231 S. Phillips Ave Suite 201,
Sioux Falls, SD 57104

Tel: (605) 367-3336 / 1-888-828-3339
Fax: (605) 367-1118

The 2019 Berkshire Hathaway Annual Meeting

By John Barker, CFA

On Saturday Berkshire Hathaway held its annual meeting in Omaha. Over 40,000 investors filled the CHI Health arena to hear Warren Buffett and his partner, Charlie Munger, answer questions from shareholders, analysts, and journalists. Buffett, 88, and Munger, 95, sit on stage for six hours and answer questions while eating See's peanut brittle and chocolate and drinking Buffett's favorite beverage – Cherry Coke. Buffett, Munger, and Bill Gates (Berkshire Director) also spent three hours Monday morning with CNBC and I included those comments as well. I paraphrase much of the discussion and didn't fully edit this document to usual standards in order to disseminate quickly – please excuse any grammatical errors. Below is a quick synopsis from a few central themes, in no particular order, including:

1. Berkshire, succession planning, portfolio moves, buybacks
2. Politics & capitalism
3. Trade wars & China
4. Market volatility, general investing, & valuation
5. Money printing, interest rates, & healthcare
6. Private equity & alternative investing

1. <u>Berkshire, performance, succession planning, portfolio moves, buybacks:</u>

Berkshire: Understanding the Berkshire model is paramount to appreciating the earnings power and sustainability of the business. When you have a business valued at $500B composed of nearly a hundred smaller business, $200B of stocks, $100B of cash and a giant insurance operation, the question of "Why keep it together?" gets asked often. The Berkshire model is advantaged in a few ways:

- Insurance: the operation has $125B in float (unpaid long-dated insurance liabilities) and profitable underwriting, meaning Berkshire is paid about 5%/year (on premiums) to take capital and invest for the long-term. If float continues to grow (which is has and should continue) so does the portfolio of public and private businesses. The insurance business is worth significantly more sitting inside Berkshire versus a standalone entity, given Berkshire's capital and investment acumen.
- Culture & capital allocation: Berkshire's decentralized, long-term, patient, accountable culture is now its largest advantage, in my opinion. The Berkshire managers spend zero time on management meetings, powerpoints, investor relations, and committee meetings – they simply manage the businesses and Buffett decides who gets capital. Typical public companies do not have as many options for capital allocation as Berkshire and instead force growth in no growth markets or make acquisitions to fuel growth – at Berkshire, if your business is profitable, but has slow/no growth, they simply reallocate capital to its highest and best use, tax-free within the

business. This sounds simple and obvious, but most management teams are incentivized and paid to grow, not return capital.

Performance: Berkshire's stock hasn't kept up with the market over the previous five- and ten-year periods. Buffett acknowledged it's been hard to keep up in a straight-up market environment, given the cash holdings and size of the business. We know Buffett is extremely competitive and wants to perform but will likely need a cycle to present compelling investment opportunities to put capital to work.

Succession: Anytime the CEO & Chairman is 88 and the vice chairman is 95, you can expect succession planning to enter the conversation. Buffett has made it clear he has no plans of slowing down or stepping aside, but he continues to paint of picture of continuity, including:

- Greg Abel running Berkshire operating companies and likely the next CEO
- Ajit Jain running all insurance operations
- Ted Weschler and Todd Combs running the marketable portfolio and working on private deals
- Howard Buffett (son) as non-executive chairman

We're satisfied with the plan and think Berkshire continues in its current form, post Buffett. But Buffett made it clear, if the company doesn't deserve to maintain its current form (is underperforming) it'll be broken up, as it should be. He still maintains the stock price will be higher the day after he dies as investment bankers salivate over the breakup potential.

Portfolio moves:

<u>Occidental:</u> Timely that last week Berkshire announced a $10B investment in Occidental Petroleum, contingent on Occidental successfully acquiring Anadarko. Berkshire will get 8% preferred stock and a warrant to purchase more Occidental shares. On Monday, Buffett said it's a bet on higher oil prices over the long-term and the Permian Basin. Buffett mentioned multiple times his interest in writing more $10B (or larger) checks on short notice. He said Berkshire can turnaround an investment (from call to check) in a few days, unlike any competition.

<u>Tech:</u> Buffett and Munger lamented (again) on their thumb-sucking regarding missing investing in Google as they had direct exposure via Geico. Again, Munger said he didn't mind missing Amazon because Bezos has worked miracles and he can't predict miracles. Munger said the Apple investment may atone for missing Google and Microsoft.

<u>Wells Fargo:</u> Both continue to support Wells Fargo. Munger called out the previous CEOs (not Tim Sloan), Dick Kovacevich and John Stumpf, for creating a culture of incentives which drove profits but also pushed the envelope too far. Buffett indicated his advice to the company is to hire an outsider (non-Wall Street) CEO.

Buybacks: Popular topic from shareholders and in the current press, many questions centered on the Berkshire buyback program. Buffett mentioned a few weeks ago Berkshire could potentially buyback $100B of more of its stock, assuming valuation was compelling. Berkshire bought back about $1.7B in the latest quarter and Buffett made it clear he feels Berkshire is trading below its intrinsic value but not so low he wants to "Back up the truck." Nonetheless, we'd expect Berkshire to continue to buyback shares at this level. Buffett also discussed the idea of corporate buybacks, saying they can be good or bad, depending on the price paid, like any acquisition. Buying back stock should be price-to-value-contingent, not a capital allocation decision. Far too many boards buy high (when cash is plentiful) and stop buying when the market drops. Buffett made it clear, Berkshire stands ready to deploy significant capital if the price of its shares drop.

2. Politics & capitalism:

Given the heat around the current topic, the questions on this topic were many. Buffett said he is a "Card-carrying capitalist" and doesn't think America will embrace socialism by 2020, 2040, or 2060. He said (paraphrase) from 1776 until today, compare what our country has created under capitalism to any country or system in the world. Many countries have promised much under centrally-planned economies, but all have failed. The question isn't what is the best system but understanding the deficiencies of capitalism and planning accordingly. Capitalism leaves some behind as people, markets, and economies specialize. We need to take care of those without market skills, get them trained and provide safety nets and incentives – this makes more sense than shutting down the economic engine which has created and sustained our country's success.

Buffett mentioned he has voted for many Republican presidents over the years but didn't mention his intentions for 2020 – it can be assumed he holds capitalism as his number one priority. Neither Buffett or Munger seemed to think a real threat to capitalism was realistic.

3. Economy, trade wars & China:

Economy: Buffett continues to marvel at the US economy. A few questions were asked around the risk of technological obsolescence and its impact on employment. Buffett discussed how in 1800, 80% of the jobs (population ~5 million people) were farming. Today, the US has roughly 3 million jobs in farming but has 125 million other jobs. He said capitalism's job is to do more, with less. But to-date, the "More" always results in other jobs in adjacent or new industries. Capitalism reallocates resources to the highest and best use.

China: Timely conversation given Trump's tweet on Sunday, Buffett and Munger spent much of Monday discussing China and the current trade spat. Buffett said investors should anticipate the US and China to always have tensions over trade, as the world economic super-powers are each (and should be) interested in extracting the best trade terms for its citizenry. Buffett and Munger believe China and the US will find a reasonable settlement, but can't rule out the possibility of a prolonged trade war, under which the whole world suffers from reduced trade, tariffs (equal to higher taxes), and the risk trade wars lead to real wars. Ultimately, each country has an incentive to avoid a long-term, costly trade war.

NAFTA: Buffett said he was a fan of NAFTA and the US should be happy to have Canada and Mexico as neighbors – and the US should treat them as neighbors/allies, not adversaries.

4. Market volatility, general investing & valuations:

Volatility: During the Monday interview, Buffett was asked about volatility and its impact on his appetite for making investments. Buffett said he prefers low prices, so after identifying a business to purchase, he welcomes temporary news that might depress the stock price. Buffett has given this advice for decades – and somehow people continue to ask the question. His long-term optimism for American business is unwavering – and with a long enough time horizon (remember Berkshire is a perpetual organization) everything is temporary. Buffett said if you pick the right businesses, the stock shouldn't matter, unless you pay an exorbitant price or get emotional (greedy or fearful).

IPOS: Buffett and Munger said they've never purchased an IPO. Buffett said, "With ten thousand investment options, what's the likelihood a new issue, after being hyped on road-shows for months, with 10% equity commissions to selling brokers, and heavy insider selling (from people who know a lot more than you do) would be the best thing to buy? The incentives are terrible, so they avoid IPOs.

Investment ideals: Reading between the lines and observing Buffett and Munger for many years, they are very cautious of broad investment ideals, like we don't do blank or we always do blank. Buffett avoided airlines for decades, saying they were terrible investments. He is now the largest shareholder in American, Delta, Southwest and United. The business changed so Buffett changed his mind. This sounds simple, but in practice (and in front of millions of people on the global stage) it's incredibly difficult and requires humility. No one is better at changing their mind when the facts change than Buffett and Munger.

Equity valuation: Buffett gave the same valuation statement he's given the last several years: "If one believes interest rates will stay low for the foreseeable future, equity valuations are extremely cheap." One cannot value equities without an opinion on where interest rates go long-term. Reading between the lines (and knowing Buffett has mentioned on many occasions he expects inflation at some point) he doesn't believe rates will stay low forever, as evidenced by the over $100 billion in cash at Berkshire.

Misc.: A few questions were asked about index funds. One investor asked if Buffett likes the S&P 500 so much, why doesn't Berkshire invest a portion of the $115 billion in cash? He made the point if excess cash would've been invested in the S&P 500, instead of US Treasury bills, an additional $50 billion in value would've been created. Buffett didn't argue the point – and Munger quipped, 'We're too old to change." Buffett understood the point and there is a limit to how much cash Berkshire should hold. Paying dividends is not tax-efficient, but Berkshire needs to buyback more stock, buy index funds, or put more capital to work. Remember, an additional $2 billion comes in monthly or nearly $70 million/day.

5. <u>Money printing, interest rates & healthcare:</u>

Monetary policy: A popular topic for years given the dynamics playing out across the world over the last decade. On Monday, Buffett said, "If you would have told me ten years into an economic recovery that we could have a 3% long-term bond (30-year), low inflation, 5% budget deficits, and full employment, I would have said it was impossible." Buffett and Munger have both stated on many occasions they cannot believe the current monetary policies have not resulted in inflation.

Munger mentioned his fear of anyone who thinks they can print money without consequence. He said, "Ask Venezuela how it worked!" Many of the proponents of modern monetary theory (MMT) believe printing more money can solve any problem – and since we can always print more, we'll never default and can pay for any expense. Excessive money printing, when exacerbated, leads to runaway inflation and depression. But it works until it doesn't. Munger expressed he'd like to see the US run its government like Singapore, which is debt free.

Healthcare: With healthcare nearly 20% of GDP, it's always a popular topic. Buffett discussed the new healthcare venture between Amazon, Berkshire, and JP Morgan – and it's moving slow, as expected. He still thinks the private sector can solve the healthcare issue better and faster than the government. He didn't give details on focus, timing, or business opportunities. Munger ended the interview with his longstanding prediction: the US will be a single-payer healthcare system next time the democrats control the government.

6. <u>Private equity and alternative investing:</u>

Buffett discussed the current competitive landscape for private deals. He called out the alternative investment funds broadly for high fees, excessive leverage, and aggressive performance reporting. An estimated $1 to $2 trillion in "dry powder" is on the sidelines today awaiting private equity deals. This capital may be levered-up with another $2 trillion of debt. With valuations at record high, likely peak-cycle earnings, and aggressive add-backs to EBITDA (which we all know is a poor proxy for free cash flow) – one can see the current risk in PE today. The discussion around alternative investing was reminiscent of the discussion on hedge funds back in 2008 when Buffett made the bet the S&P 500 would beat a basket of hedge funds. The competitive nature and excessive capital raising in alternatives has certainly impacted Berkshire's ability to put capital to work.