a number of publicly-traded companies (13% of American Express, 8.8% of Coca-Cola, 5.5% of IBM, 7.6% of Wells Fargo, 1.1% of Wal-Mart, among others). The company employs more than 270,000 persons world-wide, and revenues for 2011 were $143.7 billion.

Investment Thesis
<u>Warren Buffett:</u> Mr. Buffett is arguably the best investor of all time. Since he took control of the company 47 years ago, BRK's book value per share has increased from $19 to $99,860 or 19.8% compounded annually. During this same time frame, the S&P 500 (with dividends reinvested) has compounded at an annual return of 9.2%. If BRK would have matched the S&P's return, it would have a book value of around $1,200, instead of $99,860. Buffett manages the

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[1] The commitment and consistency bias refers to the tendency of people to act consistently with their own words, beliefs, and attitudes.
[2] Social proof, sometimes called herd mentality, refers to the psychological bias where people assume that the actions of others reflect correct behavior.

company as a partnership, where he considers all shareholders as his limited partners. All decisions are made to improve long-term shareholder value, and not to appease the short-term mentality of Wall Street. To top it all off, we get Buffett's services for almost nothing, as he earns a salary of only $100,000 per year and receives no options.

Low-Cost Float: Insurance is BRK's most important business. This business currently holds just over $70 billion of float. Float is money that does not belong to the company, but that the company gets to invest for its own benefit before it has to pay the money out in claims. Think of your car insurance—you pay your premiums, but you may not receive any of it back if you do not have an accident for many years. If BRK pays out less in losses and expenses than it receives in premiums, the company generates an underwriting profit, meaning that the float costs less than nothing. BRK has had nine consecutive years of underwriting profits.

Moat: Many of BRK's businesses possess an economic moat (i.e., a sustainable, competitive advantage) that will increase earnings power for many years or even decades to come. These moats come in different varieties: economies of scale (insurance, Shaw Industries), brand quality (See's Candies), low cost operator (GEICO), etc.

Fort Knox Balance Sheet: BRK generates close to $1 billion of cash per month. With assets of just under $400 billion, equity of about $165 billion, and cash of close to $40 billion, BRK's balance sheet is unparalleled. A check from BRK will have no problem clearing. While Buffett will always maintain a minimum of $20 billion in cash, BRK's cash generation provides him with the ability to take advantage of opportunities, especially when there is panic in the markets (e.g., Buffett invested close to $50 billion during the 2008 downturn).

Stock Buyback Program: BRK's recently announced buyback program is an unprecedented and explicit message from Mr. Buffett that the stock is substantially undervalued. The buyback should provide a long-term floor on the price of the stock.

Valuation

Two-Column Approach: Separate the insurance business from the operating companies. Value the insurance business based on cash and investments and the operating companies based on a multiple of operating income. Cash and investments per share are $98,366. Operating income per share is just under $7,000. Assigning a 12x multiple to operating income and adding cash and investments yields an estimate of intrinsic value (IV) of just over $182,000 per A share. This is equivalent to $121.50 per B share.

Float = Equity: In his 1995 letter to shareholders, Buffett said, "Since our float has cost us virtually nothing over the years, it has in effect served as equity." Adjusting book value to exclude intangible assets and to include investable float, we can arrive at an appropriate multiple of "price to tangible equity plus float" (P/TE+F). Since the GenRe acquisition in 1998, P/TE+F has fluctuated from just under 1.0 to 2.0. We calculate tangible equity to be $111.6 billion and float to be $70.6 billion. This equates to $110,375 in TE+F per A share. Assigning a multiple of 1.5x P/TE+F yields an estimate of IV of around $165,500 per A share, or $110 per B share.

Risks/Caveats

Succession: Buffett will turn 82 in August. A post-Buffett BRK will be a less attractive company than a Buffett-led BRK. When Buffett retires or dies, his Chairman post will be given to his son Howard, who will serve as non-executive Chairman. His CEO duties will be divided in two: (1) an "operations" CEO, who has not been named, but whose name is known by the Board, and (2) a small number of investment officers, two of which have already been named (Todd Combs and Ted Weschler) and currently manage a portion of BRK's portfolio.

Double-Dip Recession: Would affect Berkshire's earnings, as many of its businesses are economically sensitive, especially those that are related to the housing market.

Conclusion

Charlie Munger, in his characteristic curmudgeonly manner, commented at the Berkshire annual meeting, "Investing is not easy. If you think it's easy, you're stupid." After two consecutive quarters of seemingly easy gains, this past quarter made many people seem stupid. We do not know how the situation in Europe will materialize, and we expect this uncertainty to result in continued volatility in the market. As long-term investors, we will continue to look to take advantage of this volatility and the short-term thinking of most market participants to buy world-class businesses selling at attractive prices.

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