Pecaut & Company

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

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EXECUTIVE SUMMARY

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Pecaut & Company Update

Whew! It has been a busy summer for our firm.

First, we are very pleased to announce that John Pecaut is re-joining the firm. After a sabbatical that included marriage, living in Hawaii, living in Minneapolis, and starting a family (more on that in a moment!), John will be bringing his keen intellect and attention to detail to our operations. In addition, we look forward to all of you getting to know John in the months ahead.

Second, we are very, very pleased to share that John and his wife, Laura, had a beautiful baby boy, James, on July 16. Even better, John, Laura, and James have already relocated to Sioux City. All three are excited about their new digs, though James simply grunts when asked about it. (Needless to say, Grandma and Grandpa Pecaut are thrilled to have James in the 'hood.)

Third, as you already know, Corey and Lisa became grandparents when Melissa and Jake had Ophelia on June 13. With an English teacher for a mother, it should be no surprise that Ophelia is already devouring books (no kidding, Corey has pictures of her eating a book). In addition, she has a full wardrobe of Iowa Hawkeye gear to wear on game days.

So if you're exceptionally bored and would like to see some baby pictures, make Pecaut and Company your first stop. Corey is beaming about being a grandpa. Likewise, Dan is still a bit awestruck to have a grandson. James represents the seventh generation of Pecauts in Siouxland!

Publishing Updates

Corey and Dan have done more than collaborate on grandparenting. We've also written a book, The University of Berkshire Hathaway. It's a compilation of our notes from 30 years' worth of Berkshire Hathaway annual meetings. While it's not for everyone, for Buffett fans, we hope it will become a must-read. Kirkus reviews calls it "a rare look into the mind of Warren Buffett." And the mind of Charlie Munger, we would add. We are excited to have this project in the homestretch and look forward to checking in with you when it reaches completion!

Our mission to elevate financial literacy in the world continues apace. Book sales of Save, Spend, Invest, Give continue to grow. (Again, book profits go to supporting the healing work at the All Nations Gathering Center at Pine Ridge, SD.) Our podcasts continue to be popular with nearly 6700 downloads to date in 6 continents, 65 countries and 49 states. We've gotten hot in Australia (388 downloads). 8 downloads in Mozambique! Not sure what impact that may make, but it feels exciting.

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.

In addition, Dan has written up his health story, Beating Bronchiectasis, which is available at Amazon via Kindle for 99 cents. For those who don't know, Dan had a respiratory breakdown in the winter of 2012. The book details the illness, Mayo diagnosis (likely permanent lung damage), a bold move to a more holistic/integrative approach to health, and, well, we won't spoil the ending (though the patient does live.)

Market Update

On to the more mundane affairs of finance. Our friend, Murray Stahl of Horizon Kinetics, points out that current interest rates are not merely low, but *the lowest in all of recorded history*. According to Sydney Homer's A History of Interest Rates, in the last 5000 years, we have never before seen a time of extended negative interest rates. Rates of between 6%-15% rates prevailed for much of the period. In other words, throughout history, the idea that borrowing money required some form of "rent" to compensate the lender held sway.

Stahl also notes that history shows that rates can go up as well as down. And it can happen suddenly. In 1745, during the Jacobite Rebellion, the English Government Bond yields jumped from 3% to 4%, causing a 25% decline in bond values. This, according to Mr. Homer, was the first black Friday.

In sum, we are in unusual times. The world's central bankers are very far down the rabbit hole of their massive stimulus and zero/negative based interest rate experiment. A seemingly small increase in interest rates could send very large ripples through world markets. So, our age-old advice, based on the observation of 5000 years of markets and market calamities, continues to be:

Pay off your debts. Have an emergency cash fund and a couple years' worth of living expenses on hand. For long term funds, invest in companies/funds that have intelligent, high integrity owner/managers. And we'd add one more quality – look for captive capital.

Captive Capital in the Age of Allocation

Back in 2012, we dubbed this post 2008-09 subprime mortgage crash period "the age of allocation." With slowing global growth and massive liquidity sloshing through the system, we predicted that how capital gets allocated will have an outsized impact on future investment returns.

Now let us add "captive capital" as a key element in our investment thinking. To the extent that a company or fund has capital that is "captive," the owner/operators can choose their allocations without (or with less) regard for outside opinion AND know that capital is available at the opportune moment. This stands in stark contrast to the massive stampede in index funds and ETFs. Such entities must buy as money comes in, whether that makes sense or not. In a panic, such entities must sell, whether that makes sense or not. Total fund assets invested in such funds have gone from 25% to 33% over the last several years. In truth, since everyone is buying the same index-able stocks, this a process of *concentrating risk*, not spreading it! As value investors, combing through the universe of non-indexed stocks and owner/operator companies (many of which don't fit into an index) should prove worthwhile.

In the case for captive capital, Berkshire Hathaway would be our prime exhibit. Since Berkshire is owned and controlled by Warren Buffett, its capital can be allocated in the most rational, long term beneficial way. This can happen regardless of shrieking from disgruntled shareholders, pension funds, or other detractors. With Berkshire's remarkable record of compounding wealth, Buffett has clearly demonstrated the clarity of mind needed to stay the course. For example, many were shrieking during the Internet bubble that Buffett didn't get it and should pay Berkshire's large cash

hoard out as a dividend. Buffett calmly held his ground and put that cash to work during the ensuing crash. This approach paid off hugely during the 2008-2009 subprime mortgage crash period when Berkshire put nearly $100 billion to work, including the purchase of the Burlington Northern Santa Fe railroad. Currently, cash balances are piling up again, north of $70 billion. While Buffett earns next to nothing on the cash, he knows that dry powder will prove most valuable in the next time of distressed pricing.

Open-end mutual funds and ETFs (exchange traded funds) are the opposite of the captive capital model. The most nervous or most excited investor sets the price at the margin. If investors choose to stampede into the fund, the managers must dutifully buy ever more shares of the appropriate index or strategy, *whether that makes any sense or not at current market prices.* While indexing makes sense in a general way, it can (and often at the most untimely moments) be completely nonsensical in practice.

Take utility stocks, for example. Recently the utility index had never been more richly priced as yield-hungry investors piled into the group. In addition, utilities are also a major component of "low-volatility" funds, claiming to offer less-than-average market risk. Back testing five years, utility stocks have done great. But today's investors are investing for the future. What then? Well, for one, if interest rates go up, few stock groups will be harder hit (and, indeed, utilities sold off sharply on word that the Fed may raise rates). In addition, with de-regulation, rooftop solar panels, Apple starting its own power company, etc. the utility franchise has never been more in question. Given business and interest rate risks, utilities should be trading at a discount to past valuations. But they're not. Again, utility fund managers and low-volatility fund managers must buy more shares as more money flows in. And, when investors decide to sell, those same managers will sell, regardless of price or value.

Closed-end funds are another example of captive capital. While the shares may trade at discounts to the underlying net asset value (NAV), the internal performance of the fund's assets will be entirely up to its managers. An old favorite, **Source Capital (SOR)**, is now run by Steve Romick of FPA, one of our favorite value investors. SOR currently sells at a 9% discount to NAV (so you're currently getting a $1 of assets for 91 cents.) With just $336 million to manage at SOR, Romick is likely to do even better with this small pool of assets than with his flagship FPA Crescent Fund (open-ended with $16.3 billion in assets). In addition, the expense ratio at SOR (0.85%) is lower than that of FPA Crescent (1.11%).

Age of Allocation Updates

We just read Shoe Dog, Phil Knight's memoir of building NIKE. It's a fun read. We were struck in particular how Knight bet everything on the next order of shoes. He was in constant tension with his bank. He invested everything to double the business at each turn. That was essential to the company's success. It could have been its demise – and nearly was several times. That's a big part of what makes it an exciting read.

So how many companies reinvest like that? Very few. In fact, according to Yardeni Research, Inc., the S&P 500 are spending more on buybacks and dividends than they are earning! For the 12 months ended June, 2016, S&P 500 corporations had operating earnings of $857 billion and spent $974 billion on buybacks ($585 bb) and dividends ($389 bb). Such a strategy may increase shareholder value in the short run but most likely has companies eroding their competitive positions by failing to invest aggressively in the future. This stands in stark contrast to companies like Amazon and Alphabet/Google, which are reinvestment machines. Every day these companies are building their competitive moats. To the extent the competition is not doing so, the gulf is widening every day. What grocery store will be able to compete? What bricks

and mortar vendor has a chance? Amazon clearly announced its cloud services intentions just a few years ago. Now Amazon Web Services (AWS) is knocking it out of the park. The competitive response has been surprisingly soft. While Amazon's lack of earnings doesn't work for us (perhaps it's more of a category-killing co-operative), we do acknowledge that CEO Jeff Bezos is a serial re-investor.

Alphabet (GOOG) – CEO Larry Page and co-founder Sergy Brin have built the world leader in advertising and are relentlessly growing market share day by day. The stock became reasonably priced earlier this year, giving us a chance to purchase shares for our long term growth accounts. Consider just one portion of its service: Google maps. How many times do you use that a year? It's indispensable for many of us. And it's free. Apple tried to develop their own map service. When it failed, they had to go back to Google with their tail between their legs. Apple had to have it. There was no "across the street" from Google maps. Alphabet is constantly adding more and more free services to its offering as well investing in entirely new business lines. The moat is growing.

In sum, while the shares of serial re-investors may be very richly valued and high risk with unproven business models, such companies do have the ethos of full investment in building and expanding their business castles. In a world of cautious cash management, stock buybacks, and dividend income-focused investors, such all-in companies may indeed have a major advantage.

Texas Pacific Land Trust (**TPL)** – As noted in our last client letter, we have nibbled on shares of TPL , which was founded in 1888 after the railroad went bankrupt. The Trust owns some 900,000 acres of West Texas land. With cash generated by rents, royalties and land sales, the Trust has steadily bought in shares (about 3% annually). Only 8.1 million shares remain. Sitting on an oil formation called the Delaware Trend, TPL has major upside from here. Stock got a boost as a bit of a land grab has developed in the area. Apache recently announced that its 350,00 acre "Alpine High" Permian Basin play, mostly in Reeves County, would be a game-changer for the company. TPL owns 185,000 surface acres in Reeves County.

Wells Fargo Update

We are deeply disappointed to hear about Wells Fargo's account opening fraud. Some 2 million personal accounts were opened without customers' knowledge. $2.6 million in fees were collected (just $1.30 per account), a rounding error for a $92 billion revenues bank. That makes the loss in confidence and sense of betrayal all the more mind-boggling. The banks' financial gain in this boondoggle was next to nothing. The cost in image and reputation, easily in the billions. We are awaiting the board's response. Here's Corey's recent notes after Wells Fargo CEO John Stumpf's congressional testimony:

I think we were both surprised by the testimony yesterday. Stumpf looked pretty defensive and evasive to me at least.

As many times as Berkshire Hathaway has talked about incentives causing bad behavior, I'm surprised that something more hasn't been done at Wells and sooner. They had poor controls wrapped around an incentive system that was poorly controlled.

Also, we have to remember that part of it is the political theater. The net financial losses to consumers amounted to about $2.6 million. It didn't amount to that much, but the penalty was huge ($185 million). That said, millions of accounts are millions of accounts and why it wasn't addressed more forcefully a few years ago, I don't really understand. The bank must have realized the reputational and regulatory risk it was up against versus the value created.

Dan Pecaut Corey Wrenn