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**September 2015**

**EXECUTIVE SUMMARY**

- **Market Update**
- **University of Berkshire Hathaway**
- **Addendum: In the Beginning**
- **Berkshire's Cash/Bond/Stock Ratio**

## Market Update

*"The stock market is a wonderfully efficient mechanism for transferring wealth from the impatient to the patient."*

- Warren Buffett

The market has been choppy of late so we thought a brief review was in order. While a slowdown in China does have significant impacts for the world economy, China only represents about 8% of U.S. exports. Meanwhile, America's grinding recovery continues, creating about 200,000 jobs a month. The banking system is far more solid than it was in 2008-09. Energy prices are low. Valuations are reasonable. Fearful investors have made net redemptions of $100 billion from equity mutual funds this year. These are not the makings of a market top.

The centerpiece of our approach is that when you own a stock you own part ownership of a business. Thus, *the key to success in the stock market is to think like a business owner and have a long view.* Those who get scared and sell at the random market wobble have set themselves up for disappointment. On average the stock market has had a 10% decline about every year or so and a 20% or larger decline every 3-5 years. Be prepared to patiently hold winning companies and look to accumulate more when these occasional declines come along.

For example, one company we've been adding to conservative growth accounts is Union Pacific Railroad (UNP). The U.S. rail industry has consolidated to a Monopoly board of four major rails: UNP, Burlington Northern Santa Fe, Norfolk Southern, and CSX. UNP is arguably the best run of the bunch. Down 34% from its high, selling at 14 times earnings, this is an attractive entry point for one of the few monopoly-type businesses the world has to offer.

## BERKSHIRE HATHAWAY – CAPITAL ALLOCATION MACHINE

*"The lack of skill that many CEOs have at capital allocation is no small matter: After ten years on the job, a CEO whose company annually retains earnings equal to 10% of net worth will have been responsible for the deployment of more than 60% of all the capital at work in the business." 1987 Berkshire letter*

Intelligent capital allocation is the essence of sound wealth-building. In last year's review, we noted how dramatically Buffett has reshaped Berkshire into a capital allocation machine over the last 15 years. As it is now configured, the future compounding of Berkshire's value depends less on Warren Buffett than at any other time in Berkshire's history.

When considering how poorly capital gets allocated in the main, Berkshire stands out even more as one exceptional story. What we didn't realize until this year's Berkshire Hathaway annual report is how strongly capital allocation affected Berkshire from the very beginnings. Buffett celebrates Berkshire's 50$^{th}$ year under his command with a terrific annual report including excerpts from old annual reports, buy out term sheets, and other historical notes. In fact, Buffett notes that it was a *buyback announcement* that initially attracted him to Berkshire. It was not the business, but *the reallocation of capital* that drew Buffett to the stock.

The above furnished without charge, for the information of our customers, was derived from sources we believe trustworthy, we do not however, guarantee its accuracy or represent that it contains all facts which might be deemed material in deciding on the purchase or sale of the securities discussed. Opinions expressed are subject to change without notice. Pecaut and Company may from time to time own and buy and sell the shares of this stock.

See our addendum for his telling of the story and our analysis of his capital allocation moves in those early days. It is really quite spectacular.

**THE UNIVERSITY OF BERKSHIRE HATHAWAY**

As Corey says, "it's time for church". Attending UBH is an opportunity to be immersed in the tenets of value investing from the masters, "professors" Warren Buffett and Charlie Munger. Corey's laser-like meeting summary two years ago was "stocks good, bonds bad". This year an update: Stocks good if interest rates stay low. Not so good if interest rates go up a lot. Bonds still bad.

40,000 of Warren's and Charlie's closest friends gathered for the extravaganza in Omaha. The event was once again a Chamber of Commerce's dream. Last year, Nebraska Furniture Mart did over $40 million of business for the week and our guess is that number was exceeded this year!

Buffett joked that they expanded transportation beyond planes, trains and automobiles as Justin Boots brought two big steers and Wells Fargo brought a stagecoach to parade down to the annual meeting at 6:30am. IBM had a booth, making it clear that Buffett's investment here is for the very long run. (In the annual report he adds IBM to Wells Fargo, Coca Cola, and American Express, calling them the "Big Four".)

With the recent market sell-off, Berkshire B shares currently trade around $130. This is about a 20% discount to our adjusted book value calculation as of the end of the second quarter (though book value is most likely a bit lower now with the sell-off.) So Berkshire represents high quality and very reasonable value at current prices. In addition, we would argue the discount should narrow in the future for two reasons. One, with its large and growing stable of earning businesses, Berkshire is at long last being seen as an earnings compounder, not just a collection of assets. Second, Berkshire has an outstanding buyback offer in place at 120% of stated book value. Stated book at the end of the quarter was about $100 per B share. 120% of that would be $120, or just $10 below the current trading price. This is unique. If Berkshire sells off just another 8%, Berkshire itself would become a buyer of the stock. While size is an anchor to its growth rate, Berkshire's quality has never been higher. One of the great wealth compounding stories of our time is well positioned to keep doing just that for years to come.

On with the meeting……..

**THE MOVIE**

If Corey has his way, he might just come for the movie in future years. Great stuff. One of the highlights was an interview with Buffett's longtime associates from the early days, Gladys Kaiser and Bill Scott. Buffett and Scott talked about the acquiring of Berkshire and the partnership days. Kaiser remembered that 1991 was an awful year, the year of the Solomon Brothers scandal, and that Buffett was totally focused, "That was quite a responsibility. You saved their behind."

The other show-stopper was a Rocky-style bit; Warren Buffett versus Floyd Mayweather. Cameos from Steve Wynn and Charlie Rose. Buffett fighting under the moniker "the Berkshire Bomber" and trash talking Mayweather. Munger, "Mayweather people asked me first but I was too busy". Rocky music throbbing throughout. At start of the fight, they ask Buffett if he's going to fight with his glasses on, to which he responds, "Damn right I will"! Just as they're going to hit each other the screen goes blank…….

Buffett put up a slide of Berkshire's quarterly earnings. He noted there was nothing particularly remarkable except that BNSF did much better than last year in both earnings and other performance measures. Buffett admitted that the railroad got behind last year early in the year so Berkshire spent a lot of money to get things the way they should be. Those expanded efforts have paid off. Burlington Northern has gained market share and improved earnings.

**CLAYTON HOMES**

A question came about a *Seattle Times* story alleging predatory lending practices at Berkshire subsidiary, Clayton Homes. Buffett was prepared with his

response, saying that there were some important mistakes in the article and claimed that Clayton's lending practices are exemplary. So began an interesting lecture on lending and manufactured housing.

Buffett asserted that mortgage problems in 2008 and 2009 happened in large part because the mortgage holder and the mortgage originator became "totally divorced." Mortgage originators sold the loans to investment bankers who sliced and diced the loans into derivative products where the eventual buyers often didn't really know what they owned. The default rates in those years was far, far higher for $800,000 and up homes than they were for loans at Clayton.

In contrast, Clayton retains nearly all of the mortgages that it originates. Clayton has retained over $12 billion of mortgages on some 300,000 homes. It is not in Clayton's interests to sell a house where the buyer defaults, since that will be loss for the company as well as for the customer. That is not true of most mortgage originators, though there has been some talk to have originators retain 3% or so of the mortgages they originate so they have some skin in the game

Buffett acknowledged that manufactured housing covers the lower end of the market in terms of Fico scores (620 or below). 70% of homes selling for $150,000 or less are manufactured. The average payment is about $670 a month. So the challenge is to lend to people in a way that they are likely to make the payments and keep their house.

For Clayton, about 3% of these mortgages default. The primary reasons for mortgage default are loss of job, divorce, and death. However, 97% don't. Without the financing Clayton and others makes available, they wouldn't be able to own such a home. Buffett said the Clayton home on display in the Century Link auditorium goes for $69,500. Land usually costs about $25,000. So for a total of $95,000, someone could get into a home with appliances, a couple of bedrooms, and 1200 square feet of space.

Buffett noted that there were mistakes in the *Seattle Times* story, which alleged that Clayton's average profit was $11,600 per home sold. Buffett said he knew that was nonsense. He read the affidavit about three times and nowhere in the affidavit was that statement made. What was in the affidavit was a comment on *gross profit, not net profit*. In the case of Clayton, the gross profit is around 20%, while the net profit margin is about 3%.

An interesting aside, Buffett shared that they have had absolutely no complaints about Clayton's lending standards. However, Buffett admitted that he gets letters of complaint about other subsidiaries on a regular basis.

Buffett added that Clayton is regulated by each state in which it has financing, so it is regulated by nearly every state. In the last three years, Clayton has had 91 compliance examinations by the state. In those 91 examinations, the largest fine Clayton paid was $5,500 and the largest refund was $110,000. (Ed: Buffett did his homework.)

Buffett concluded that he is proud: "Clayton put over 30,000 people, at a very low cost, into very good homes last year. And a very high percentage of those people are going to have those loans paid off in 20 years and have a home that was a real bargain."

Munger mused that while Clayton has around 50% of the manufactured housing market, he's surprised the market isn't bigger since it's such an efficient way to build houses.

**3G PARTNERS**

Buffett also came prepared for questions about his partnership with 3G Partners. The question was about 3G's style of reducing the number of workers at companies it takes over.

Buffett noted that the 3G people are successful business builders and buyers. They seek to run their businesses efficiently and that includes reducing headcount when there are considerably more people in the business than are needed. After reducing expenses, 3-G businesses have done well. Buffett observed that Burger King is now

outperforming its competitors by a significant margin. Burger King's most recent acquisition, Tim Horton's, is already showing marked improvement.

Munger pointed out that the alternative to having your company right sized is what eventually happened in Russia. He quoted the Russian worker who said, "Everyone has a job and it all works out. They pretend to pay us and we pretend to work."

Buffett noted that the railroad business after World War II had 1.6 million people employed in the business and it was a lousy, undercapitalized industry. Today the rail industry has less than 200,000 employees, and the industry is much larger, more efficient, and far safer. No one is claiming today that it would be better to run the railroads with 1.6 million folks. "Efficiency is required over time in capitalism."

Buffett concluded, "I tip my hat to what the 3G people have done."

**VAN TUYL**

Asked about Berkshire's recent acquisition of Van Tuyl, Buffett noted that it is a very productive auto dealer. Renamed Berkshire Hathaway Automotive, the unit is one of the largest dealership groups in America, with over $9 billion in revenue and 81 independently operated dealerships in 10 states.

Some dealers like Carmax have gone to a more transparent model with less negotiation. Buffett noted that Van Tuyl will adapt to what the customer wants. However, the negotiated model is still predominant. Munger shared that negotiating for cars has been the primary model for his entire lifetime and he's amazed that this hasn't changed more. Buffett assured shareholders that Van Tuyl would be fine however things unfold, though he wouldn't be surprised if things don't change that much in 10 to 15 years. Overall, there are 17,000 dealers in the country and Berkshire plans on buying more of them through Van Tuyl in the years to come. Interestingly, Buffett does not see any scale advantages to owning auto dealers. Most dealerships work on local considerations.

Buffett does not see Berkshire getting into the car finance business. Wells Fargo is the largest auto finance company with a cost of funds around 12 basis points, so they have an unbeatable advantage.

Munger concluded that Van Tuyl has "a system of meritocracy, where the right people have a significant ownership." It reminds him of the Kiewit company in Omaha, another very successful culture.

**FILTERS**

Asked for five or six criteria for choosing an investment, Munger asserted that Berkshire does not have a one-size-fits-all system. Each industry is different. Also, they keep learning.

Buffett observed that they do have filters. A key one is whether they have a good idea of how the business is going to do over the next five or 10 years. That filter eliminates many businesses from consideration.

Another filter is people. Buffett wants people to run the business the same way after selling to Berkshire as they ran it before selling to Berkshire. That filter also eliminates a lot of deals.

Buffett concluded, "I can't give you five criteria. Maybe Charlie has kept them from me."

**IBM**

Asked whether IBM wasn't a cigar butt, similar to those textile mills of the 1960s, Munger said "no". He noted that IBM has been rare in its ability to adapt to technological change. Munger sees IBM as "a very admirable enterprise bought at a reasonable price."

Buffett chimed in that he finds it interesting when he gets asked questions about investments Berkshire owns and that people think he would want to talk them up. Either Berkshire or the investee companies may be buying more shares in the future so why would they want the price to go up? Buffett concluded, "Wall Street thinks it's better if price goes up the next day even if you're planning on buying more shares in. Charlie do you have any idea why?"

Munger replied, "Warren, if people weren't so often wrong, we wouldn't be so rich."

**BUILDING THE INSURANCE BUSINESSES**

In building Berkshire's insurance empire, Buffett allowed that he had many pieces of luck. Three in particular: visiting Lorimar Davidson of GEICO, buying National Indemnity, and hiring Ajit Jain.

Buffett claimed the education he received from just 4 hours with Davidson was better than any university course he could have taken. That's when he realized insurance was something that he liked and understood. That understanding prepared him to buy National Indemnity when it came up for sale; and, of course, prepared Buffett to buy a major position in GEICO and eventually the entire company in the decades to follow.

Buffett has often said that Jack Ringwalt had five minutes every year when he wanted to sell his company, National Indemnity. In 1967, Buffett got that call and jumped on it. National Indemnity became the base on which Buffett would build Berkshire's insurance empire.

In the mid-80's, Ajit Jain walked in on a Saturday volunteering his services, even though he hadn't worked in the insurance business.

Buffett marveled at his good fortune for this trifecta and shared that the real key was being open to ideas as they came along.

Munger noted that the real key is that Berkshire bought wonderful businesses.

**CULTURE**

Buffett asserted that Berkshire's culture runs deep. He shared that Berkshire had just closed on a transaction in Germany, Detlev Louis Motoradvertriebs GmbH, a motorcycle apparel and accessories retailer. Mrs. Louis and her husband lovingly built the business over 35 years. Her husband died a couple of years ago and she came to Berkshire because she wanted to sell to Berkshire.

It is essential for Berkshire to have a culture that runs throughout the entire company as well as the shareholders. Buffett was pleased that 97% of shareholders voted against having a dividend and in favor of having management invest the cash.

Buffett observed that the culture gets reinforced and becomes self-selecting over time. Buffett believes that this culture has become institutionalized and has no doubt that it will continue long after he and Charlie are gone.

Munger did note that Berkshire's rate of gain will slow: "There are worse tragedies in life than having Berkshire's compounding slow down - that's inevitable. "

Buffett quipped," Name one."

Culture comes from the top according to Buffett. The leader must be consistent, communicate well, and reward proper behavior and punish misbehavior. Since it takes time, it's actually easier to inherit the culture that you like. Buffett concluded that one of his core values at Berkshire is to always strive to treat people the way you would want to be treated.

Munger's insightful conclusion, "I think one thing that we have done that's worked best is that we were always dissatisfied with what we already knew and we wanted to know more. We kept learning and that's what made it work."

**BRANDS**

Asked about Berkshire being long sugar consumption for the past 50 years and changing consumer tastes, Buffett countered that Coca Cola has a very wide moat.

With 1.9 billion 8 oz. daily servings of Coca-Cola products consumed worldwide, the company is still a force. And it will need to adjust to the changing preferences of consumers. However, much like negotiated auto sales, Buffett said he just doesn't see anything revolutionary happening here. He predicted that 20 years from now more Coke will be consumed than today.

In a startling admission, Buffett declared that he estimated one quarter of all the calories he has consumed over the last three decades came from Coca Cola. He joked, "If I would've been eating broccoli and brussel sprouts my whole life, I don't think I would've lived this long."

Buffett shared that while there are shifts in preferences over time, it's remarkable how durable some brands can be. Coke started in 1886. Heinz ketchup came out in 1870.

Buffett reiterated that a strong brand is really powerful, though you do have to build them and promote them. He marveled that Gillette bought the rights to radio advertising for the 1939 World Series for $100,000. "Think about how many people heard those commercials."

**STOCK MARKET AND INTEREST RATES**

There was a very good question about valuations. One ratio that Buffett is known to track is the total market cap to GDP. Recently it was at 125%, which is a level approached in 1999 during the internet bubble. Another number that Buffett has mentioned is the ratio of corporate profits to GDP. From 1951 to 1999, that number ranged from 4.5% to 6%. More recently that number has been up over 10%. Should investors be concerned about these numbers and the market?

Buffett replied that those percentages suggest that American business is doing very well, though that might be a concern for society. The valuation picture is very much affected by our zero-based interest rate structure. Clearly stocks are worth far more when government bonds yield 1% than when they yield 5%.

Munger noted that people have limited alternatives with bonds paying so little. This has pushed stocks to higher prices than they would reach otherwise.

Buffett added that the question is how long will these low rates continue? In Japan, this has gone on for decades. Or will we get back to normal? If rates go back to a more normal level, stock prices are high. If rates stay low, then stocks look "very cheap". Buffett concluded, "Now I've given you the answers and you can take your pick."

Buffett noted that he would have never predicted five years of zero interest rates. "We're operating in a world that Charlie and I don't understand."

Munger wryly noted, "If we failed to predict what happened before, why would anybody ask us what our prediction was for the future?"

Fortunately for shareholders, macro predictions are not essential to the Berkshire process. Buffett took pains to emphasize that he and Charlie had never, to the best of his memory, ever turned down an acquisition based on macro factors. As examples, Buffett noted that See's Candies and BNSF were purchased during difficult times in the economy. He said the real key is to be able to figure out what the average profitability of the business will be over the long term and how strong the business moat may be.

Buffett's punch line, "We think that any company that has an economist has one employee too many."

**THE RAILROAD**

Regarding concerns about railcar safety, Buffett noted that BNSF, as a common carrier, is required to carry certain dangerous substances, such as ammonia and chlorine. The government develops the rules for these issues, and rail is the most logical way to transport many of these substances. BNSF leads the industry in safety and, overall, Buffett believes that rail has gotten significantly safer over the years.

**RENEWABLE ENERGY**

Solar's cost per megawatt hour has plummeted from $315 in 2009 down to $128 today. The energy cost of wind per megawatt hour is $85.48, down from $96.09. Renewable energy costs are becoming more competitive.

Greg Abel, CEO of Berkshire Energy Group, said that by the end of 2016, 58% of power in Iowa will be from wind.

**ALL IN**

Winding up, Buffett noted that all of his and his families' net worth is in BRK.

Munger noted that Berkshire is only lightly levered and that "it's crazy to sweat at night."

Buffett quickly clarified, "Over financial things."

Buffett concluded that with $60 billion in cash, Berkshire would be ready and willing to act if some economic turbulence creates an opportunity.

**ADDENDUM: PRECISION CASTPARTS**

True to his word, Buffett was ready to act with that $60 billion in cash. In August, Berkshire agreed to its biggest acquisition ever, buying Precision Castparts (PCP), an aerospace parts company, for $32.4 billion in cash or $235 per share. Berkshire expects to fund the deal using about $23 billion of its cash and another $10 billion of borrowed money. Buffett wasn't shy about saying how much he likes Precision Castparts CEO, Mark Donegan, "The guy is fantastic. He's as in love with his company as I am with Berkshire, and that's saying a lot."

We would also note that PCP has done dozens of acquisitions over the years. No doubt Buffett sees PCP as another company that can allocate billions of dollars of future cash flow to additional acquisitions. Precision Castparts - another cog in the Berkshire Hathaway Allocation Machine.

**ADDENDUM: IN THE BEGINNING…..THERE WAS CAPITAL ALLOCATION**

The story of Buffett's takeover of Berkshire Hathaway begins with capital allocation. It was the company's massive buyback proposal at the 1962 shareholders' meeting that caught Buffett's attention; this at a time when buybacks were virtually nonexistent. We thought the whole thing was fascinating, so here's Buffett's telling of the story in the 2014 Berkshire annual report:

*"On May 6, 1964, Berkshire Hathaway, then run by a man named Seabury Stanton, sent a letter to its shareholders offering to buy 225,000 shares of its stock for $11.375 per share. I had expected the letter; I was surprised by the price.*

*Berkshire then had 1,583,680 shares outstanding. About 7% of these were owned by Buffett Partnership Ltd. ("BPL"), an investing entity that I managed and in which I had virtually all of my net worth. Shortly before the tender offer was mailed, Stanton had asked me at what price BPL would sell its holdings. I answered $11.50, and he said, "Fine, we have a deal." Then came Berkshire's letter, offering an eighth of a point less. I bristled at Stanton's behavior and didn't tender.*

*That was a monumentally stupid decision.*

*Berkshire was then a northern textile manufacturer, mired in a terrible business. The industry in which it operated was heading south, both metaphorically and physically. And Berkshire, for a variety of reasons, was unable to change course. (Ed. Charlie Munger once referred to textiles as "congealed electricity", so the move of production to the TVA southern states was inevitable. In his classically understated way, he concluded that the New England textile business was a "totally doomed, certain-to-fail business.")*

*That was true even though the industry's problems had long been widely understood. Berkshires' own Board minutes of July 29, 1954, laid out the grim facts: "The textile industry in New England started going out of business forty years ago. During the war years this trend was stopped. The trend must continue until supply and demand have been balanced."*

*About a year after that board meeting, Berkshire Fine Spinning Associates and Hathaway Manufacturing – both with roots in the 19th Century – joined forces, taking the name we bear today. With its fourteen plants and 10,000 employees, the merged company became the giant of New England textiles. What the two managements viewed as a merger agreement, however, soon morphed into a suicide pact. During the seven years following the consolidation, Berkshire operated at an overall loss, and its net worth shrunk by 37%.*

*Meanwhile, the company closed nine plants, sometimes using the liquidation process to repurchase shares. And that pattern caught my attention.*

*I purchase BPL's first shares of Berkshire in December 1962, anticipating more closings and more repurchases. The stock was then selling for $7.50, a wide discount from per-share working capital of $10.25 and book value of $20.20. Buying the stock at that price was like picking up a discarded cigar butt that had one puff remaining in it. Though the stub might be ugly and soggy, the puff would be free. Once that momentary pleasure was enjoyed, however, no more could be expected.*

*Berkshire thereafter stuck to the script: It soon closed another two plants, and in that May 1964 move, set out to repurchase shares with the shutdown proceeds. The price that Stanton offered was 50% above the cost of our original purchases. There it was – my free puff, just waiting for me, after which I could look elsewhere for other discarded butts.*

*Instead, irritated by Stanton's chiseling, I ignored his offer and began to aggressively buy more Berkshire shares.*

*By April 1965, BPL owned 392,633 shares (out of 1,017,547 then outstanding) and at an early-May board meeting we formally took control of the company. Through Seabury's and my childish behavior – after all, what was an eighth of a point to either of us? – he lost his job, and I found myself with more than 25% of BPL's capital invested in a terrible business about which I knew very little. I became the dog who caught the car.*

*Because of Berkshire's operating losses and share repurchases, its net worth at the end of fiscal 1964 had fallen to $22 million from $55 million at the time of the 1955 merger. The full $22 million was required by the textile operation: The company had no excess cash and owed its bank $2.5 million. (Berkshire's 1964 annual report is reproduced on pages 130-142.) For a time I got lucky: Berkshire immediately enjoyed two years of good operating conditions. Better yet, its earnings in those years were free of income tax because it possessed a large loss carry-forward that had arisen from the disastrous results in earlier years.*

*Then the honeymoon ended. During the 18 years following 1966, we struggled unremittingly with the textile business, all to no avail. But stubbornness – stupidity? – has its limits. In 1985, I finally threw in the towel and closed the operation. "*

**A TUTORIAL ON CAPITAL ALLOCATION**

While Buffett grills himself for buying a dying textile business out of pique for Stanton Seabury's chiseling, we think he doth protest too much. In truth, Buffett's maneuvers in the years to follow constituted an amazing exercise in aggressive capital reallocation.

Here are the numbers. In 1964, the year before Buffett took control, Berkshire's per share book value stood at $19.46 with per share earnings of $0.15. ***At year-end 1969, Berkshire's per share book value was $43.18, up 120%, with per share earnings of $8.07.***

How the heck did Buffett do that with a dying textile business? Let's take a look.

***Buybacks***. At the time of purchase, Berkshire was undergoing a dramatic buyback program. In 1964 Berkshire bought in 469,602 shares, leaving 1,137,778 shares outstanding, a 29% cap shrink! Furthermore, this was done at an average price paid of $11.32 share, far below book value. Massive per share value was being created by shrinking the capitalization at very low prices. Under Buffett's command, Berkshire bought in an additional 120,231 shares to further shrink the cap. In all, Berkshire's share count went from 1,607,380 in 1964 to 1,017,547 in 1969, a 37% reduction. (Compare this to just over 1.6 million shares outstanding today. Berkshire has had little share expansion over the past 50 years.)

***Hidden Value***. As of 1964, Berkshire had $5 million of "tax loss carry-overs". With the accounting rules of the day, this asset was not included in the calculation of book value. In addition, this asset could be especially valuable at the time since the top

corporate tax was 48%. We estimate this asset added over $2 per share of value, as Berkshire used up the tax loss carry-overs within a few years, sheltering a significant portion of earnings from taxes.

***Investments.*** Buffett created cash for investment through additional asset sales and reductions in inventory and overhead. He invested in securities that appreciated significantly, liquidating the portfolio during 1968 and 1969. He reported net per share earnings from the gains on those sales of $2.20 ($1.49 from the parent and $0.71 from insurance subsidiaries) in 1968 and $4.16 ($3.87 from the parent and $0.29 from insurance subsidiaries) in 1969, adding a total of $6.36 of after-tax value.

***Acquisitions.*** In 1967, Berkshire bought National Indemnity for $8.4 million, which became the base for building Berkshire's insurance empire. As of the 1969 report, Berkshire was moving into surety, workmen's compensation, and reinsurance as well. In 1969 Berkshire purchased The Illinois National Bank and Trust Co. of Rockford, Illinois.

***Earnings and Earnings Power.*** With these two new lines of business, Buffett transformed Berkshire's earnings power. Of those $8.07 of per share earnings in 1969, $4.66 came from operations: $0.79 from the textile operation, $2.31 from the insurance subsidiaries, and $1.56 from the banking operation. (Again, $4.16 of those earnings represented non-recurring gains from the liquidation of the investment portfolio.) The key to note here is that the bulk of *Berkshire's future earning power was no longer in the textile operation but in the insurance, banking and investment operations.*

Note that the $43.18 book value in 1969 represented a far better company, more diversified, with more earning power and better growth prospects than the $19.46 book value of 1964, so the increase in *intrinsic per share value* was even greater than the 120% increase in per share book value. Despite its beginnings in the ill-fated textile industry, Buffett's ability to re-allocate resources transformed Berkshire Hathaway into a dynamically growing juggernaut within just 5 years.

## Berkshire's Cash/Bond/Stock Ratios 1979 through 2014

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 the highest levels since 1997. Note that the investment portfolio increased 8% last year and has increased over 372-fold in 35 years. The chart illustrates that Berkshire has been a significant buyer of equities and other deals. Interestingly, fixed income securities fell again this year to only 12% 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 |
| 2014 | 228,906 | 25 | 12 | 63 |

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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