Second Quarter 2020 Commentary

After its historic decline during the first quarter of 2020, the stock market came roaring back in the second quarter. No amount of bad news—statewide lockdowns, economic shutdowns, increasing coronavirus cases, record unemployment claims—was enough to dampen the mood of investors, thanks in large part to unprecedented liquidity injected into the system by the Federal Reserve. The Fed signaled that it intends to use all of its powers to prevent economic calamity, and investors cheered on the stock market as it rose higher and higher.

For the quarter the S&P500 returned an astounding 20.5%, while the Dow Jones Industrial Average surged 18.5%.

Madness on Main Street

Driven mainly by curiosity but perhaps also a tinge of hypochondria, some days it seems like we have become amateur epidemiologists during this pandemic. Our usual diet of financial and business news and analysis—*The Wall Street Journal*, *The New York Times*, *Barron's*, *Fortune*—has now been supplemented by such publications as *The Lancet*, *Science*, and *Nature*. Epidemiologists, medical doctors, and public health analysts that we had never heard of prior to just a few months ago—names such as Marc Lipsitch, Michael Osterholm, Eric Topol, Scott Gottlieb, Tomas Pueyo—are now household names for us.

While we won't bore you with the specifics of studies analyzing the viral load of asymptomatic vs. symptomatic patients or the level of antibodies found in the citizens of Vo, Italy, there is one public health issue that we do want to comment on: the potentially lifesaving yet somehow controversial issue of wearing a mask.

Anecdotal evidence, peer-reviewed studies, and good ol' common sense all provide solid proof that wearing a mask during a pandemic saves lives. From the June 26, 2020, issue of Science Magazine (Vol. 368, Issue 6498, pages 1422-1424):

> *From epidemiological data, places that have been the most effective in reducing the spread of COVID-19 have implemented universal masking, including Taiwan, Japan, Hong Kong, Singapore, and South Korea. Taiwan (population 24 million, first COVID-19 case 21 January 2020) did not implement a lockdown during the pandemic, yet maintained a low incidence of 441 cases and 7 deaths (as of 21 May 2020).*

Honk Kong provides another excellent case study on the effectiveness of masks. For all intents and purposes, Hong Kong should have been an unmitigated disaster when facing this pandemic. Hong Kong is one of the most densely populated cities in the world, its citizens rely heavily on mass public transportation, and it is right next door to China; in fact, Hong Kong received more than 2.5 million visitors from China in January alone, and it has direct flights and trains to and from Wuhan, the epicenter of the virus. Yet, as of this writing, Hong Kong, with a population of 7.5 million—more than Arizona—has reported only 1,366 cases and 7 deaths. One main reason for this success is that—you guessed it—the vast majority (more than 97%) of people wear masks when they are out in public.

But, alas, all of this scientific evidence has been construed as somehow political, or foreign, or inconvenient, or even as “fake news” to a significant portion of our citizenry. We have watched in horror as hundreds of people in the U.S. have recently congregated at political rallies, on beaches, or in restaurants, bars, and other venues, all without wearing a mask in the midst of a global pandemic. Perhaps not coincidentally, this pandemic has lately intensified, killing more than 130,000 Americans to date. Failed leadership from our elected authorities, a climate of political polarization, an anti-science culture, and utter ignorance are all playing a role in this unqualified disaster.

If we sound frustrated and sad, there is a simple explanation for that: we are. Not only is our beloved country experiencing—and will continue to experience—a significant number of unnecessary deaths, but the economy will also experience an unnecessary burden unless people change their behavior and everyone starts wearing a mask. A recent report from a team of economists at Goldman Sachs projects that not having a federal policy mandating mask wearing is unnecessarily harming the U.S. economy. They estimate that implementing a national mask mandate would save the domestic economy from a 5% hit to GDP, representing an avoidable loss of $1 trillion.

Madness on Wall Street

The recent madness has not only been contained to Main Street. Wall Street, also, is exhibiting some irrational behavior of its own. As one example, this quarter saw the stocks of a couple of bankrupt companies go up by more than 100%, as speculators—perhaps bored by the lockdown and unable to gamble because the casinos were closed—bid up the shares to illogical levels.

But we would like to concentrate our attention on a very specific example of irrationality which has a big impact on your portfolio: the market’s under-valuation of Berkshire Hathaway stock. To illustrate our point, it helps to see what Warren Buffett has said on the matter. In the 2014 letter to shareholders, Buffett wrote:

> *… I believe that the chance of permanent capital loss for patient Berkshire shareholders is as low as can be found among single-company investments. That’s because our per-share intrinsic business value is almost certain to advance over time.*
>
> *This cheery prediction comes, however, with an important caution: If an investor’s entry point into Berkshire stock is unusually high – at a price, say, approaching double book value, which Berkshire shares have occasionally reached – it may well be many years before the investor can realize a profit. In other words, a sound investment can morph into a rash speculation if it is bought at an elevated price. Berkshire is not exempt from this truth.*
>
> *Purchases of Berkshire that investors make at a price modestly above the level at which the company would repurchase its shares, however, should produce gains within a*

> *reasonable period of time. Berkshire's directors will only authorize repurchases at a price they believe to be well below intrinsic value.*

This naturally leads to the question: at what level will Berkshire's directors authorize the repurchase of shares? We happen to have a clear answer to that. In September 2011 Berkshire announced that it would repurchase shares at a price up to 110% of book value. In December 2012 Berkshire increased its criteria from 110% to 120% of book value, after recognizing that getting a price of 110% of book value was too conservative and unrealistic. Finally, in July 2018, Buffett loosened the policy further, abandoning the 120% hurdle and authorizing repurchases when he believed the stock was trading "below Berkshire's intrinsic value," a determination that would be made "conservatively."

So, where are we know? By our estimate, Berkshire stock at the time of this writing is currently trading at a mere 105% of book value, a level even lower than the greatly conservative and "unrealistic" first threshold for repurchases given back in 2011. Yeah, it's really that cheap.

But that's just one angle on the issue. Let's look at this in a different way. Berkshire currently has a market cap of a little over $430 billion. What do you get for that $430 billion? For starters, you get about $140 billion in cash plus an equity portfolio worth about $220 billion. If you were to buy Berkshire in its entirety outright, you could immediately liquidate the stock portfolio, pay the associated capital gains taxes, combine that with the cash on hand, and you'd have around $330 billion in your pocket.

Essentially, this means that the stock market is ascribing a value to Berkshire's businesses of about $100 billion: the $430 billion total value less the $330 billion you'd have left over if you liquidated all the stocks. One of Berkshire's businesses is the Burlington Northern Santa Fe (BNSF) railroad, which had pre-tax earnings of $7.25 billion in 2019. BNSF's closest competitor is Union Pacific (UNP), which trades on the New York Stock Exchange. UNP has a current market capitalization of about $113 billion and pre-tax earnings of $7.75 billion in 2019. If we value BNSF using a similar ratio of ~14.5x pre-tax earnings, we get about $100 billion.

That means we get the rest of Berkshire for free, including a utility and energy business that generated pre-tax earnings of $2.6 billion in 2019, a number of manufacturing, service and retailing businesses that produced pre-tax earnings of $12.4 billion in 2019. See's Candies, XTRA trucking, Shaw Industries, Nebraska Furniture Mart, Fruit of the Loom, several jewelry stores, a real estate brokerage, Lubrizol, NetJets, and many, many others, all for free.

Any way you look at it, Berkshire Hathaway is cheap. Very cheap. And that is why we sleep well at night having Berkshire, with its Fort Knox balance sheet and diversified businesses, as the largest holding in your portfolio.

Conclusion

There is madness on Main Street, and there is madness on Wall Street. In times like these, we do well to remember the admonition of Nobel laureate Rudyard Kipling from over 100 years ago in his famous poem "If." To paraphrase that poem's first line, each day we come to work with the goal of keeping our heads though everyone about us may be losing theirs. We believe that staying calm and rational will allow us to make the best decisions with regard to your portfolio.

Thank you again for the privilege of serving you, and we look forward to reporting to you again in three months.

Sincerely,

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