Third Quarter 2011 Commentary

"May you live in interesting times." —Chinese curse

We were reminded of the above Chinese proverb in the third quarter. 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. The first-ever downgrade of U.S. government debt by Standard & Poor's. Europe's debt problems. The possibility of a double-dip recession. Slowdown in the Chinese growth machine.

Reacting to all this uncertainty, equities declined sharply, with the Dow Jones Industrial Average falling about 12%. This marked the largest quarterly percentage decline for the Dow since the first quarter of 2009. The broader S&P 500 index did no better, showing a loss of 13.9%. Mutual funds investing in equities performed even worse. According to Thomson Reuters' Lipper unit, the average diversified U.S. stock fund declined 16.7%.

In one stretch in late July and early August, the Dow suffered eight straight losing sessions. One more losing day and it would have marked the first time that has occurred since 1978. In fact, the Dow has fallen nine or more days in a row only ten times in its 115-year history.

Enjoy the Rollercoaster

The decline in equities came amid wild and unprecedented volatility. In August, for the first time ever, the Dow moved by more than 400 points in four consecutive days. This quarter, the Dow experienced its 6th, 9th, and 11th worst days (by points) since 1899 (yes, the 19th century!) with point declines of 635, 520, and 513 points, on August 8, August 10, and August 4, respectively. On the other hand, the Dow had its 10th and 11th best days (by points) after enjoying gains of 430 and 423 on August 9 and August 11.

While the volatile market behavior may be nerve-racking and gut-wrenching to speculators and traders, we, as long-term investors, are not bothered. As we mentioned in our August 8 memo ("Market Fluctuations"), we view investing not as the arbitrary trading of slips of paper, but as the part-ownership of actual businesses. "Mr. Market" is a very emotional fellow and he exists to serve us, not to guide us. We never cease to be amazed by the impact of fear and greed in the market. And when fear is rampant, speculators and traders sell first and ask questions later.

Many market participants have exited equities for the safety of U.S. Treasury bonds, despite yields that are at historic lows. The search for safety has lowered the 10-year U.S. Treasury note to a yield below 2%—a level not seen since the 1940s. We believe this buy-U.S. Treasuries-at-whatever-price behavior is a mistake.

We cannot comprehend why anyone would want to lock in a return of less than 2% for ten years, when you can buy quality companies offering solid dividend returns of more than 3.5%. Buying a 10-year U.S. Treasury note will most likely produce a negative real return (after taking inflation into account). On the other hand, companies such as Johnson & Johnson, Nestle, Procter & Gamble, PepsiCo, and Microsoft—to name just a few—are all offering yields higher than the yield on the 10-year U.S. Treasury, and those dividends will most certainly rise over time.

We have no idea what the market is going to do in the next week or next month or next year (and we don't think anyone else has any idea either). We also do not have a strong opinion on whether the U.S. economy will enter a double-dip recession. Intelligent observers disagree on this point. The Economic Cycle Research Institute says that it is very probable that we will enter one. On the other hand, Warren Buffett, after reviewing the recent performance of Berkshire Hathaway's 70-some businesses (jewelry sales, railroad car loads, furniture sales, etc.) does not see evidence of the U.S. entering a double-dip recession. In fact, several Berkshire subsidiaries are on their way to record sales and profits in 2011.

We think a more important consideration in whether to buy equities is the current valuation level and what is priced into stocks. As of this writing, the stock market is trading at about 75% of the last reported gross domestic product (GDP). This very simple valuation metric for the market as a whole has proven to be a good predictor of future returns. In 1999 and early 2000, the market was trading at about 200% of GDP, suggesting that the market was very expensive. We know what happened then.

The current level of valuation is an attractive one. In late 2001, Warren Buffett, in an article for Fortune magazine, wrote, "If the percentage relationship falls to the 70% or 80% area, buying stocks is likely to work very well for you. If the ratio approaches 200%—as it did in 1999 and a part of 2000—you are playing with fire."

Berkshire Hathaway's Eventful Quarter

Berkshire Hathaway, one of the largest holdings in your account, had an eventful third quarter to say the least. The three most significant events were a $5 billion investment in the ailing Bank of America, the appointment of another investment manager to oversee Berkshire's billions, and the announcement that Berkshire will buy back its own stock.

Buffett Signals That the Stock is Massively Undervalued

First and most important is the buyback. Berkshire announced on September 26 that it will repurchase, on the open stock market, its own shares up to a price equal to 110% of book value, in the belief that Berkshire's stock is "worth considerably more than this amount." We are in agreement that Berkshire's intrinsic value is considerably more than 110% of its book value, which is why we have made it one of your largest holdings.

Only once before in Berkshire's history has it announced its intention to buy back its own stock. This occurred in March 2000, at the height of the Internet bubble, when Berkshire's stock was trading at 109% of book value. Over the ensuing 12 months, Berkshire stock increased by 73% at a time when the overall market declined by 12%. We have no idea if a similar level of out-performance will accompany the current announcement, but we have confidence that there will at least be some out-performance.

So how big could this buyback be? Based on its per-B-share book value of $67.34, 110% of book value would be $74.07. At any price less than that, Berkshire is prepared to buy in as much stock as it can so long as its cash balance does not go below $20 billion. With $47.9 billion on hand, that is $27.9 billion that Berkshire could use to retire its stock. This is slightly larger than Berkshire's largest-ever acquisition (Burlington Northern for $26.5 billion) and equivalent to 377 million B-share equivalents, 251 thousand A-share equivalents, or about 15% of Berkshire's total shares outstanding (the ratio of B shares to A is 1,500:1). We would note that all of this math is based on Berkshire's financial statements as of June 30, 2011. As a living, breathing corporation, Berkshire's cash balance and book value are changing every day, and the trend for both is up.

Buffett May Not Stick Around Forever?

The second most significant announcement in the quarter is that Berkshire has hired Ted Weschler as a second investment manager, in addition to Todd Combs who was hired in 2010. Mr. Weschler brings a wealth of expertise not only in the investment management field, but also in private equity and in the actual management of companies. With Mr. Buffett recently turning 81, Mr. Weschler's deep level of business acumen will surely come in handy for Berkshire shareholders. Given that he is a relatively spry 50, we hope that he has many more productive years—no, decades—ahead at Berkshire.

One telling comment from the press release announcing Mr. Weschler's arrival is the beginning portion of the following phrase (our underline added): "<u>After Mr. Buffett no longer serves as CEO</u>, Todd and Ted … will have responsibility for the entire equity and debt portfolio of Berkshire." This is the first-ever public indication that Mr. Buffett has given that he may one day retire from his CEO role before his death. Up until now, he had always claimed that he wanted to "manage the company by séance" after his death.

"Déjà vu all over again"

Finally, Berkshire announced in August that it would purchase $5 billion worth of perpetual preferred stock of Bank of America with an annual dividend payment of 6%. As an added bonus, Bank of America is throwing in warrants for Berkshire to be able to buy 700 million shares of its common stock at $7.14 each. These warrants could end up being worthless (if Bank of America stock does not appreciate above $7.14 before they expire), or they could end up becoming enormously valuable. If Bank of America recovers to its 2011 high of $15 before they expire, these warrants would then be worth $5.5 billion in pure pre-tax profit to Berkshire.

This deal is reminiscent of deals made by Warren Buffett during the financial crisis in 2008. Back then, Berkshire made similar $5 billion preferred stock investments in Goldman Sachs and General Electric. In a sense, this deal is not as good as those back then; Berkshire is getting a 6% return versus a 10% return in 2008. Nevertheless, the current environment is not remotely as dire as three years ago. On the other hand, Berkshire got a better deal on the warrants this time around, with an expiration date ten years in the future, instead of the five years postulated by the previous deals.

The bottom line is the following: a deal like this—a multi-billion dollar transaction made in a moment's notice—cannot be made by anyone but Warren Buffett. This is made possible by Berkshire's Gibraltar-like balance sheet and by Buffett's patient, but opportunistic, behavior. This is a good deal for Berkshire Hathaway shareholders, as the company is able to deploy a substantial amount of cash earning a reasonable return. The warrants are icing on the cake, giving Berkshire the opportunity to make a significant amount of money when the financial environment improves.

Conclusion

On a personal note, we want to announce the birth of Isaac Clifford Byrd. Born on August 11, Isaac (which comes from the Hebrew word for "laughter") is Kari and Aaron's first child. He came in at a strapping 8lb 11oz. The new parents couldn't be happier. Aaron reports that he puts the baby to sleep by reading annual reports to him. One can never start learning about businesses too early.

Thank you for your continued interest, confidence, and support. We look forward to reporting to you again in three months.

Sincerely,

Felipe

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