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EXECUTIVE SUMMARY

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Market Update

With all the natural disasters citizens have weathered this year, it seems unfair to have so much volatility in the markets as well. The Dow has risen or fallen by 1% or more in 15 of the past 20 trading days. It may offer U.S. investors some solace to know that the S&P 500, down some 3% for the year to date, is the top performing major equity index in the world. The Dow Jones Global Index (ex-US) is down 14% for the year as worries over the sovereign debt crisis continue to grab headlines.

We believe part of the S&P 500's outperformance is due to the ultra- strong balance sheets of U.S. corporations. In addition, companies are selectively using that cash to increase shareholder value through buybacks (even Berkshire Hathaway announced a buyback – see below), make acquisitions, and grow their businesses. Another part is that the S&P 500 is really a global index (40% of revenues are overseas). And it is global growth that will drive the economic bus for decades to come.

In a recent TED talk, historian Niall Ferguson opens with the thought that some 106 billion people have ever lived. 94% of them are dead. Of the nearly 7 billion living, some 60% live in Asia. Mostly poor. Of the world's $195 trillion in wealth, 66% of that wealth is in the West which has just 19% of the world's population. How did that happen?

Ferguson notes that this is actually a recent event in the scope of world history. Just a couple hundred years ago, China's per capital GDP exceeded that of the U.S. By 1970, however, U.S. per capita GDP exceeded that of China by 20 to 1. He claims America's institutions promoting competition, scientific innovation, property rights, modern medicine, a rising consumer society, and a strong work ethic (the "6 killer apps" Ferguson calls them) combined to create an economic juggernaut.

Those trends have clearly reversed. Today, U.S. per capita GDP exceeds that of China by just 5 to 1. Remarkably, in just 40 years, China has dramatically closed the GDP gap. Ferguson asserts that China has done it by copying and applying those "killer apps". While property rights are still suspect, China has joined Japan and Korea as a world leader in patent development. In addition, the education system assures that the pipeline of scientific innovation keeps growing. 15 year-olds from China and Singapore are maxing out the PISA Mathematics Scale with perfect 600 scores, while U.S. kids come in at about 480. Asia also has the work ethic. The average Korean worker now puts in 1000 hours per year more than the average German worker. India is on track to pass Japan as the world's third largest economy. By 2016, it is estimated that China will surpass the U.S. as the largest economy in the world.

While we agree that resolving the sovereign debt crisis is critical, we continue to see the bigger long-term economic theme as the "Rise of the Rest". Those companies and economies able to participate will have a major economic advantage over those that do not.

Grabbing for the Marshmallow

"At the end of World War II, the average American investor held the average American equity for four long years. By 2000, those four years had dwindled to eight months. By 2008, eight months had shrunk to just two months. In the absence of current data, we will have to speculate about 2011. Our best guess is 20 minutes."

- *Grant's Interest Rate Observer*, 7/29/11

20 minutes just happens to be the timeframe of a famous study. Back in 1995 we wrote a newsletter advocating patience in investing. As a metaphor, we talked about the 1972 Stanford Marshmallow Experiment by Professor Walter Mischel which was designed to test a young person's ability to delay gratification. A group of four-year-old children were studied. Each was given one marshmallow with the promise of a second marshmallow if they could wait twenty minutes before eating the first marshmallow. Roughly a third did not wait. A third waited a bit but then ate the first marshmallow. A final third waited the full time and received the two marshmallows. By 1995, data was in on how those kids

had performed in life. As a group, those able to delay gratification were better adjusted psychologically, more dependable, earned better grades, went to college, and were generally more successful than the other two thirds of the kids. Mischel's study famously showed that the ability to delay gratification was an important element in successfully managing life. (By the way, there is a youtube video of a similar study. The antics of the kids while they struggle to wait are a hoot.)

Today, we share Jim Grant's lament about the increasingly short holding periods for U.S. equities. We seem to have devolved into a market dominated by four-year-old marshmallow grabbers. In our last newsletter we decried the manic behavior of "professional" traders. The average mutual fund turns its portfolio over several times a year. The average holding period for exchange traded funds is less than a week. High frequency trading is measured in fractions of a second. Operating from the lizard brain's "fight or flight" mechanism may give one a jolt of adrenaline, but we doubt it's the pathway to growing and preserving long term wealth.

This trading addiction may be even worse than we thought. According to an article in the German magazine *Der Spiegel*, researchers in Switzerland recently concluded that professional equity traders may have some behavioral issues: *"Naturally one can't characterize the traders as deranged," said one of the study's authors, "but for example, they behaved more egotistically and were more willing to take risks than a group of psychopaths who took the same test."* Yikes. And, yet, extreme egotism and risk taking certainly does capture the ethos of investment banking in the subprime mortgage meltdown.

The fact is that each investor has the option of choosing to see a stock as a piece of paper to be traded or to see it as a part ownership of a business. For us, what the market chooses to price the business in the short run is far less interesting than the fundamental growth in value of the business itself. One of the ironies of the current market is that businesses are doing well even as short term traders dump stocks on a given day.

For the short run, our advice remains the same. Pay off your debts. When you are debt free, in times of great uncertainty, even if the most unpredictable things occur, *you will keep what you own*. In addition, keep funds you will need within two years in cash equivalents.

For the long run, equities offer compelling value. The gap between the cash flow yield on equities and the bond coupon on Treasuries is remarkable. Longleaf Partners estimates that with the S&P 500's growing, after-tax free cash flow yield around 10% and the pre-tax, fixed 10-year Treasury at around 2%, *shareholders receive over five times the return of bondholders*. In addition, for the most part, these are businesses that have great balance sheets, are largely self-funding, and have the flexibility to grow and adapt in a global economy.

The Marshmallow Grabbing Society

The people who had power in the society, and were charged with saving it from itself, had instead bled the society to death. The problem with police officers and firefighters isn't a public-sector problem; it isn't a problem with government; it's a problem with the entire society. It's what happened on Wall Street in the run-up to the subprime crisis. It's a problem of people taking what they can, just because they can, without regard to the larger social consequences. It's not just a coincidence that the debts of cities and states spun out of control at the same time as the debts of individual Americans. Alone in a dark room with a pile of money, Americans knew exactly what they wanted to do, from the top of the society to the bottom. They'd been conditioned to grab as much as they could, without thinking about the long-term consequences.

- Michael Lewis, "California and Bust", *Vanity Fair*, November 2011

Impulsive marshmallow grabbing has not been limited to the actions of stock market traders and investment bankers. In a brilliant essay, Michael Lewis examines the failure of California leaders to rein in runaway expenses. In so doing, Lewis comes to see a widespread conditioning of Americans at all levels of society to grab as much as we could without thinking about the long-term consequences. When times are good and growth is steady, the system can stand a certain amount of abuse. When growth stalls and the bills come due, there is a time of reckoning. We are in such a time, particularly in the public sector.

In the article, Lewis notes, *"As much as they claimed to despise their government, the citizens of California shared its defining trait: a need for debt. The average Californian, in 2011, had debts of $78,000 against an income of $43,000."* He also notes that a prison employee of 45 needs to work just five years to earn a pension nearly equal to his salary. The same fiscal year in which California spent $6 billion on prisons, the state spent just $4.7 billion on its higher education system of 33 campuses with 670,000 students. No wonder the 15 year-olds in China and Singapore are outscoring U.S. kids on math tests. Sacred cows and pension liabilities and entitlement programs are draining away dollars desperately needed to invest in our future.

We once wrote about GM as a monster pension liability with a little auto company attached. Many municipal budgets have become something like that. In the case of Vallejo, CA, which declared bankruptcy back in 2008, 80% of the city's budget was wrapped up in the pay and benefits of public-safety workers.

And it's not just California. According to the Bureau of Labor Statistics, the average compensation of state and local workers nationwide was 1.44 times that of private sector workers. Benefits averaged 1.66 times more. It's as if there was an alternate universe. There is the world of double digit unemployment and people and companies struggling to compete in a global marketplace. Then there is the world of Alice in Wonderland of the public sector where reality has been suspended. Up until now.

And it's not just America. We read where the Greek train system had €100 million in revenue and €400 million in salaries, with another €300 million in expenses. Unbelievable! To a remarkable degree, Greece has essentially been borrowing to finance the wages of government workers. A government-sponsored retirement plan for some 600 different "hazardous" jobs (like hairdressing and radio work) was available at 50 years of age.

Ireland has its own share of madness. From the Irish paper *The Independent:* "A Labour senator has questioned the need for massive social welfare payment to many families after revealing yesterday that some are receiving €90,000 a year for doing nothing."

We believe that Lewis captures the real root of the issue. It is a culture that is unable to manage its basic impulses. Given a choice of long term rationality and short term gratification, we have for too long chosen the latter. Debt is merely the metaphor. Give to me now, and I'll figure how to pay you later. Today's gargantuan sovereign debt levels are the outward manifestation of Western society's ingrown habit of grabbing marshmallows as they appear. As Lewis put it, "*Alone in a dark room with a pile of money, Americans knew exactly what they wanted to do, from the top of the society to the bottom.*"

Maybe this is where we can begin to build again from a place of collaboration and shared sacrifice: the joint realization that we did it to ourselves.

Waiting for the Second Marshmallow

"It is extraordinary to me that the idea of buying dollar bills for 40 cents takes immediately with people or it doesn't take at all… It doesn't seem to be a matter of IQ or academic training. It's instant recognition or nothing."

Warren Buffett, The Superinvestors of Graham and Doddsville

Over the years our experience has mirrored that of Mr. Buffett. As logical as the value concept may sound, we have come across many people with whom it does not take. The approach is "too boring" or they seek "higher returns". These are simply euphemisms describing people whose impulses exceed their patience. Value investing suits the temperament of the patient and repels the restless. If you want to maximize the growth of your wealth, examine the behavior of those who have the most marshmallows. Virtually all of the world's wealthiest individuals are patient, long term business owners.

Much has been made of the "lost decade" of the flat market from 2000-2010. Logic suggests the next decade will do better. It is fear and disappointment that creates the low prices necessary for a long term bull market. In a recent Wall Street Journal article, Professor Richard Sylla of NYU's Stern School of Business researched equity returns over the past 200 years and found some remarkably consistent patterns. Using 10-year average inflation-adjusted returns, Professor Sylla found that when returns drop below 5% a year for a decade, markets are likely to bottom out and begin a recovery. When secular bull markets return 15% a year, the cycle peaks and a new downturn commences. 2000 marked the end of a decade of great returns, so the next 10 years of flat returns fit the pattern. As of 2011, 10-year average returns are now below 5%, suggesting the next 10 years will do well if the 200 year pattern holds.

Buying Value – Berkshire Hathaway

Investors have famously paid millions to have lunch with Warren Buffett in an annual charity auction Buffett holds to support GLIDE. Imagine you could have Buffett lean over and whisper in your ear the name of a stock that he believes is insanely cheap. So much so that he stands ready to invest billions in it. And that the name of that stock is……… Berkshire Hathaway.

OK, so he didn't whisper it. He announced it publicly. For the first time since March, 2000, Warren Buffett announced a stock buyback for Berkshire shares. However, back in March of 2000, the stock jumped on the news and Berkshire did not buy in one share. This time, the stock has simply moved with the market, so we would guess he's actually been able to buy in some shares. In addition, he made the announcement in a way that provides a long term platform for buybacks, stipulating that Berkshire will buy in shares at no more than 110% of book value. The press release asserts that "the underlying businesses of Berkshire are worth considerably more than this". Also, Berkshire will maintain a minimum cash cushion of $20 billion.

Corey and I have been saying for some months that Berkshire is as cheap as it has ever been. One must include the quality factors as well. Never before has Berkshire had so many cash flow streams from so many diverse businesses. A recession in housing may slow Berkshire's housing related subsidiaries but the railroad is chugging right along. Reinsurance pricing may be flat but GEICO is gobbling up market share in auto insurance. More than ever, Berkshire is a wealth-building machine, though its size dampens the rate of future growth.

In addition, Berkshire announced that Ted Weschler, 50, of Charlottesville, Virginia, will be winding up his fund in order to join Berkshire early in 2012. With Todd Combs already on board, Buffett has two of the three investment managers he set out to hire to manage Berkshire's equity and bond holdings in the future.

Buybacks

How does a buyback build value? Imagine a twelve piece pizza selling for $24, or $2 per slice. You and I purchase half the pizza for $12. Now imagine the other "sliceholders" decide pizza isn't so healthy, are eager to cash in their slices so they can buy something more trendy, or simply need money for the meter. Because they are in a hurry, they are willing to sell for $1.50 per slice. We buy in those 6 slices for $9. Now we own the whole pizza for $21. We created $3 of value by buying in those slices/shares. The pizza did not grow or change. The value was created by the purchase of slices at discounted prices. That, very crudely, is how buybacks increase per share value. Note that this method of value creation does not require a rising market or luck; merely the discipline to buy when others are despondent.

Berkshire is not alone in seeing its stock as a great investment. White Mountains Insurance recently announced its *second* Dutch auction this year. Intel just increased its share repurchase authorization by $10 billion. Wells Fargo repurchased 22 million shares in the third quarter and has already repurchased another 6 million shares this quarter. In August, 198 companies authorized new share buybacks, according to research firm Birinyi Associates, the highest monthly total since February 2008, putting 2011 on track to be the third-busiest buyback year on record.

Acquisitions Heat Up

With modest equity valuations and ultra low interest rates, we would not be surprised to see a pick-up in acquisition activity. There have already been some strategic purchases. This week, Kinder Morgan announced a $21 billion buy-out of El Paso Corp. which would make KMI the largest pipeline company in the U.S. With China hungry for natural resources, Sinopec is purchasing Canadian energy company Daylight Energy for $2.1 billion. In July, BHP Billiton purchased Petrohawk Energy for over $15 billion for its shale gas reserves.

The Coiled Spring

One of our favorite value plays is when a company is clearly growing intrinsic value even as its stock price declines. The effect can be like coiling a spring. The tighter the compression of value, the more likely a value-unlocking event will occur. In the case of Berkshire, the buyback announcement has been the response. Deals, spin offs, and restructurings are other possible value creating events.

The banking industry has been through its own mega-disaster in the last few years. Questions remain around the impacts of a sluggish economy, ripple effects from the European sovereign debt mess, and the impact of new regulations from Dodd-Frank. Reflecting investor disgust, the SNL Bank and Thrift Index has fallen close to 30% in 2011. In March 2009, at the bottom of the panic, the index traded around 130% of tangible book value. Today, banks in the Index are trading even more cheaply at a composite value of 112% of tangible book value.

So fundamentals must be getting worse and worse for the banks? But they are not! According to SNL: "U.S. bank stocks have taken hits despite rebuilding their balance sheets, building capital and liquidity and growing earnings….aggregate net income for the more than 7500 insured institutions rose 38% from year ago levels, average return on equity increased to 7.57% from 5.75% one year ago and their average return on assets rose to 0.85% from 0.63% a year earlier, according to the FDIC." In sum, financial stocks are getting cheaper. Fundamentals are getting better. Coiling the spring.

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