Second Quarter 2018 Commentary

After taking a brief breather in the first quarter, the stock market continued to climb a wall of worry during the second quarter. Looking at the headlines of political turmoil in Washington, trade wars abroad, and relatively anemic economic growth, one might guess that the stock market would not fare so well. To the contrary, the S&P 500 advanced a healthy 3.4% during the April-June period and, as of the time of this writing, is up a further 2.7% already in July. The Dow Jones Industrial Average has lagged those numbers a bit, posting a 1.3% increase for the quarter.

Technology shares continue to lead the market in a big way. During the second quarter technology-related stocks accounted for slightly *more than 100%* of the overall market's gain. In other words, stocks not in the technology sector posted an aggregate loss for the quarter. In fact, just six stocks—Facebook, Amazon, Apple, Netflix, Alphabet, and Microsoft—were responsible for 98% of the S&P 500's return in Q2, which means that the other 494 stocks barely accounted for anything.

The highlight for Inkwell Capital's second quarter was, as it usually is, our annual trip to Omaha, Nebraska, to attend the Berkshire Hathaway shareholders' meeting led by CEO Warren Buffett. We continue to attend this meeting each year, primarily because it's a fruitful time of rejuvenation in our value investing doctrine, but also because it's helpful to hear what the world's greatest investor has to say about the issues of the day. Below we share what we consider to be the most interesting comments from the meeting.

A Lesson in Compounding

Unlike most years when Buffett immediately jumps into answering questions at the start of the meeting, this year he had a small preamble prepared. He showed copies of the front pages of the New York Times from March 10-12, 1942. Why did he choose those particular dates? On March 11, 1942, an 11-year old Buffett made his first purchase of stock, buying 3 shares of preferred stock of Cities Service. If you're like us, you've probably never heard of Cities Service before this anecdote, but back in the day the company was a pretty big deal. Its former headquarters in New York City, when completed in 1932, was the world's third-tallest building after the Empire State and Chrysler buildings.

But back to those historical New York Times newspapers. The headlines of the day were dire: most were about the difficulties the Allies were having waging war on the Pacific during World War II. Buffett made the point that it would have been a big mistake if an investor had focused on those grim headlines and, instead of investing in the stock market, had put his money in a "safe haven" like gold. A $10,000 investment in an American stock index fund on March 11, 1942, would today be worth $51 million. That same $10,000 would have bought you 300 ounces of gold back then and would now be worth just $400,000.

An increase from $10,000 to $51 million in one man's investing lifetime is nothing to sneeze at and is a clear example of the power of compounding. Buffett believes that American business will continue to do well over time and will be able to overcome our modern difficulties just as it did in 1942 (and 1968, and 1974, and 1980, and 2001, and so on).

On Apple

Berkshire owns about 5% of Apple, currently worth more than $40 billion, so it was not surprising that the tech company came up a few times during the meeting. Buffett commented that the main reasons he bought the stock were the strength of the Apple ecosystem and his belief that the ecosystem will remain strong for a long time due to continued customer loyalty.

On the issue of companies buying back stock, Buffett noted Apple's $100 billion buyback. He loves the idea of having Berkshire's 5% stake in Apple increase to 6% or 7% without him having to lay out a dime, just by the nature of the buyback. And he would prefer for the stock price of Apple to remain low, so that the $100 billion will be able to buy back more shares.

On Cryptocurrency

Cryptocurrency is the investment craze of the day, so Buffett and Munger were bound to get a question on bitcoin and its brethren. Buffett is not a fan of non-producing assets, like cryptocurrency or gold, where a successful investment depends on another person eventually paying more for it than you did. On the other hand, a productive asset, such as a rental property or a business (and its stock) produces cash flow that generates a return as one holds it. In the end, Buffett thinks that the cryptocurrency mania will end badly. Munger was even more blunt, saying: "I like cryptocurrencies a lot less than you do. To me, it's just dementia. It's like somebody else is trading turds, and you decide you can't be left out."

On Insuring Against a Cyber Attack

Insurance is the main business at Berkshire Hathaway. Buffett believes there is a 2% probability of a $400 billion super catastrophe happening in any given year. And the big unknown in this field is the risk of a massive cyber attack. When pricing hurricane or earthquake policies, Berkshire has a general idea of the probability of events happening, due to history and weather patterns. Cyber risk, on the other hand, is a big unknown, so they are very careful in how they approach this business. Buffett believes that Berkshire, due to its financial strength and stronger risk controls, is in a better position to insure against cyber calamities than any other company in the field of insurance.

On Wells Fargo

Wells Fargo is another major investment of Berkshire, with the company owning more than $20 billion of the bank's stock. The investment has been a poor performer as of late, with the bank facing fines and restrictions from regulators due to the company misleading customers and opening accounts without consent. Buffett said that what happened at Wells Fargo shows the power of having the wrong incentives in place. Nevertheless, Buffett likes Wells Fargo as an investment, and he thinks the new CEO is doing the right things in correcting their issues.

On China and Trade

The current political climate came up on a couple of instances during the meeting, especially in regard to the Trump administration's approach to free trade. Buffett and Munger extolled the benefits of free trade and believe that free trade with China is a win-win situation. They do not believe that a significant or prolonged trade war with China will occur and that cooler heads will eventually prevail. Munger said that "both [countries] will realize the last thing they should do is have ill will for the other."

Conclusion

Going to the Berkshire Hathaway annual meeting is a treat for us and something that we look forward to every year. It is a unique event in Corporate America, as there is no other large company whose CEO takes six hours' worth of unscripted questions from shareholders. We believe any serious investor should experience this event at least once in their lifetime. We are honored to have personally participated in the experience over the last 20 years, and to then share our learnings with you.

We thank you again for the trust you have placed in us, and we look forward to reporting to you again in three months.

Sincerely,

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