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EXECUTIVE SUMMARY

- **Investing for the Long Run**
- **Debt Dealings**
- **Invasion of the Killer BBB's**
- **Team Building – Welcome Rachel!**
- **Willkommen University of Berkshire Hathaway**

Investing for the Long Run

At this year's Berkshire Hathaway shareholder meeting, Warren Buffett said that he never would have dreamed you could have a 5% budget deficit, record low employment, super low interest rates, and low inflation all at the same time. It just doesn't compute. And if something doesn't make sense, at some point things will change. Perhaps in unexpected ways.

We have a bi-polar world of investors. On the one hand, there is fear – fear of the unknown, political risks, trade and tariff wars, massive debt accumulations at both the sovereign and corporate levels, rapid technological change, and more. Plenty to be concerned about. On the other hand, there is greed – greed to keep up with the hottest technology stocks (the S&P 500 has largely become a technology fund!). The IPO market is the hottest we've seen since the Internet bubble nearly 20 years ago. Cloud computing companies are selling at 10x revenues (never mind earnings – there aren't any.). Uber announces a quarter of a billion loss and goes *up* 2%. Uber doesn't even pretend to have a profit-making business model. It simply is out to capture the world. In a zero-based interest rate world, venture capital companies can lose money for longer in the hopes of creating a product or service business that some larger company will buy. Corey and I are used to analyzing companies with 10 to 20-year track records. These new companies haven't even been through one business cycle. When we hit stormier times, how will these companies hold up?

The good news from our value perspective is that there are some fine companies, with very long track records, selling at reasonable prices. In complete contrast to our highly levered world, these companies also have sound balance sheets and solid cash flows. It's reminiscent of what we described as the "opening scissors" market of 2000. At the top end of the scissors were the "new economy" internet stocks. On the bottom end of the scissors were the "old economy" stocks. Scores of these internet start-ups had no hope of ever making money, counting "eyeballs" and "page views" as if they were revenues. Investors were systematically selling the old economy stocks to rush out and buy the new economy stocks; hence the "opening scissors." As a stodgy old economy stock, Berkshire Hathaway got so cheap that it announced a stock buyback for the first time in decades. Berkshire sold at the equivalent of about $30 per B share in early 2000.

This metaphor proved predictive as well as descriptive. When the Internet bubble popped, the scissors closed. The high-flying dot.com stocks collapsed and the old economy stocks rallied. The NASDAQ fell some 80% over the next few years while the S&P 500 fell about 40%. Thousands of dot.com and telecom companies went bankrupt. Meanwhile, Berkshire went from 30 to 45 by early 2003 on the B shares. Today, the B shares trade at $215 per share. That's an 11% compounded return from its $30 price in 2000 and a 10% compounded annual return from $45 in 2003.

The technological changes in our world are real. The winners and losers in such a world are less obvious. Future business cycles will tell the story.

Debt Dealings

"Holding cash is simply more expensive than building an empty house."

- *Martin Hess, economist of the Swiss Bankers Association*

One of the most important things we do for our clients is to ask, *"What could go wrong?"* That question drives our risk-averse, value-oriented approach. Asking that question today, caution most certainly remains in order. Top of our list of concerns is the ongoing Central Bankers' experiment with zero-based interest rates. From what has amounted to an effort to solve a debt problem by issuing evermore debt, unexpected outcomes abound; one of the most surprising of which is a mind-boggling ***$14 trillion in negative-yielding debt.***

Our thanks to *Grant's Interest Observer* for unearthing that dilly of a quote by Mister Hess, who is referring to this $14 trillion pile of negative-yielding debt. Think of it. A lender paying ***you*** to borrow money! The lender is guaranteed to lose money on the deal. Bizarre. Now imagine that every lender in town is doing the same thing. Crazy. Yet, that is the case in Europe. When last we looked, the entire Bloomberg Barclays Global Aggregate Bond Index had a market value of some $53 trillion, which means that roughly 25% of the market value of the index is in bonds that yield less than zero to maturity. It is hard to fathom. As Grant's summarizes: *The institution of negative yields serves to remind us that radical monetary policy only begets more radical monetary policy……artificially low rates call forth artificial investments.*

In 4000 years of interest rates, nothing of this sort has ever happened. It follows that investors should add some caution to their expectations of investment returns.

Invasion of the Killer BBB's

"We can never do merely one thing."

- *Garrett Hardin, Filters Against Folly*

We submit here another entry in the list of unintended consequences: the explosion in BBB bond issuance. In response to the subprime mortgage debacle, federal overseers tightened up banking regulations. Today we have the best capitalized, highest quality banking system in the world. Yay! However, *we can never do merely one thing.* The combination of tighter bank regulation with zero-based interest rates has led to an offsetting anomaly: we now have the "junkiest" corporate bond market in history. Dubious grade corporations, unable to get bank loans in accustomed size and terms, went to the bond market to get debt financing. There they met yield-starved investors who were desperate to find some yield in this ZBI world. Together they exploded the BBB market. Today, some 50% of our $6 trillion bond market is rated BBB, the lowest of investment grade ratings. In addition, much of this lending has become "covenant lite", meaning borrowers have less than average protection in the bond covenants. This, in turn, means the bonds are even junkier than they may first appear.

This $3 trillion in BBB bonds is an amount equal to the size of *the entire bond market in 2009*. The big risk here is downgrades. When a BBB bond is downgraded, there is forced selling. Insurance companies, pension plans, and others with institutional mandates that require investment grade ratings must sell non-investment grade bonds. In a deleveraging cycle with rising defaults, many bond investors may be stung with BBB downgrades. In complete contrast to our highly leveraged world, many of our favorite investees have very large cash positions. Berkshire Hathaway famously has over $100 billion in Treasury securities. We will have a deleveraging cycle someday, and the BBB's may well lead the way. Shrewd capital allocators with plenty of cash and cash flow will be the investment beneficiaries of such an eventuality.

Team Building – Welcome Rachel!

Pecaut & Company is pleased to announce that Rachel Weitzel has joined our service team. Rachel is already enjoying working with you, our cherished clients. She was pleased and surprised to find that everyone seems so nice!

Rachel comes from the pension administration world so she brings a sound understanding of numbers, regulations and systems. She loves helping people and trouble-shooting – "detective work" as she calls it. She's finding her role at Pecaut & Company ideal for doing both. Rachel graduated from Morningside College with a major in psychology and a minor in business (again, combining people and numbers!) When's she's not problem-solving for clients, Rachel enjoys reading, knitting, gardening, and running. She's currently training for a half marathon! We are delighted to have Rachel aboard.

Willkommen University of Berkshire Hathaway

UBH is now available in German! With his German heritage, Corey is especially excited about this development. He may need to do a Munich Oktoberfest book signing tour!

Launched March of 2017, it has been a kick to see the book do so well in this Internet world. UBH continues to be a best seller at Amazon with a 4.6 star (out 5 stars) rating. Now it is going international. In fact, if all the irons in the fire work out, UBH will be translated into 11 different languages. Das ist gut!

Dan Pecaut | Corey Wrenn | John Pecaut