Pecaut & Company

Our Mission: To Be Our Clients' Most Trusted Financial Advisor

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EXECUTIVE SUMMARY

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Market Update in the Age of Allocation

"On March 4, 2014 RadioShack announced that it planned to close as many as 1,100 lower-performing stores, almost 20% of its 5,200 US locations"

We're old enough to remember when, back in 1977, Radio Shack introduced the TRS-80, one of the first mass-produced personal computers. Last month a blog post featured a picture of a 1991 Radio Shack ad that displayed a computer, camcorder, mobile and home phones, voice recorder, clock radio, stereo, CD player, and more costing thousands of dollars in total. Today, of course, people can duplicate all of these functions – and more - with an I-phone. Long term investment success hinges on proper analysis of both the value and viability of the business that underlies each stock. Rapid changes in technology are increasing viability risks for many companies.

As Radio Shack's business castle is slowly turning to rubble, one investor response to such creative destruction has been to chase what is new and shiny. Speculation has picked up. 74% of this year's IPO's have *no earnings*, a level not seen since the 1999-2000 Internet bubble years. Just prior to the recent correction, Twitter, Yelp, and NetSuite all sold in excess of *20 times revenues*. They have no PEs as they have no Earnings. These stocks appeared cheap, however, when one considers that Facebook paid $19 billion for WhatsApp, a firm with 50 employees and $20 million in revenue; a purchase price of *950 times revenue*. Speculation has cooled of late. Twitter is down 50% in recent months as the new tech and biotech sectors have sold off sharply.

Our preferred response to this changing world is to focus on those businesses that have large (and preferably growing) moats around their business castles and can allocate future cash flows to earn high returns. Wells Fargo, for example, continues to dominate the banking scene with the highest revenue/asset as well as fee/asset ratios of all the major banks. With massive amounts of complexity to manage, the size and sophistication of Wells' platform of products provides a sizable moat around their business. Impressively, Wells is #1 in the U.S. in commercial real estate lending, small business lending, auto lending, mortgage originations, and mortgage servicing. All this and earnings too! Wells sells at little more than a 12 PE.

As discussed in our December 2012 letter, we believe we are in **The Age of Allocation**. In a world with massively indebted governments needing to deleverage (in effect, we have borrowed from future growth to get through the subprime mortgage crisis), growth is likely to remain slow for years to come. At the same time, with corporations sitting on trillions in cash, refinancing debt at ultra-low rates, and record profits rolling in, corporate America has seldom been more liquid. How that liquidity gets invested over the next decade will have a major impact on investment returns. If history serves, much of it will be poorly invested. (e.g. Radio Shack's once proudly expanding store count is now in reverse.) Companies that can reinvest large amounts of capital into their core businesses at high rates of return are always valuable. In a competitive slow growth world, such companies are much more valuable than most investors realize. In addition, companies run by shrewd owner/managers that can allocate capital intelligently will have many opportunities to create value over and above the growth rate of the general economy.

From our view, the best combination of value and strength in this market lies in those companies selling at reasonable prices that can grow their business moats. Few companies are doing a more impressive job of capital allocation and moat building than Berkshire Hathaway.

THE UNIVERSITY OF BERKSHIRE HATHAWAY

We greatly appreciate Corey's copious notes from the meeting. (Dan missed the meeting as he was under the weather.) Corey's summary of the meeting from last year: stocks good, bonds bad. That proved totally prescient! Corey's summary of the meeting from this year: stocks still good, bonds still bad. There you have it. Read on if you must.

The convention arena was packed as some 40,000 eager attendees sought to hear the latest wisdom from Chairman Warren Buffett and vice chairman Charlie Munger during the 6-hour shareholder meeting. It is an impressive learning experience, especially considering that "Professors" Buffett and Munger (ages 83 and 90, respectively) are still going strong. Shopping was robust at the "Berkshire Mall", where dozens of Berkshire subsidiaries had their wares for sale. We understand that the Nebraska Furniture Mart did over $40 million of business for the week. That's 10% of the store's annual sales! No question the Berkshire annual meeting is the Omaha Chamber of Commerce's dream event.

Always looking to increase the fun, Buffett and Munger had special edition Heinz ketchup bottles for sale. The Buffett versions sold for $2.00 each while the Munger version, ever the curmudgeon, sold for just $1.50. They joked that they will be keeping track to see who sells more ketchup. Jumping in on the fun, all Pecaut and Company clients will be receiving a bottle of special edition ketchup to augment your summer picnics! (A random sample of client choice ketchup has Charlie winning by a ratio of 2:1!!!)

Buffett and Munger have presided over one of the greatest records of wealth building in history. Since Buffett took over Berkshire 49 years ago, Berkshire's per-share book value has grown from $19 to $134,973 a rate of 19.7% compounded annually. That's nearly double the S&P 500's 9.8% annualized percentage gain for the same period.

Over those 49 years, Berkshire Hathaway has grown from a small New England textile company into one of the world's most powerful conglomerates. Berkshire now ranks as one of the world's largest companies in revenue ($140 billion), profits ($19.5 billion) and assets ($485 billion). With $230 billion of equity and $77 billion of float, Berkshire has substantial capital with which to fund its operations.

Back in 2011, Berkshire traded for around $117,000 per A share, roughly a 25% discount to our appraisal of intrinsic value per share at the time. With the recent rally to 190,000 per A share, the price has actually risen a bit faster than the growth in the company, closing the discount for the first time in a number of years. So while intrinsic value has grown significantly, the value gap has narrowed a bit. However, the quality of the company is unparalleled (see below), so the value is still compelling at current levels.

Corey and I have noticed that we are getting progressively grumpier as we age. One pet peeve of ours is the annual media circus surrounding the Berkshire meeting. (We usually start with…"I remember back in 1984 when the meeting was just a couple hundred people….." and ends with "ah yes, those were the days.") While the media creates lots of feverish excitement, there is little real understanding. More sizzle than steak, to our way of thinking. So, to rectify the situation, rather than review the entire meeting in this letter, we decided to share with you what we believe are the most important points from this year's meeting.

Five Things You May Have Missed

We have long noticed the paradox of craziness that surrounds Warren Buffett: no investor gets more media attention and yet so little understanding flows out of that attention. We suppose it's a problem of the short attention span/instant gratification culture bouncing off the wisdom of the ages. In any case, now that the media frenzy over the Berkshire meeting has died down, we check in with our observations on the annual gathering. Here's what seems big to us and few seem to have really noticed:

Berkshire is more invested in equities than any time since 1997 (and less invested in fixed income than any time since 1995). (see our Cash/Bond/Stock allocation analysis on the last page) How's that for a headline! In all our post meeting reading, we did not see this point made. To all those wringing their hands about an imminent bear market, apparently Buffett didn't get the notice. This is especially noteworthy as Buffett was so cash heavy during the "lost decade". He most decidedly is not all in all the time. So the fact that he is leaning so decisively toward equities is worthy of note. In addition, while the investment portfolio has shifted over the last decade from being the centerpiece of the Berkshire empire to merely a part of the whole, it still represents his thinking about the opportunity costs of various asset classes over time. He clearly believes equities are the superior choice to bonds and cash at this time. That's a point worth noting.

Buffett is touting Berkshire's value. This is a complete about face. For decades we well remember Buffett and Munger downplaying Berkshire's value and low-balling expectations for future growth year after year after year. You could almost hear the violins in the background! In recent years, Buffett has been more upfront about what makes Berkshire so remarkable and hinting at what those values might be. This year Buffett did a ***"shout out"*** on Berkshire's value. He was quite direct that Berkshire's plan to buy back shares at 120% of book value is nothing less than a not so subtle hint to own Berkshire from the master himself. To put some numbers on that, Q1 equity of $230 billion equates to $93 of book value per "B" share. 120% of that would be $112. With the "B" shares at $126, they are selling at just 12% above the price at which Buffett would buy in large amounts of stock – a value differential that Berkshire's growth will close within the year. After years of low-balling Berkshire, Buffett is fairly screaming to whoever will listen to notice the value here.

Buffett loves banks. It's well known that Buffett likes Wells Fargo. It's less well known that Buffett likes banks. For example, what is Berkshire's 5th largest equity holding? Come on now, make a guess. The Big Four get plenty of press: Wells Fargo, Coca Cola, American Express, and IBM. What's number five? If you don't know, don't feel bad. We asked several of our friends who study Berkshire and they did not know. The answer: Bank of America. Assuming exercise of the warrants, the shares were worth $10.9 billion at year-end and $12 billion at the end of Q1. Between Wells Fargo, Bank of America, U.S. Bancorp, Bank of New York Mellon, and M&T Bank, Buffett has a $40 billion investment in U.S. banks. This is a huge position and, thus, worth close inspection. For all the hand-wringing about increased regulation, increased capital requirements, ongoing lawsuits, and narrow interest rate spreads, something must be very right about banking and/or these particular banks for Buffett to have his LARGEST SECTOR WEIGHTING IN BANKS. We would add that Buffett knows banks, having purchased the Illinois National Bank of Rockford in 1969. In the 1977 Berkshire report, Buffett proudly took note of Gene Abegg's able management in building a bank whose rate of earnings to assets was about three times that of most large banks.

Buffett is happy. Over the years, we have found Buffett's general level of energy and enthusiasm remarkable. However, some years are more difficult than others and that shows up in a more somber demeanor at the meeting (ed: the Solomon scandal and the year David Sokol stepped down come to mind). This year we report that we have seldom seen him happier. We believe a big contributor is that ***Berkshire is hitting on all cylinders***. Every one of his major investments and important hires of the last decade is working out and – in certain cases – working out very well. The man is on a roll.

Berkshire is a smooth-running capital allocation machine. Allocation of capital is THE key to future returns in the business world. Never before has the world seen an allocation machine like Berkshire Hathaway. Generating in the neighborhood of $20 billion a year in growing cash flow, *Berkshire will easily generate more than $230 billion of cash in the next decade, an amount equal to its current equity value*. In other words, what Berkshire does with its excess cash over the next decade will match or exceed in scale everything Buffett has done over the last 50 years. Buffett knows full well he may or may not be around to preside over these allocation decisions, so the more capital allocation can be mechanized or delegated in a good way, the better. And Buffett has done this to an absolutely stunning degree over the last 15 years. Perhaps, in years to come, this transition will be seen as his greatest work. Let's take a closer look at what he has created.

Berkshire Hathaway – Allocation Machine

In our December 2012 letter we noted there are essentially five things public corporations can do with a dollar earned: reinvest in the business, acquire other businesses or assets, pay down debt, pay dividends, and/or buy in shares. Deciding how much to allocate to each of these five areas ideally is driven by "opportunity cost". In other words, each extra dollar should go where it gets the best risk-adjusted return over the long run compared to all other competing opportunities.

Warren Buffett, more than anyone else we know, has brought the art of capital allocation to the forefront of American business thinking. For years he and Charlie Munger have noted that American business managers promoted to CEOs were much like the world renowned violinist who finally makes it to Carnegie Hall and then is told to play the piano. After years of mastering accounting or just in time production or sales and marketing, the rising manager is suddenly in charge of something he's had no training for: capital allocation. Not surprisingly, the overall record of capital allocation in American business has not been good. Back in the 1980's we hardly ever heard companies speak of this function. Today it has become commonplace (though execution still can and often does leave much to be desired). For example, according to a recent ***Wall Street Journal***, corporate spending on share buybacks rose 23% last year to $477 billion and dividend payments increased 14% to $1.3 trillion while capital spending is expected to climb 6% this year $650 billion. That's a great little summary and not the sort of thing one read in the paper 30 years ago.

For years Buffett has modeled a rational, intelligent and sometimes inspired approach to capital allocation. In this year's annual report, Buffett was quite specific as to how the allocation went for 2013 at Berkshire:

Reinvesting in the businesses. Here is where the biggest changes have occurred. Prior to 1998, Berkshire owned little in the way of operating businesses that could reinvest large amounts of cash. In fact, Buffett distinctly preferred low-capital, high cash flow businesses so he could reinvest the cash flow himself. Since then, however, Berkshire has been on a buying spree of capital heavy businesses, high-lighted by his "Powerhouse Five": MidAmerican Energy, Burlington Northern Santa Fe, Iscar, Lubrizol and Marmon Group. Exhibiting a remarkable flexibility of mind, Buffett totally shifted gears. After years of buying low-capital, high cash flow businesses, Buffett has assembled a group of businesses that can guzzle cash. Berkshire subsidiaries spent a record **$11 billion** on plant and equipment during 2013. BNSF alone plans to invest $5 billion in 2014. When current projects are completed, MidAmerican Energy will have spent $15 billion on renewable energy. From a standing start in 2004, MidAmerican now provides 7% of the nation's wind generation capacity and, when projects are completed, an even larger share of the nation's solar capacity. In addition, Berkshire spent $3.5 billion buying the portions of Marmon Group and Iscar that it did not already own. We speculate here, but note that Berkshire bought in the shares of GEICO that it didn't already own in 1995. Buffett then put the pedal to the metal on the ad budget such that GEICO outspent the rest of the auto insurance industry combined! We can't help but wonder if the success of that capital intensity applied at the right time with the right company informed Buffett's more recent purchases and capital investment policies. Being able to think and invest very long term and not worry about current earnings or Wall Street analysts can be a major competitive advantage in *certain businesses.*

Acquire other businesses. *Here Buffett continues to be on a tear.* ***THE BASIC DEAL*** *– Buffett has long loved to buy control* of good companies. In fact, Buffett said at the meeting he much prefers to buy operating businesses that can add to Berkshire's earnings power versus marketable securities. Last year Berkshire spent **$18 billion** to acquire NV Energy and a major interest in Heinz (with 3G Capital). Just prior to the meeting, Berkshire announced the $2.9 billion acquisition of AltaLink which operates power transmission services for about 85 percent of Alberta. **THE FANCY DEAL** - Buffett has long been famous for cutting special deals that only he and Berkshire could dream up. Debt with warrants attached. Insurance quota shares. Double digit convertible preferred issues. Berkshire cut a couple of interesting, tax-advantaged deals last year: a swap of Washington Post shares for a TV station in Miami and Berkshire shares and a swap of $1.4 billion of Phillips 66 shares for full ownership of the energy firm's pipeline-services business. **THE BOLT-ON ACQUISITION** – Berkshire's smaller subsidiaries have the green-light to grow by intelligent acquisition. Last year $3.1 billion was invested in bolt-on acquisitions at Berkshire subsidiaries. **THE PORTFOLIO** – Once the crown jewel of Berkshire, the $211 billion portfolio of cash, bonds and equities is now merely a part of this burgeoning empire. However, Buffett added Ted Weschler and Todd Combs to the team in recent years, with each now running portfolios of over $7 billion. Buffett clearly likes what these two are doing and hints they have also contributed to some of the other deals mentioned here.

Pay down debt. Years ago, Buffett taught that the time to borrow money is when money is cheap. Debt is cheap now, so the question really might be "why doesn't Berkshire borrow more?" Buffett said he prefers to keep the balance sheet super strong (with a minimum of $20 billion in cash). This unquestionable strength creates a durable competitive advantage for the insurance subsidiaries. (Ed: We note that a sly old favorite of ours, Leucadia National, did just that, raising $3.3 billion on a variety of bond issues last year. Borrow money when money is cheap, indeed!)

Pay dividends. Berkshire has famously not paid dividends. However, Buffett did suggest during the meeting that in the "not too remote future", Berkshire's cash generation might be so substantial, that would be a question to revisit. "May you live until Berkshire pays a dividend" may not be so long!

Buy in shares. Here we come to the SHOUT OUT. Berkshire has implemented this remarkable authorization to buy in shares at 120% of book value. While few shares have been repurchased to date, it creates a floor under the price. Interesting note - Buffett mused during the meeting that when Berkshire bought BNSF it paid 70% of the cost in cash and the remainder in stock, he would have been wise to have bought those shares back in on the open market. One other point here, a number of Berkshire's investees repurchase shares, increasing Berkshire's percentage ownership over time. Yet one more form of "automatic" capital allocation for Berkshire.

There you have it. The Berkshire Hathaway Allocation Machine is no longer dependent on Buffett's next idea. The Powerhouse Five can reinvest cash to grow their own operations for years to come. Smaller subsidiaries can do bolt on acquisitions. Weschler and Combs are on the hunt for bargains in both the stock market and in the world of deal making. And nearly all of this capital allocation capacity has been created by Buffett in just the last 15 years. A remarkable achievement.

Again, with Berkshire selling at a small premium to where the company would buy in shares, this company stands as one of the highest quality, lowest risk equities one could own.

Changes at Pecaut and Company

We are sad and glad here.

Sad to report that John Pecaut has left the firm to pursue life in Minneapolis with his new bride, Laura (married June of 2013). We loved having John here the last three years. He was a great help with our administration and research efforts and has rapidly assimilated the value approach. He has a great analytical and strategic mind, so we know he'll do well where ever he lands.

Glad to report that Shelby Pierce joined the firm. Shelby was a classmate of John's at West High, managed a dental clinic most recently, and brought her ebullient energy and management skills to our firm at the end of last year (and trust us, managing Dan is no easy task!). Most clients have met Shelby by now so you know how special she is. We are lucky to have her aboard.

Berkshire's Cash/Bond/Stock Ratios 1979 through 2013

In a reprise of our April 1999 newsletter, we review Berkshire's cash/bond/stock allocations. We find it worthwhile to contemplate changes in allocations. For example, after keeping equities around 40% for much of the "lost decade", Buffett's had the pedal down since 2008, with equities and other investments rising to 67%, the highest level since 1997. Note that the investment portfolio increased a handsome 20% last year and has increased over 343-fold in 34 years. The chart illustrates that Berkshire has been a significant buyer of equities and other deals. Interestingly, fixed income securities fell to only 13% of the portfolio – the lowest level since 1995. Buffett keeps a minimum $20 billion in cash reserve for insurance catastrophes

		Percentage Allocation		
Year	Investment Portfolio (in millions)	Cash and Cash Equivalents	Securities with Fixed Maturities	Equities and Other Investments
1979	$ 615	5%	30%	65%
1980	764	8	24	68
1981	911	8	22	70
1982	1,162	5	16	79
1983	1,516	5	14	81
1984	1,710	10	18	72
1985	2,676	38	18	44
1986	3,288	9	34	57
1987	4,666	5	44	51
1988	5,639	5	32	63
1989	8,263	2	34	64
1990	8,994	3	34	63
1991	12,283	6	19	75
1992	14,948	8	14	78
1993	16,487	11	13	76
1994	18,355	2	15	83
1995	26,362	10	6	84
1996	35,537	4	18	78
1997	47,548	2	22	76
1998	74,589	18	29	53
1999	73,565	5	41	54
2000	77,086	6	43	51
2001	72,471	7	51	42
2002	80,494	13	50	37
2003	95,589	33	27	40
2004	102,929	39	22	39
2005	115,615	34	23	41
2006	125,715	30	20	49
2007	141,217	27	20	53
2008	122,025	20	22	58
2009	145,982	19	22	59
2010	147,772	24	23	53
2011	153,909	22	20	58
2012	176,331	24	18	58
2013	211,308	20	13	67

Note: In 1985 cash swelled due largely to the buy-out of General Foods by Philip Morris.
The 1998 General Reinsurance merger shifted the percentage in equities from 76% to roughly 55%.

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