Elgethun Capital Management

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

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

The 2017 Berkshire Hathaway Annual Meeting

By John Barker, CFA

On Saturday, May 6th Berkshire Hathaway held its annual meeting in Omaha. If you haven't attended a Berkshire annual meeting it's difficult to explain the scene and is unlike any other annual meeting. Over 30,000 investors fill the CenturyLink arena to hear Warren Buffett and his partner, Charlie Munger answer questions from the shareholders, analysts, and journalists. Buffett, 86, and Munger, 93, 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. Below is a quick synopsis of my main takeaways from the 2017 meeting, in no particular order.

Incentives:

Buffett discussed the importance of understanding incentives in businesses, relationships, and every other arrangement. He and Munger have discussed this topic many times in the past, but it was acutely relevant in the Wells Fargo account-opening scandal last year. Buffett said designing and critiquing the incentive system in a business in one of the most important actions. If you're not aware of your current incentive system, that's a scary thought, because everyone is motivated by incentives and if you haven't carefully and thoughtfully designed yours, it's possible they're misaligned.

Amazon, Apple and Google:

Buffett discussed how many of the largest businesses today do not own a material amount of tangible assets – think Google parent Alphabet, Apple, and Microsoft. Much different than a time when tangible assets and capital investments in PPE were a necessity to compete globally in most/all markets. Today, technology companies are benefitting from the vast scale offered by the internet and networking. He seemed regretful that he missed out on investing in Amazon, Google, and Apple earlier. Buffett discussed his admiration for Jeff Bezos. He didn't say this, but it was obvious that he doesn't want to compete with Amazon with his portfolio companies or directly. This could have something to do with why he sold part of his IBM position (IBM is a major player, along with Amazon in cloud computing).

Changing His Mind:

No one is better than Buffett at recognizing mistakes and shifting gears. When new information is presented Buffett changes his mind about a company, an entire sector, or asset class. This is difficult for many obvious reasons, but Buffett doesn't have attachment issues. This was on display for two reasons.

1. Apple purchase – Buffett, going back to the Dot-Com bust, has been cautious to invest in technology, avoiding it like the plague. Today, with technology making up almost 20% of the value of the S&P 500, it's become difficult to avoid the fastest growing sector of the US economy. He purchased IBM in 2011, but regretfully admitted he should have bought Amazon and Google instead (even the best investor of all time makes mistakes!). He started buying Apple last year and has built a $20 billion position in the handset maker.
2. Airlines – Buffett had a bad experience investing in the airline business in the 1980s. He's said many times that if a capitalist would have been at Kitty Hawk they would have shot down the Wright brothers because airlines have destroyed so much shareholder value since inception. But, Buffett believes the economics in the airline business have dramatically changed and is now the largest shareholder in the four largest airlines, investing 6% of his portfolio in Southwest (LUV), Delta (DAL), United (UAL), and American (AAL). He basically laid out his thesis for the airline industry:
    a. Better labor stability
    b. Consolidation, leading to higher utilization and rationale pricing
    c. Growing global demand
    d. Somewhat insulated from technology and new entrants (there aren't many sectors today that don't compete with Amazon, Apple or Google – airlines are one of them
    e. Lower fuel prices (30% of COGs for airlines), indicating he doesn't think oil is going back to $100 soon
    f. More ways to generate fees (baggage, change, upgrades, food/beverages, etc.)

Buffett said the airline business is still a tough business, but given valuations today, long-term investors have a reasonable likelihood of making money.

<u>Valuations / Holding Cash:</u>

Berkshire was holding over $90 billion in cash as of March 31, 2017. Today that number is close to $100 billion or roughly 40% of his investable assets, compelling evidence that he's having a hard time putting money to work. Buffett mentioned before when asked about valuations of stocks, that interest rates are the most important variable, saying if rates stay low for a long time (think Japan) that equities are not overvalued at all. If rates normalize to historic ranges, that equities would be quite expensive. Long-term, low interest rates are associated with stagnation, low growth (negative), lower productivity (negative), and less investment (negative), all probably leading to lower profits and valuations.

<u>Taxes and Healthcare:</u>

Buffett, when asked about tax reform, said lower taxes would certainly benefit Berkshire given the billions of dollars in capital gains (remember corporations don't get preferential cap gains treatment), in addition to lower taxes on current earnings. He said each business would be impacted differently, as some businesses would pass the savings along to consumers.

Buffett called out healthcare costs as the biggest impediment to American competiveness. From the 1960s, healthcare costs, as a percent of US GDP, have risen from 5% to 17%, while corporate tax revenue shrank from 4% to 2% of US GDP.

Berkshire, Post Buffett:

Every year Buffett is asked about continuity and Berkshire Hathaway post Buffett. He indicated again this year that it's likely Berkshire will pay a dividend in the future as cash swells. He also believes that stock price will go up the day after he dies, saying many will speculate the company will be worth more if someone if willing to separate it. Buffett believes (and we agree) that the advantages of Berkshire (a deep management bench and strong Board, decentralization, rational/prudent capital allocation, patient and disciplined investment strategy, heroic cash flows from incredibly strong, diverse businesses, etc.) will continue long into the future.

Investment Advice – General:

Buffett and Munger both discussed the pains and regrets of investing in businesses they believed were fixable. As most know, young Buffett practiced a deep value investment strategy, often purchasing lousy businesses at a fraction of book value. Munger came along and pulled Buffett out of the "dumpster" and into the strategy of buying compounding businesses with competitive advantages. As usual, someone asked for Buffett's investment criteria, and as usual, Buffett recited the four attributes he seeks:

1. A business he understands
2. A business that possesses a durable, competitive advantage
3. Trusted, aligned management with skin in the game
4. A fair price

Charlie Munger:

Charlie Munger is one of my favorite persons. He's witty, rationale, and always says exactly what's on his mind. When asked about the sources of Berkshire's success, Munger deadpanned: we were less stupid than everyone else. Munger continued, saying that staying rationale is much better than attempting brilliance. He discussed the often underappreciated concept of compound learning. He said the Berkshire system is well equipped to avoid the blinding effects of self-interest and blind spots.