Pecaut & Company

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EXECUTIVE SUMMARY

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Market Update

"Reality leaves a lot to the imagination."
- John Lennon

The market dipped 10% and then recovered to finish a wild first quarter about where it started. It's been seven years since the market bottomed, and volatility has returned with a vengeance. For value investors this is good. We believe a bear market for most world markets started a year ago. Increased volatility tends to create more disparity in the pricing of assets. More disparity creates more bargains. While prices may get cheaper in the interim, volatility increases the opportunity set for value investors.

Dan recently visited Southeast Asia and a highlight was seeing the spectacular ruins of Angkor Wat. Felt like Indiana Jones! Our guide, Hem, is a survivor of the Cambodian genocide of 1975-79 instigated by Pol Pot and the Khmer Rouge. 25% of the population died during this brutal regime. Despite losing 9 of his 13 family members in the atrocity, Hem is an optimistic and hard-working father. His dream: to buy his oldest son a bicycle.

Back to the good old U.S. of A. Here are some facts. Unemployment today is under 5% versus over 10% in October of 2009. Bankruptcies totaled 820,000 in 2015 versus 1.5 million in 2009. Foreclosures totaled 1.1 million last year versus 2.9 million in 2010. These numbers are not just better but miles better than they were seven years ago. So we were somewhat dismayed to read of a Wisconsin survey that had 94% of those polled as "somewhat or very worried" about the economy. Readings we might have expected to see in 2009. While there are problems, as always, there is much that is going right as well in this 240 year old economy. The per capita GDP of Cambodia is $744 (about $2 a day). The per capita GDP of the U.S. is about $56,000. With a massively corrupt dictator, Cambodia ranks 99th out of 102 countries for rule of law. Yet Hem is the optimistic one.

In fairness, there is indeed plenty to be concerned about. China, ZIRP and now NIRP (Negative Interest Rate Policy), the effects of technology and productivity on the future of jobs, rhetoric of building walls and blocking trade. Our primary economic concern continues to be the massive amounts of sovereign debt that need to be reconciled eventually.

For the patient investor, we continue to believe well run companies at reasonable to bargain prices offer better return potential than the 1.7 % offered by 10 year Treasuries. We especially like companies with large insider ownership. Times of volatility and duress give them more opportunities to allocate capital at high rates of return.

Interesting Tidbits

In Vietnam, you get 22,400 dong per US dollar. When I exchanged $100 for 2.2 million dong at the hotel, the clerk exclaimed, "Hey, you're a millionaire!" I suppose the line works every time.

From Jamie Dimon's excellent letter in the JP Morgan 2015 annual report: ""Of the 26 million businesses in the United States, only 4,000 are public companies. While accounting for less than 0.02% of all firms, these companies represent one-third of private sector employment and almost half of the total $2.3 trillion of business capital expenditures."

In support of open trade, Frederick Smith, the CEO of FedEx Corp, from a recent talk at Yale: "From less than $50 billion in total trade in 1966, the U.S. now imports and exports over $4 trillion annually in goods and services."

General Motors sold more vehicles in China (3.6 million) than in America (3.1 million) last year.

The Berkshire Hathaway annual meeting, for the first time, will be webcast. Go to https://finance.yahoo.com/brklivestream at 9 am central, Saturday, April 30th.

MidAmerican Energy's average retail rate is 6.8 cents per KWH (kilowatt hour). Alliant, the other major electric utility in Iowa, averages 9.5 cents. The national average is 10.4 cents. MidAmerican Energy customers have had just one rate hike since 1999, a period during which industry rates increased 44%.

Berkshire Hathaway Energy

Let's mull over that last tidbit for a moment. Each of the states that border Iowa sports electric rates over 9 cents per kwh. Electricity is a commodity. One kilowatt is equal to another (please correct us if we're wrong about this.). How can BHE charge rates that are nearly a third cheaper than its competitors??? You want to be the low cost producer in a commodity business, and BHE is....by a mile. How is this possible?

Berkshire bought out MidAmerican back in 1999 and the division now consists of MidAmerican Energy, PacifiCorp (Oregon and Utah), Nevada utilities, U.K. utilities, the Northern Natural and Kern River gas pipelines, a Canadian transmission utility, renewable projects, and Home Services. Buffett has been busy!

In addition, Berkshire has invested capital into these businesses. With MidAmerican alone, Berkshire invested $6.6 billion in Iowa wind power and just announced another $3.6 billion project that will take its Iowa wind power generation capabilities to 85% of sales. By far, Iowa is the number one state in the nation in wind power. BHE is doing similar things with solar.

This reminds us of GEICO, where Berkshire massively increased the advertising budget once it had 100% control of the company. This created the share of mind that makes GEICO a market share gobbling machine today. With BHE, Berkshire has put the pedal to the metal with capital spending, building the low cost, most eco-friendly generator of kilowatts in the nation. How is Buffett doing this?

First, federal tax credits. Large federal tax credits are available to encourage investment in renewable energy. However, one must have taxable income to use a tax credit. Most utilities don't. Large depreciation charges generally offset the taxable income. That is not the case with BHE. Thus, in contrast to the bulk of the industry, Berkshire can be an aggressive user of tax credits. And it has.

Second, renewable energy is socially desirable, especially wind and solar. That is the reason for the tax credits. While the tax credits could go away at anytime, BHE is making these renewable incentives a huge success, so the political winds (ahem) are blowing in its favor.

Third, all utilities share the feature of recession resistant earnings, which result from these companies offering an essential service on an exclusive basis. However, rather than pay large dividends like most utilities, BHE is reinvesting every penny of those earnings in building this low cost empire.

Fourth, Berkshire's capital strength has allowed a number of subsidiaries to significantly lower their cost of debt.

Fifth, by owning a number of utilities across the spectrum, BHE has created a diverse earnings stream so that BHE cannot be unduly harmed by any one regulatory body. While Berkshire itself is a fortress, BHE is fast becoming a fortress unto itself. BHE is no longer your garden variety utility.

We actually don't understand the power business that well. But if America builds a national grid where anyone can buy electricity from anyone else across the country, as the low cost producer, BHE would be the most sought after provider. If America can invent large scale batteries that can store electricity, how much might BHE be worth in a world like that?

This story also tells us that Buffett is much more than a stock picker and a business buyer. He is a business builder. Especially when there are wide moat possibilities involved. From a modest start with the acquisition of MidAmerican Energy in 1999, BHE now represents 10% - 15% of the total value of Berkshire Hathaway. BHE is a great example of how Buffett's thought processes and aggressive action with moat building opportunities have added major value to Berkshire over the years.

Update on Save, Spend, Invest, Give

Thanks to all who have supported the book. Your feedback has been wonderful. Over 200 copies sold to date. One purchased in euros from Europe! Over 5,000 podcast downloads. (You can check them out at danielpecaut.com). We've had downloads in 57 foreign countries, with the Aussies coming up from down under into the number two spot.

We really appreciate your comments and that folks are passing it on: "I loved it. I'm buying a copy for each of my grandkids." And "I appreciate how difficult it is to take something you've studied for years and communicate the ideas in an understandable and memorable way. You've done that. I plan to share the book with my teenage nieces."

If you really liked the book, please write a review on Amazon.com. A big thank you to Eleanor Murphy who wrote this:

"*Dan Pecaut's book is a handy primer for those starting to think about these areas and a wise reminder and guide to those who have done so for a long time. A straightforward book, it is a great gift for younger relatives and friends. He writes not just of the investments you make with your money but also of the investments you make in yourself and your world."*

You're all invited to a book signing at Book People on Saturday, May 14, 11am-1pm. Hope you can come by and support the cause!

Our mission here is to improve financial literacy. As folks read the book and then share the book and podcasts with those they care about, the insights can spread. Thanks for helping to build the momentum.

The S&P 500 - the Last 17 Years

Indexing is all the rage and recent Department of Labor regulations may well add fuel to the fire. In effect, for regulators, indexing has become an unqualified good. And we don't disagree entirely. Owning an index fund like the S&P 500 is a perfectly acceptable way to participate in the long term growth of American business for years to come.

However, it's not the only way. We are of a school of investment that believes that it pays to think. To think about business quality and business valuation. The ideal of the value approach is to create portfolios with less risk and higher returns over time.

While the S&P 500 has outperformed essentially all asset classes over the last two years, is this a permanent trend? Does jumping into any index fund that has outperformed over a two year period make for a great investment?

A brief review of the last 17 years suggests the answers are "no" and "no". Responding to question one, according to research by Deutsche Asset Management and Goldman Sachs, the S&P 500 last outperformed the world from 1997-1999, the Internet Bubble. What happened after that? The S&P 500 was among the worst markets in the world from 2000-2005. The S&P was middle of the pack 2006-2012. A star from 2013-2015. History may not repeat but it rhymes. Buying the most popular market after a seven year bull market is unlikely to be one's ideal move.

Second question, as long time value followers may have guessed, buying the most popular index or market category hardly ever works. Commodities, for example, were hot stuff post subprime mortgage crash (remember $8 corn?) Over the last couple years commodities have been the worst performing asset class on the planet (hello $3 corn). And guess where some of our favorite value investors are shopping for bargains right now? In the energy patch, where double digit high yield debt is now available. It's the panic-priced trouble spots, not the premium priced winners that attract the value oriented.

One last thought on this topic. As the world funnels ever more funds into indexed products, a major value investment opportunity may be opening: the non-indexed world. Those stocks that do not fit neatly into an index may become substantially mispriced from time to time, creating a serious area of opportunity for the patient treasure hunter.

Crimson Wine Annual Meeting

Speaking of the non-indexed world, little Crimson Wine ($208 million market cap) will have its annual meeting Friday, July 22 at its Pine Ridge Vineyard in Napa Valley. The wine tasting is a great dividend for shareholders. Corey is in. Dan is thinking about it. Hope to see you there.

Dan Pecaut Corey Wrenn