

November 2009

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MARKET UPDATE

The S&P 500 has climbed 55 percent from a 12-year low in March thanks in large part to more than \$11.6 *trillion* in government spending, lending and guarantees. (How much is \$11.6 trillion dollars? If you stacked 11.6 trillion one dollar bills on top of each other, the bills could go from the earth to the moon and back - almost two times!)

Of the 394 companies in the S&P 500 that have published quarterly earnings since October 7, 84 percent exceeded estimates – the highest since 1993, according to data compiled by Bloomberg. And the big surprise behind those earnings is how quickly American corporations were able to cut costs, refinance balance sheets, and adjust inventories, product and pricing in the midst of an economic tsunami. Pretty impressive work when you think about it.

As a result, in stark contrast to the U.S. government, Corporate America is in pretty good shape, all things considered. According to a November 2nd *Wall Street Journal* article, cash as a percentage of assets at the 500 largest nonfinancial U.S. firms now sits at about 9.8%, the most in 40 years. Ex-the financials, a lean-

running Corporate America appears to be in decent shape to roll with whatever the global economy serves up.

Meanwhile the U.S. government has levered up in a huge way. The estimated \$1.6 trillion deficit is four times last year's record deficit. This year's deficit is about 11% of GDP and represents almost 40% of the overall U.S. budget. Imagine borrowing 40% of your annual budget needs at home? This is really extreme stuff here. Paying it down substantially in a reasonably short timeframe will be hugely important to America's financial position in the world. Bernanke claims to be on it. However, if Congress insists on working to get re-elected, rather than make the hard unpopular decisions necessary for America's long-term future, we could be in some deep trouble.

Which brings us back to stocks. We continue to believe that well-run, well-financed, market leading businesses with strong brands and economies of scale are the place to be. Fortunately, the market has paid comparatively little attention to such companies in this rally. It's been more of a "dash to trash" where junk bonds, highly levered companies, emerging markets, and small cap stocks have been the star performers.

That leaves a number of wonderful, AA and AAA rated, global powerhouse companies

selling at low double digit PE's offering a compelling package of value, quality and safety. And best of all, they will participate in the one great theme of the next 20 years – global growth from Asia to Africa to South America. The Rise of the Rest as Fareed Zakaria, editor of Newsweek International, calls it in his recently published book.

WARREN BUYS A RAILROAD

It's every little boy's dream – to have his own train set. Well now Warren Buffett has an entire railroad, a collection of 390 different railroad lines acquired over 150 years totaling 32,166 miles of track called the Burlington Northern Santa Fe Railway. On November 4, Warren Buffett made the biggest deal of his career, agreeing to buy BNI in a \$26.3 billion cash and stock deal. Berkshire agreed to purchase the 77% of BNI that it doesn't already own for \$100 a share.

As discussed in previous Pecaut letters, BNI is a call on continued growth in global trade and a call on higher oil prices as the rails have a significant cost advantage over the trucking industry. As Buffett chortled on CNBC, BNI can ship a ton of product 470 miles on a single gallon of gas. As a result, the rails are also a "green" play, as they are easier on the environment versus the trucking industry.

Finally, rails are "forever". Even as low-wage competition from overseas countries pressures many U.S. industries, the rails are relatively immune. And to build another railway would be wildly cost prohibitive. Pricing power is strong as the "Final Four" railroads, Union Pacific Corp., Burlington Northern, CSX Corp.

and Norfolk Southern Corp., control 86% of the railroad business.

As Buffett put it, it's an all in bet on America.

A FEW THINGS YOU WON'T READ IN THE NEWSPAPER

It's also the case that Berkshire Hathaway's all in with its cash. While the rest of Corporate America is husbanding record cash levels, Warren has gone the other way taking a previously huge cash position down to \$20 billion, Buffett's minimum balance. We believe people will look back at the economic crisis of the past year as Buffett's finest hour, as he put some \$60 billion to work at very favorable terms.

The BNI deal is Berkshire's biggest ever. Not including Berkshire's \$22 billion GenRe deal, this is the biggest in Berkshire history by more than 5 to 1! The "inevitability" of BNI is key here. With its \$60 billion or so of float, Berkshire is a levered institution by a factor of roughly 1.5 to 1. It is critical to the long run success of the enterprise that Buffett buys businesses that are durable and sustainable and BNI fits that requirement. (No Lehman-esque outcomes for him!)

In addition, while Buffett abhorred capital-intensive businesses in the early days, now Buffett seeks them. With Berkshire's huge scale, Buffett's universe of meaningful investment targets has shrunk dramatically, increasing the difficulty of putting Berkshire's excess cash flow to work. As a result, we believe Buffett is actively seeking businesses that can deploy lots of capital at decent rates of return over time. Berkshire subsidiary,

Pecaut and Company

MidAmerican Energy, for example, reinvests all of its earnings, much of it into wind power. Likewise with Iscar, which has been expanding its metal working enterprise both by acquisition and by building new plants. BNI will require many billions of capital investment over the next decade both to maintain its track and to build out the network. Here again, BNI fits the bill.

Finally, there can be major advantages for a public corporation to be freed of the bane of quarterly earnings reports. As part of Berkshire, BNI can focus solely on the building of long term value without concern for quarterly earnings and disgruntled Wall Streeters. It may well be that BNI puts the pedal to the metal and significantly accelerates its capital spending program. This could give it a chance to build significant competitive advantages in prime markets over the other major rail carriers (which are all publicly traded) as well as the trucking industry.

If BNI works out this way, it wouldn't be the first time for Berkshire. When Berkshire bought the 49% of GEICO it didn't already own in 1995 for \$2.3 billion, GEICO was the seventh largest auto insurer with 3.7 million vehicles insured. After being acquired by Berkshire, and free of worrying about quarterly earnings, Buffett ramped GEICO's tiny ad budget to \$600 million a year – *more than the rest of the auto insurance industry combined*. What public company could think of such a thing? And it's worked. Fourteen years later (and still spending about \$600 million a year, so that's *\$8.4 billion of cumulative ad spend*). GEICO is now number three in the industry with over 16 million vehicles insured, is number one in brand identity, and is gaining fast on number two - Allstate.

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