Pecaut & Company

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

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EXECUTIVE SUMMARY

- **ETFs Strike the Market**
- **Look Through Cash**
- **Going Forward**
- **UBH Goes to HBS**

ETFs Strike the Market

Last week the market ended a record 588 days without a 5% sell-off. ETFs and leverage products were at the center of the selling squall. As we've cautioned in recent years, ETFs and index funds represent "non-thinking" investing. The managers of such funds must buy when buy orders come in and sell when sell orders come in. If the sell orders come all at once, things could get interesting. And so they have.

The most spectacular culprit was something called the VelocityShares Daily Inverse VIX Short-Term ETN (XIV). The VIX is the Chicago Board of Options Exchange Volatility Index, which shows the market's expectation of 30-day volatility. The VIX represents a way to trade volatility. Shorting the VIX is a way to bet on calm markets and that's what the XIV (VIX backwards) was. It took a little over 6 years for the XIV to go from $10 to $144. It took only one day for the product to implode. One wag compared the XIV trade to "picking up nickels in front of a steamroller."

One casualty was reported by Bloomberg to be LJM Partners, a Chicago-based hedge fund with about half a billion dollars in assets. Their mutual fund, known as the LJM Preservation and Growth Fund, collapsed by 82 percent over the last week. So much for preservation.

These products are toast, so the damage at the epicenter of this little quake is done. The ripple effects, however, may take some time to work through the market. With all the leverage and the recent rise in speculation, the market could be lumpy for a while.

We'd also note that of $24 billion pulled from mutual funds last week, $21 billion was from ETFs. The ease of selling ETFs contributes to their volatility. Since they are easy to sell, they are the first to be sold. And, again, the managers must sell as the orders come in.

Look Through Cash

As for our favorite companies, many of them sport unusually liquid balance sheets. In addition, most of them generate substantial free cash flow as well. While their stock prices will gyrate with those of the general market, for these unique companies, ***long-term value creation is helped by volatility.*** These owner/operators are ***free to think*** with a focus on building intrinsic value over the long run.

Take, for example, shares of White Mountains Insurance. Clearly this is an equity position. However, the intelligent owner/operators sold a majority of its subsidiaries in recent years at very favorable prices. Cash currently stands at $2.2 billion; that's $606 per share of cash on a $800 stock with a book value of $917 per share. In addition, WTM has been serial buyer of its own stock. Shares outstanding have shrunk from 6.3 million to 3.8 million over the past five years. WTM welcomes lower prices as an opportunity to continue to buy in shares.

We can say the same for each of the following owner/operator entities, each of which has an excellent record of long-term capital allocation:

- **Apple** ($181 billion in cash and securities or $35 per share, 20% of the recent price)
- **Berkshire Hathaway** (over $100 billion in cash)
- **Fairfax Financial** ($27 billion in cash and short-term bonds, 70% of its investment portfolio)
- **Google/Alphabet** ($102 billion or $147 per share, 15% of the recent price)
- **IVA Worldwide** (40% cash and cash equivalents, 6% gold)
- **ONEX** ($2.6 billion in cash and short-term securities - $22 per share – though there is substantial non-recourse debt at the operating companies)
- **Source Capital** (40% cash and asset-backed securities)

<u>Going Forward</u>

This is the sort of world where thinking investors will have a substantial advantage over the unthinking world of indexation. While volatility may be uncomfortable, it is during times of turbulence that the opportunity set for shrewd allocators of capital expands.

<u>UBH Goes to HBS</u>

Our book, *University of Berkshire Hathaway*, continues to make friends and influence people. Recently, Dan was invited to speak at the Harvard Business School! Dan had a great time with a group of 15 bright, young entrepreneurs. He was also very pleased to have his own posse; his daughter, Danielle, and niece, Amina, on hand. Dan added to Charlie Munger's Worldly Wisdom idea by sharing a meditation. He also read the best part of the book that no one seems to have noticed: Appendix I.

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