Second Quarter 2014 Commentary

The stock market continued its upward trajectory in the second quarter. The Dow Jones Industrial Average grew 2.8%, and the S&P 500 index went up 5.2%. This marks the sixth consecutive quarterly advance for the S&P, putting us in rather rarefied territory. Going back to 1870, there have only been 6 occasions when the S&P's quarterly growth streak lasted longer than the current one: twice it grew for seven consecutive quarters (1944-46 and 1949-51), once for ten (1953-56), once for eleven (1962-65), and twice for fourteen (1926-29 and 1995-98).

The streak will surely end at some point, but no one knows when. And no one knows how steep or prolonged the decline will be on the other side of the peak. Not even Warren Buffett himself.

The Oracle of Omaha

Speaking of whom, we once again made our annual pilgrimage to Omaha, Nebraska during the second quarter. The Berkshire Hathaway shareholder meeting is held there each May, and we always try our best to attend. Mr. Buffett is arguably the greatest investor this world has known, and he is generous in sharing his wisdom and intelligence. Though his sermons are usually the same from year to year, we believe that exposing ourselves to his doctrines from time to time is a strong preventive measure from getting swept up in the folly of the rest of the market.

Another highlight of our investment calendar is the annual letter that Mr. Buffett writes to Berkshire Hathaway shareholders. Examining this year's letter, one cannot help but be impressed by what Buffett has accomplished in his 49 years of managing Berkshire.

Berkshire Hathaway is one of the largest holdings in your portfolio. It is a conglomerate which owns subsidiaries engaged in insurance (*GEICO*, *General Re*, *Berkshire Reinsurance*), electric utilities (*MidAmerican Energy*), railroads (*Burlington Northern Santa Fe*), candy (*See's Candies*), flight training services (*FlightSafety International*), building products (*Shaw Industries*, *Acme*, *Benjamin Moore*), retailing (*Nebraska Furniture Mart*, *Star Furniture*), fine jewelry (*Borsheim's*, *Helzberg Diamonds*, *Ben Bridge Jeweler*), jet fractional ownership (*NetJets*), newspapers, etc. The company also has large stakes in a number of public companies (14% of American Express, 9% of Coca-Cola, 6% of IBM, 9% of Wells Fargo, 2% of Wal-Mart, and 5% of US Bancorp, among others).

In 2013, Berkshire increased its book value per share by 18%. That may not seem like much when compared to the 30+% gain of the S&P 500, but considering that Berkshire is a $200+ billion behemoth, that is pretty good. Berkshire's increase in book value last year was a grand total of $33 billion, which is almost exactly equal to the book value of Carnival Corporation's properties. In other words, Berkshire's 2013 gain of "only" 18% was about equal to 100 cruise ships, give or take.

Here are some highlights for the year:

- Spent almost $18 billion in two large acquisitions: all of NV Energy and a major interest in H.J. Heinz.
- Spent $3.1 billion in 25 smaller, bolt-on acquisitions.
- Berkshire's main business—insurance—had an underwriting profit for the 11th year in a row, earning $3 billion.
- Berkshire's five largest non-insurance businesses—MidAmerican, Burlington Northern Santa Fe, Iscar, Lubrizol, and Marmon—had a record $10.8 billion of pre-tax earnings.
- The many dozens of smaller non-insurance businesses earned $4.6 billion pre-tax.

The Same, But Different

One thing that strikes us as remarkable about Berkshire is that of the five largest non-insurance businesses, only one—MidAmerican—was owned by Berkshire nine years ago. We went back and looked at the annual reports since 1980 to examine the sources of income at Berkshire during that time. What we found is a company that, while always having a big insurance operation as its backbone, has done an amazing job at diversifying into new areas of business.

Let's take a look. Here are Berkshire's main sources of earnings for 1980:

Earnings Before Tax		
(in thousands of dollars)		**1980**
Insurance Group:		
Underwriting	$	6,737
Net Investment Income	$	30,927
Berkshire-Waumbec Textiles	$	(508)
Associated Retail Stores	$	2,440
See's Candies	$	8,958
Buffalo News	$	(1,672)
Blue Chip Stamps - Parent	$	4,588
Illinois National Bank	$	5,200
Wesco	$	1,392
Mutual Savings and Loan	$	2,775
Precision Steel	$	1,352
Interest on Debt	$	(9,390)
Other	$	1,590
Total	$	54,389
Source: Berkshire Hathaway 1980 annual report		

A couple of observations arise from the above table:

- While many of the businesses from 1980 are still in the Berkshire umbrella, only insurance is still a substantial business for Berkshire

- Blue Chip Stamps was the third-largest source of non-insurance income in 1980. What in the world is Blue Chip Stamps, you ask? It was a loyalty program for customers, similar to discount cards issued by pharmacies and grocery stores today. A customer making a purchase at a participating store would be given stamps in proportion to the size of the purchase. The customer would paste the stamps into books which could then be redeemed for merchandise at a special store. Blue Chip had sales of $126 million in 1970, $19.4 million in 1980, and $1.5 million in 1990. In 2006, revenues were $25,920 (yes, twenty-five *thousand*).

Here are Berkshire's main sources of earnings for 1990:

Earnings Before Tax		
(in thousands of dollars)		**1990**
Insurance Group:		
Underwriting	$	(26,647)
Net Investment Income	$	327,048
See's Candies	$	39,580
Buffalo News	$	43,954
Wesco	$	12,441
Interest on Debt	$	(76,374)
Other	$	58,309
Fechheimer	$	12,450
Kirby	$	27,445
Nebraska Furniture Mart	$	17,248
Scott Fetzer Manufacturing Group	$	30,378
World Book	$	31,896
Amortization of Goodwill	$	(3,476)
Other Accounting Charges	$	(5,951)
Shareholder-Designated Contributions	$	(5,824)
Total	$	482,477
Source: Berkshire Hathaway 1990 annual report		

From the above table we can see that ten years later Mr. Buffett added a number of businesses in a variety of industries to the Berkshire family. Manufacturing and furniture retailing became significant sources of earnings for Berkshire.

One other curious fact is that World Book Encyclopedia generated almost $32 million of operating earnings in 1990. We all know what happened to that business after the invention of the Internet.

Here are Berkshire's main sources of earnings for 2000:

Earnings Before Tax	
(in thousands of dollars)	**2000**
Insurance Group:	
Underwriting	$ (1,585,000)
Net Investment Income	$ 2,747,000
Scott Fetzer Manufacturing Group	$ 122,000
Finance and Financial Products	$ 556,000
Flight Services	$ 213,000
MidAmerican Energy	$ 197,000
Retail Operations	$ 175,000
Other	$ 264,000
Interest on Debt	$ (92,000)
Other Accounting Charges	$ (881,000)
Shareholder-Designated Contributions	$ (17,000)
Total	$ 1,699,000
Source: Berkshire Hathaway 2000 annual report	

By the year 2000, Berkshire had so many subsidiaries that the company stopped listing them all separately in its reports. The Retail Operations category now included not only Nebraska Furniture Mart, but also R.C. Willey Home Furnishings, Star Furniture, Jordan's Furniture, Borsheim's, Helzberg Diamonds, and Ben Bridge Jeweler.

It's All About the Float

How has Berkshire managed to grow so much in the last 5 decades? While there are many factors that explain Berkshire's success—from luck to savvy investments—there is one factor that is all-important: float.

So, what is float? Insurers receive premiums upfront and pay claims at a later time. Think of buying car insurance: you pay your premiums in, and the insurance company holds onto that money until you eventually have an accident and file a claim. This business model leaves insurance companies holding large sums of money—float—that will eventually go to policyholders. Meanwhile, insurers get to invest this float for their own benefit.

Mr. Buffett's genius was realizing, very early in his career, that he could use this float to buy other businesses. In 1967, he purchased National Indemnity for $8.6 *million*. In 1970, he began investing in Blue Chip Stamps, another business characterized by generating float. (By the way, can you think of any other float-generating businesses? How about American Express travelers' checks? People buy traveler's checks upfront to use at a later time.) The float generated by those businesses allowed Mr. Buffett to make to other purchases, starting a snowball effect that has culminated in today's conglomerate. Float at Berkshire now stands at more than $77 *billion*.

Below is the growth in Berkshire's float, since 1970:

Year	Float (*in millions*)
1970	$39
1980	$237
1990	$1,632
2000	$27,871
2010	$65,832
2013	$77,240

Source: Berkshire Hathaway 2013 annual report

That's quite a big snowball.

Conclusion

Since 1964, when Mr. Buffett took control of Berkshire, book value per share has grown from $19 to $134, 973. That is a rate of 19.7% compounded annually. The price of the stock has increased similarly, increasing from the low teens to its current price of around $190,000 (for the class A shares). While Berkshire's future success will be much more muted due to its bigger size, there is no question that Berkshire's scale and strong financial position will continue to generate significant profits for many decades to come, and we are quite happy to have it as one of our clients' largest holdings.

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Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC