

**LESSONS FROM THE TRENCHES:**  
VALUE INVESTING,  
ENTREPRENEURSHIP & LIFE

# AN ANALYSIS OF BERKSHIRE HATHAWAY

BY WHITNEY TILSON | [WTILSON@KASELEARNING.COM](mailto:WTILSON@KASELEARNING.COM)

(This latest version of this presentation is always posted at: [www.tilsonfunds.com/TilsonBRK.pdf](http://www.tilsonfunds.com/TilsonBRK.pdf))

# OVERVIEW OF KASE LEARNING



KASE LEARNING

# I CLOSED MY HEDGE FUNDS IN OCTOBER 2017 AND AFTER A FEW MONTHS OF THINKING LAUNCHED KASE LEARNING

- My parents are both educators, I love to teach, and I've done a lot of teaching, writing, and mentoring over the years, so it was a natural transition
- There's a large global market of sophisticated investors who want to learn and become better, many of whom want to start/grow their own investment funds, and there's almost nobody teaching these things
  - Continuing Legal Education (CLE) and Continuing Medical Education (CME) are major industries, but there's nothing comparable for investors
- My long-time partner at Kase Capital, Glenn Tongue, has rejoined me
- We seek to capture all of the lessons we learned in nearly two decades in the hedge fund trenches, both as investors and entrepreneurs, and impart that knowledge to others so they can stand on our shoulders and achieve even greater success

# INVESTING IS A BATTLE

- The reason we call Kase Learning's core program *Lessons from the Trenches* is that investing is a battle
- This long bull market combined with the rise of indexing and the increasing sophistication of supercomputers has made the job of investors and fund managers much harder
- So, to succeed, you have to be better than ever before: do even more in-depth research, do better analysis, be more patient and disciplined, etc.
- Most importantly, you have to constantly be moving rapidly up the experience curve
- There are only two ways to get experience: learning from veterans (like us) or stumbling around on your own, making mistakes and getting scars on your back
- Which do you prefer?

# REAL-WORLD EXPERIENCES & CASE STUDIES

- We are not interested in academic theories; everything we teach is rooted in our own real-world experiences and case studies
- There are many value investing programs and books that teach the basics: intrinsic value, margin of safety and sustainable competitive advantage; various valuation methodologies; how to do a discounted cash flow, etc.
- But understanding these topics is far from what is truly necessary to successfully navigate today's difficult markets
- We teach dozens of lessons we learned – in many cases, the hard way – over two decades in the trenches: how to find great stocks, avoid value traps, manage a portfolio effectively, short sell, be an activist, control one's emotions, hire the right people at the right time, make a name for yourself, raise money, communicate well with investors, and much more

# WE FOCUS ON SUCCESS *AND* MISTAKES

- During our years at Harvard and Wharton business schools, we read hundreds of case studies and pretty much every one featured a heroic protagonist, facing a difficult issue, but almost every time reaching the right decision and achieving great success
  - We can't recall a single one in which the protagonist made wrong decisions and screwed it all up
- This is not how the world works — everyone makes mistakes and suffers setbacks
- We believe that it's just as important to teach and learn from mistakes, so we honestly share the many we made so that others can avoid them
  - “Only a fool learns from his own mistakes. The wise man learns from the mistakes of others.” – Otto von Bismarck

# HOW WE THINK ABOUT INVESTING

- We are value investors, so anyone looking for hot stock tips or advice on how to get rich quick *should not take our programs*
- That said, we are primarily “make money” investors, so we define value broadly
  - We believe that value can be found in many places, even among growth stocks, so we teach case studies that include Netflix, Alphabet, Facebook and SodaStream

# WE ALSO TEACH ENTREPRENEURSHIP

- The hedge fund industry is now very large, but at its core it's still an apprenticeship business: young guys (sadly, they're almost all men) learn the business from grizzled veterans
- But what about the 99% of investors who dream of being the next Warren Buffett or Julian Robertson, but aren't lucky enough to land a job at an established firm?
- How are they supposed to learn what they need to know to have any reasonable chance of success?



# KASE LEARNING'S THREE CORE PROGRAMS

1. An intensive, three-day, 36-hour bootcamp: *Lessons from the Trenches: Value Investing, Entrepreneurship and Life*
2. A one-day seminar (generally taken with the bootcamp): *How to Launch and Build an Investment Fund*
3. A one-day program: *An Advanced Seminar on Short Selling*
  - These programs are scheduled over five consecutive days and can be taken together (at a discount) or a la carte
  - We've scheduled these programs over five days in NYC from June 12-16, London from July 7-11, and have scheduled them over the next nine months in cities around the world:
    - Sao Paulo (Aug. 27-31), Mexico City (Sept. 3-7), NYC (Oct. 25-28), Toronto (Oct. 1-5), Shanghai (Oct. 15-19), Hong Kong (Oct. 22-26), Sydney (Nov. 26-30), NYC (Dec. 3-7) Mumbai (Jan. 7-11), Singapore (Jan. 14-18), Zurich (Feb. 4-8), Dubai (Feb. 12-22), Tokyo (Feb. 25-Mar. 1), Melbourne (Mar. 11-15)
  - In addition, via live webinar we will teach our bootcamp over nine days (2½ hours/day from 7:30-10:00pm NY time) from July 23-Aug. 1, followed by our fund seminar from Aug. 2-4
  - Lastly, we are teaching a five-day introductory seminar in NYC June 18-22 for high school and early college students entitled *An Introduction to Economics, Business, Finance and Investing*

# KASE LEARNING'S CONFERENCE ON SHORT SELLING

- This long bull market has inflicted absolute carnage on short books, and even seasoned veterans are throwing in the towel
- This capitulation, however, combined with the increasing level of overvaluation, complacency, hype and even fraud in our markets, spells opportunity for courageous short sellers
- On May 3<sup>rd</sup> in New York City, Kase Learning hosted the first-ever conference dedicated entirely to short selling, which featured 22 of the world's top practitioners, including David Einhorn and Carson Block, who shared their wisdom, lessons learned, and best, actionable short ideas
- The conference was such a success that we're hosting another one in NYC on Monday, September 24
- Contact Kase Learning for an early-bird discount

# TESTIMONIALS

- “The greatest teacher of investing was Benjamin Graham. He was followed by Warren Buffett and Charlie Munger. Believe me, the third person is Whitney Tilson. He’s a natural teacher.” – Chris Stavrou, Stavrou Partners (watch the video [here](#))
- “It was a wonderful, almost life-changing experience. In a nutshell, it felt like an intensive infusion of wisdom and practical advice. I also really enjoyed meeting the people in the group who were, without exception, intelligent, hard-working, open-minded and friendly.” – Gabriel Grego, Quintessential Capital Management LLC
- “I would absolutely recommend this seminar to anyone aspiring to run their own investment management business. What is taught in this seminar is pure gold. It’s not taught anywhere else and there aren’t that many people in the world who really understand what it takes to raise a billion-dollar fund. I think that this is an incredible product. It’s not really a proxy for business school or Columbia’s value investing program. It’s more advanced and for someone farther ahead in their career. There are so many start-up, emerging managers who have no idea how to raise money and where to start.”

# TESTIMONIALS (2)

- “As a young analyst trying to get ahead, this was the shot in the arm I needed. I know the hedge fund world has become increasingly difficult and competitive, so I’ve been looking for any leg up I could find – and the seminar delivered, far surpassing my expectations. I was blown away by the one-on-one, personalized attention and can’t imagine a better way to learn than from Whitney’s case-based format. I left the seminar a better investor, entrepreneur and, unexpectedly, better person. Highly recommended!” – Jeremy Lichtman, SevenSaoi Capital
- “At the beginning of Whitney’s course, I didn’t know what to expect and had little idea of how to set up and market my business, but after only a few days it’s not an understatement that the seminar will make me millions of dollars and save me a great deal of trouble. Whitney laid out everything he did right in launching and growing his fund for more than a decade and then, perhaps more importantly, very honestly detailed what he did wrong. Through his connections, we also met with investors at the very top of the industry who were very generous with their time and open to all questions. Lastly, I now have 12 friends who are very bright and at a similar point in their careers who I can bounce ideas off of, a clear plan for how to market and grow the business (it’s encouraging when you hear Bill Ackman tell you he likes your plan), and most importantly I know what pitfalls to avoid.” – Angelo Martorell, Martorell Capital Partners

# ARTICLES

- *So You Want to Be a Hedge Fund Star?*, Barron's, 5/11/18
  - [www.barrons.com/articles/so-you-want-to-be-a-hedge-fund-star-1526069114](http://www.barrons.com/articles/so-you-want-to-be-a-hedge-fund-star-1526069114)
- *The Last Days of Whitney Tilson's Kase Capital*, Institutional Investor, 3/20/18
  - [www.institutionalinvestor.com/article/b17f19gwp3595r/the-last-days-of-whitney-tilson's-kase-capital](http://www.institutionalinvestor.com/article/b17f19gwp3595r/the-last-days-of-whitney-tilson's-kase-capital)
- *Whitney Tilson On The Rise And Fall Of Kase Capital*, Forbes, 5/1/18
  - [www.forbes.com/sites/kevinharris/2018/05/01/whitney-tilson-on-the-rise-and-fall-of-kase-capital](http://www.forbes.com/sites/kevinharris/2018/05/01/whitney-tilson-on-the-rise-and-fall-of-kase-capital)
- *How My Success Led to My Fall*, Yahoo Finance, 5/23/18
  - <https://finance.yahoo.com/news/success-led-fall-174512177.html>
- *The Launch Of Kase Learning And Running A Hedge Fund*, Seeking Alpha interview, 5/26/18
  - <https://seekingalpha.com/article/4177128-sa-interview-whitney-tilson-launch-kase-learning-running-hedge-fund>

# FURTHER INFORMATION

- Email me at [WTilson@kaselearning.com](mailto:WTilson@kaselearning.com) if you would like to be added to my investing email list (roughly one email/week) and/or have questions or comments
- Further information is at [www.kaselearning.com](http://www.kaselearning.com) or call (212) 265-4510
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# AN ANALYSIS OF BERKSHIRE HATHAWAY



KASE LEARNING

# THE BASICS

- Stock price (5/11/18): \$301,000 (\$200.50 for B shares)
- Shares outstanding: 1.64 million
- Market cap: \$494 billion
- Total assets, equity, revenue and float (Q1 '18): \$703B, \$351B, \$236B and \$116B, respectively
- Book value per share (Q1 '18): \$211,184
- Repurchase maximum price (1.2x book): \$253,421
- Downside to the Buffett repurchase put: 16%
- P/B: 1.43x
- Berkshire Hathaway today is the 9<sup>th</sup> largest company in the world (and 3<sup>rd</sup> largest in the U.S.) by revenues

At today's price, we're not pounding the table on the stock, but if you want to sleep well at night and have a very good chance of beating the S&P over time, especially if the market does poorly, then Berkshire is a great addition to a conservative portfolio.



# HISTORY

- Berkshire Hathaway today does not resemble the company that Buffett bought into during the 1960s
- It was a leading New England-based textile company, with investment appeal as a classic Ben Graham-style "net-net"
- Buffett took control of Berkshire on May 10, 1965
- At that time, the company had a market value of about \$18 million and shareholder's equity of about \$22 million

# THE BERKSHIRE HATHAWAY EMPIRE TODAY



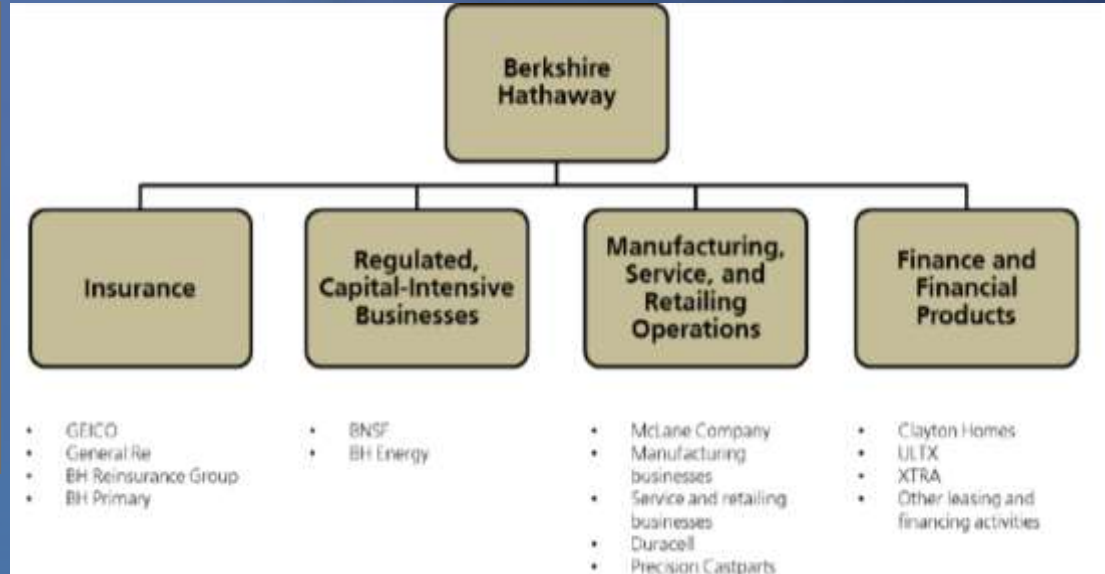
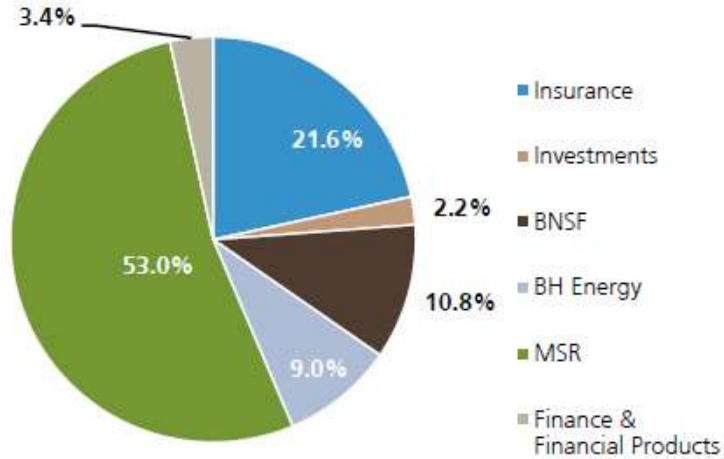
Largest Stakes in Public Companies (\$B)

<u>Company</u>	<u>Shares</u>	<u>Price</u>	<u>Value</u>
Apple	241.7	\$183.83	\$44,434
Wells Fargo	482.5	\$52.41	\$25,290
Bank of America	700.0	\$29.30	\$20,510
Kraft Heinz	325.4	\$58.01	\$18,879
Coca-Cola	400.0	\$42.36	\$16,944
American Express	151.6	\$98.35	\$14,911
Phillips 66	74.6	\$115.61	\$8,623
U.S. Bancorp	103.9	\$50.34	\$5,228
Moody's	24.7	\$166.31	\$4,103
Bank of NY	53.3	\$54.49	\$2,905
Delta Airlines	53.1	\$52.34	\$2,780
Goldman Sachs	11.4	\$234.94	\$2,676
Southwest Airlines	47.7	\$52.78	\$2,515
Charter Comm	6.8	\$276.07	\$1,874
General Motors	44.5	\$36.71	\$1,635
BYD	225.0	\$6.45	\$1,451
Others			\$24,294
<b>TOTAL</b>			<b>\$199,052</b>

Notes: Share count as of 12/31/17 13-F plus 75M AAPL; Stock prices as of 5/4/18.

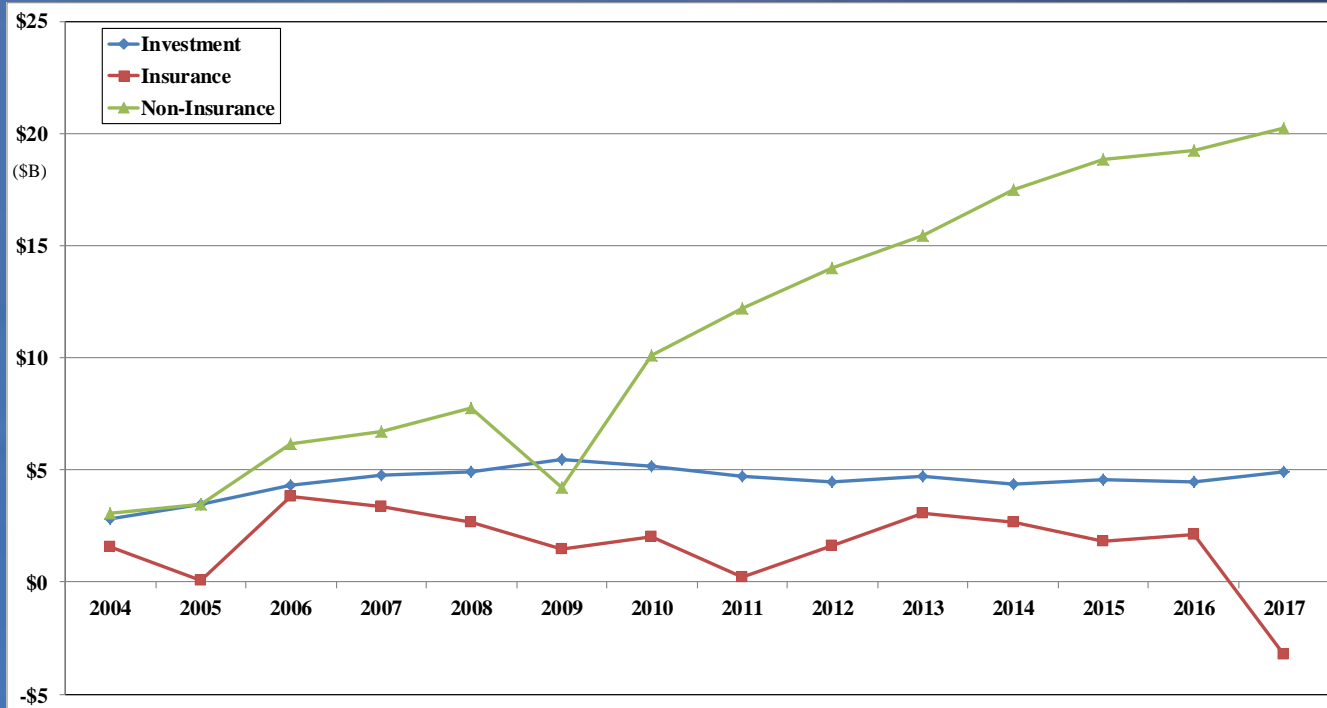
# THE BERKSHIRE HATHAWAY EMPIRE TODAY (2)

Revenues (2015)



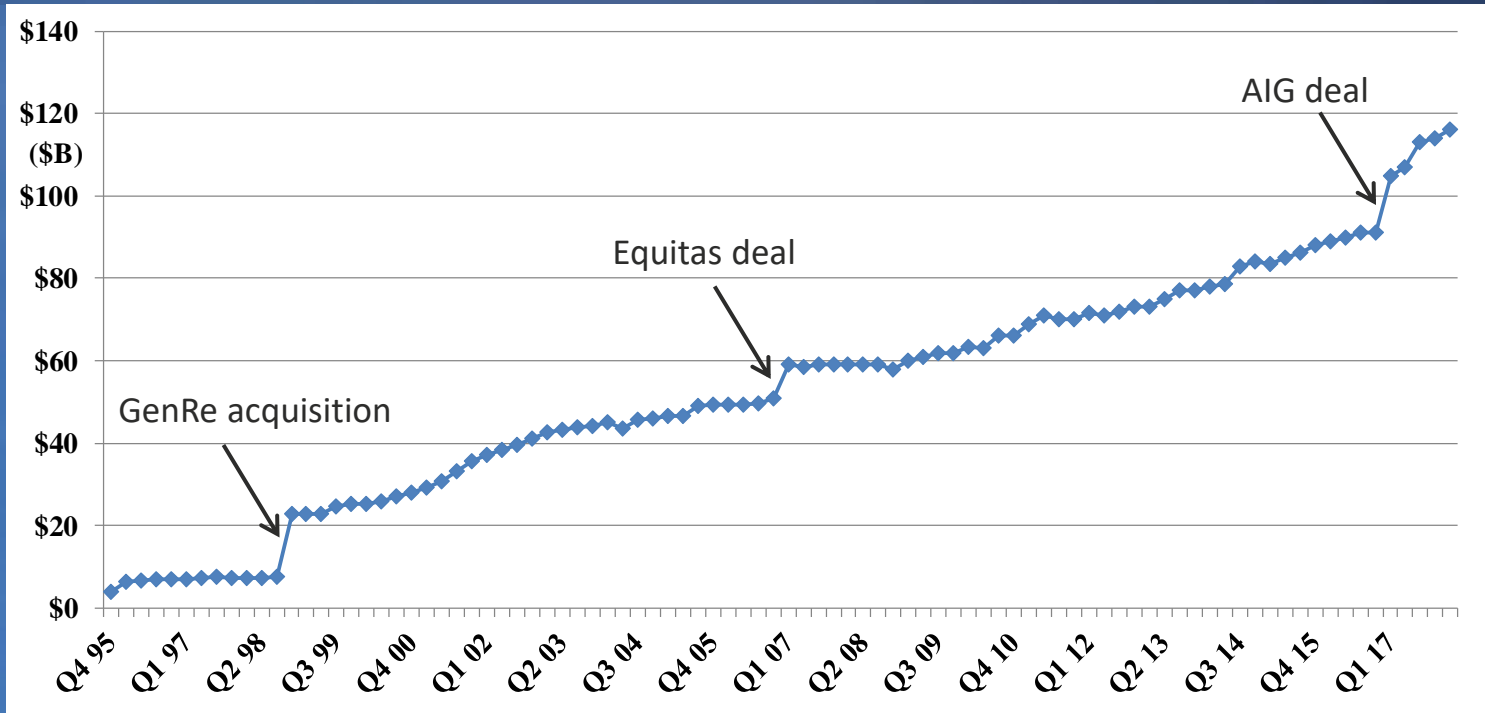
Source: UBS analyst report, 3/28/16.

# BERKSHIRE'S NON-INVESTMENT INCOME HAS SOARED OVER TIME



Note: Insurance losses in 2017 were primarily due to “several significant catastrophe loss events occurring during the year including hurricanes Harvey, Irma and Maria, an earthquake in Mexico, a cyclone in Australia and wildfires in California” and an increase in “ultimate claim liability estimates related to the...aggregate excess-of-loss retroactive reinsurance agreement with AIG.”

# BERKSHIRE'S FLOAT HAS GROWN ENORMOUSLY



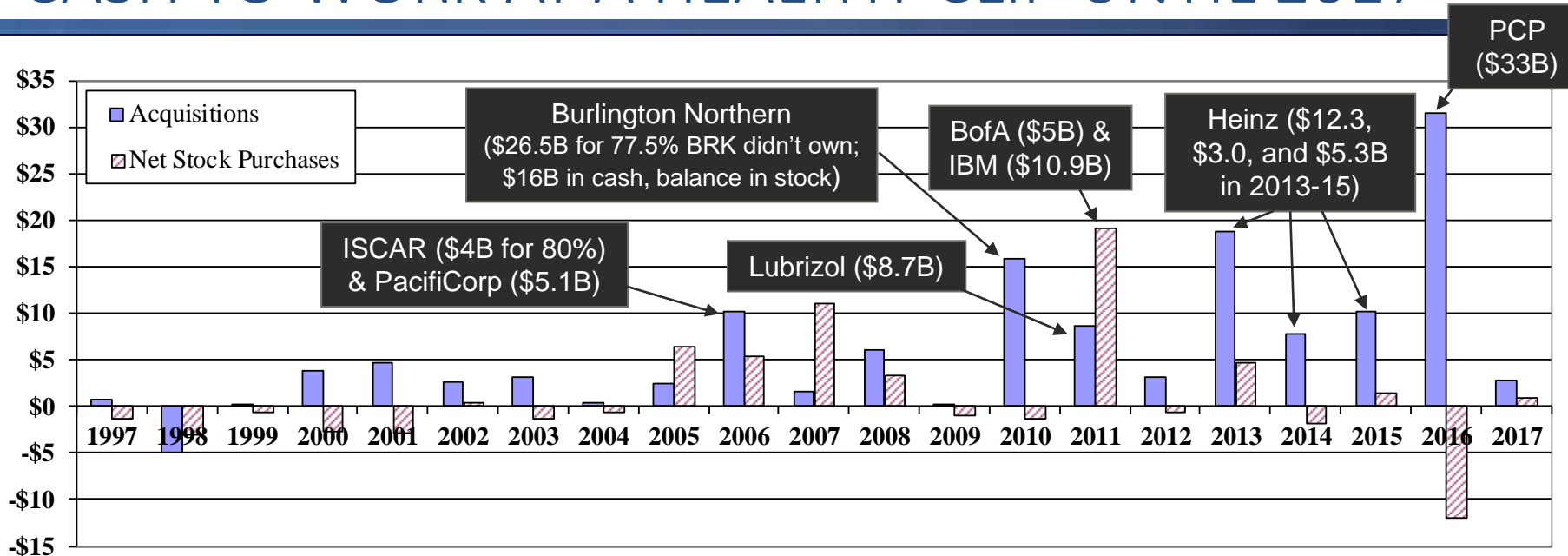
# BERKSHIRE'S Q1 EARNINGS WERE EXTRAORDINARY

- The headline number looked bad: a net loss of \$1.1 billion vs. a \$4.1 billion profit in Q1 '17
  - The headline in the WSJ was: *Warren Buffett's Berkshire Hathaway Swings to a Rare Loss on Unrealized Investment Hit*
- This was entirely due to ~\$8 billion in unrealized losses in Berkshire's nearly-\$200 billion stock portfolio, which is *totally meaningless*
  - Due to new accounting rules, the fluctuations in this portfolio appear in the net income line (formerly, it was in Comprehensive Income)
- But in reality, it was a blowout quarter, as pre-tax profits in the three largest segments soared:
  - Manufacturing up 25% from \$1.49 billion to \$1.86 billion
  - Insurance up 130% from \$750 million to \$1.7 billion
  - BNSF up 12% from \$1.35 billion to \$1.51 billion
- Overall, pre-tax profits rose 30% from \$5.1 billion to \$6.6 billion
- As a full taxpayer, Berkshire is one of the largest beneficiaries of the new tax law – its tax rate fell from 30% in Q1 '17 to 20% in Q1 '18
- This led to a 49% gain in after-tax operating earnings, from \$3.6 billion to \$5.3 billion

DESPITE BEING VERY CONSERVATIVELY POSITIONED, THE STOCK HAS KEPT PACE WITH THIS LONG BULL MARKET



# BUFFETT, COMBS & WESCHLER WERE PUTTING CASH TO WORK AT A HEALTHY CLIP UNTIL 2017



- High valuations are keeping Buffett, Combs and Weschler on the sidelines these days
- But markets have a way of presenting big opportunities on short notice

- Junk bonds in 2002, chaos in 2008

- Buffett has reduced the average maturity of Berkshire's bond portfolio so he can act quickly



# VALUING BERKSHIRE

"Over the years we've...attempt[ed] to increase our marketable investments in wonderful businesses, while simultaneously trying to buy similar businesses in their entirety." – 1995 Annual Letter

"In our last two annual reports, we furnished you a table that Charlie and I believe is central to estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace our two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments, but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column." – 1997 Annual Letter

<u>Year</u>	<u>Investments Per Share</u>	<u>Pre-tax Earnings Per Share Excluding All Income from Investments</u>
1967	\$ 41	\$ 1.09
1977	372	12.44
1987	3,910	108.14
1997	38,043	717.82

"In effect, the columns show what Berkshire would look like were it split into two parts, with one entity holding our investments and the other operating all of our businesses and bearing all corporate costs." – 1997 Annual Letter

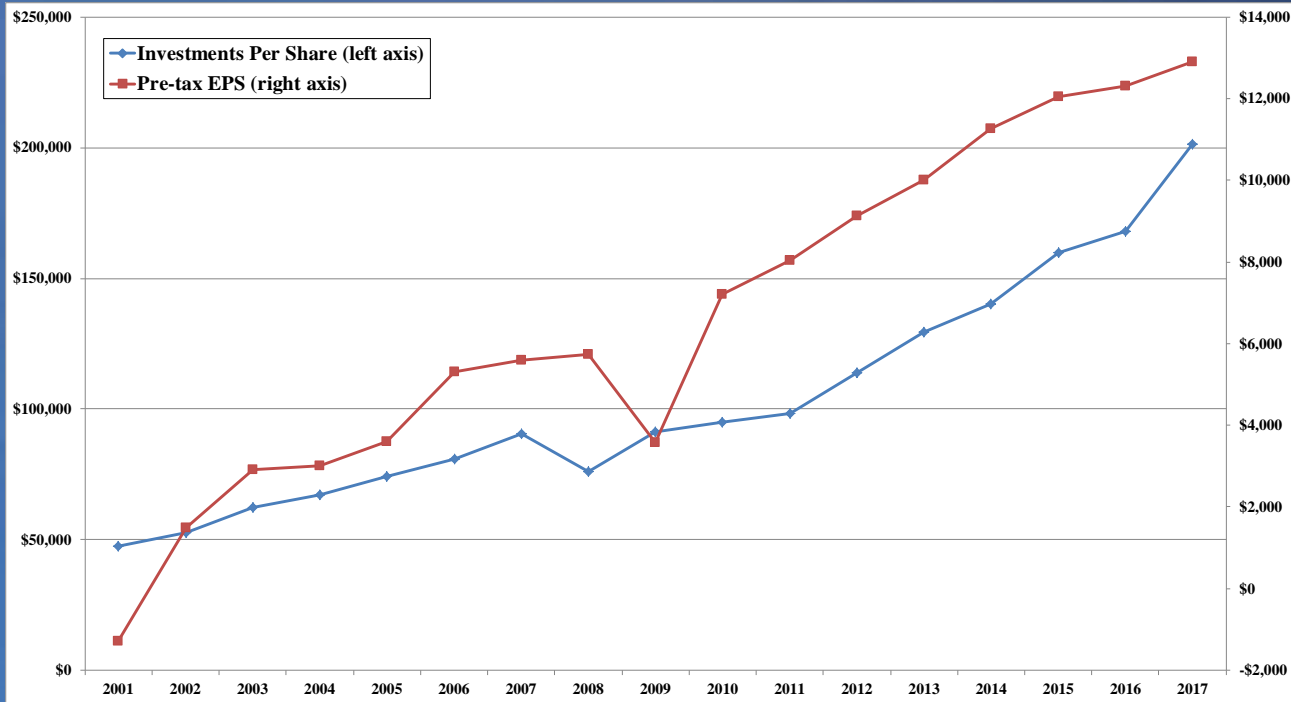


# BUFFETT'S COMMENTS ON BERKSHIRE'S VALUATION LEAD TO AN IMPLIED HISTORICAL MULTIPLIER OF ~12X

<u>Year</u>	<u>Investments Per Share</u>	<u>Pre-tax EPS</u>		<u>Intrinsic Value</u>	<u>Implied Multiplier</u>
		<u>Excluding All Income From Investments</u>	<u>Year-End Stock Price</u>		
1996	\$28,500	\$421	\$34,100	\$34,100	13
1997	\$38,043	\$718	\$46,000	\$46,000	11
1998	\$47,647	\$474	\$70,000	\$54,000	13
1999	\$47,339	-\$458	\$56,100	\$60,000	

- 1996 Annual Letter: "Today's price/value relationship is both much different from what it was a year ago and, as Charlie and I see it, more appropriate."
- 1997 Annual Letter: "Berkshire's intrinsic value grew at nearly the same pace as book value" (book +34.1%)
- 1998 Annual Letter: "Though Berkshire's intrinsic value grew very substantially in 1998, the gain fell well short of the 48.3% recorded for book value." (Assume a 15-20% increase in intrinsic value.)
- 1999 Annual Letter: "A repurchase of, say, 2% of a company's shares at a 25% discount from per-share intrinsic value...We will not repurchase shares unless we believe Berkshire stock is selling well below intrinsic value, conservatively calculated...Recently, when the A shares fell below \$45,000, we considered making repurchases."

# BERKSHIRE'S EARNINGS AND INVESTMENTS PER SHARE HAVE STEADILY RISEN



Note: We subtract insurance earnings, but then add back a conservative estimate of normalized earnings from Berkshire's insurance businesses: half of the \$2 billion of average annual profit over the 14 years prior to 2017, equal to \$608/share.

# BERKSHIRE'S INTRINSIC VALUE: 2001-2017

<u>Year End</u>	<u>Cash and Investments Per Share</u> <sup>1</sup>	<u>Pre-tax EPS Excluding All Income From Investments</u> <sup>2</sup>	<u>Intrinsic Value Per Share</u> <sup>3</sup>	<u>Subsequent Year Stock Price Range</u>
2001	\$47,460	-\$1,289	\$64,000	\$59,600-\$78,500
2002	\$52,507	\$1,479	\$70,255	\$60,600-\$84,700
2003	\$62,273	\$2,912	\$97,217	\$81,000-\$95,700
2004	\$66,967	\$3,003	\$103,003	\$78,800-\$92,000
2005	\$74,129	\$3,600	\$117,329	\$85,700-\$114,200
2006	\$80,636	\$5,300	\$144,236	\$107,200-\$151,650
2007	\$90,343	\$5,600	\$157,543	\$84,000-\$147,000
2008	\$75,912	\$5,727	\$121,728	\$70,050-\$108,100
2009	\$91,091	\$3,571	\$119,659	\$97,205-\$128,730
2010	\$94,730	\$7,200	\$152,330	\$98,952-\$131,463
2011	\$98,366	\$8,036	\$178,725	\$114,500-\$134,060
2012	\$113,786	\$9,124	\$205,027	\$139,610-\$178,275
2013	\$129,253	\$10,013	\$229,381	\$163,038-\$229,374
2014	\$140,123	\$11,260	\$252,720	\$192,200-\$224,880
2015	\$159,794	\$12,060	\$280,396	\$189,640-\$249,711
2016	\$168,099	\$12,322	\$291,323	\$240,280-\$299,360
2017	\$201,317	\$12,903	\$343,253	?

1. In every annual letter through 2015, Buffett disclosed both pre-tax earnings as well as cash and investments per share.<sup>2</sup> Since then, we estimate them.

2. We subtract insurance earnings, but then add back a conservative estimate of normalized earnings from Berkshire's insurance businesses: half of the \$2 billion of average annual profit over the 14 years prior to 2017, equal to \$608/share.

3. Historically we believe Buffett used a 12x multiple, but given compressed multiples during the downturn, we used 8x in 2008-2010, 10x from 2011-2016, and 11x in 2017 (due to the benefits of the tax reform bill passed at the end of 2017).



# BERKSHIRE IS TRADING 12% BELOW ITS INTRINSIC VALUE



Intrinsic value\*

\* Investments per share plus 12x pre-tax earnings per share through 2007, then an 8x multiple from 2008-2010, a 10x multiple from 2011-2016, and an 11x multiple in 2017.

# 12-MONTH INVESTMENT RETURN

- Current intrinsic value: \$343,000/share
- Plus 6% annual growth of intrinsic value of the business
- Plus ~\$10,000/share cash build over next 12 months
- Equals intrinsic value in one year of \$374,000
- 24% above today's price

# CATALYSTS

- Continued earnings growth of operating businesses
- Tax reform benefits boosting after-tax earnings
- Likelihood of meaningful acquisitions
- New stock investments
- Additional cash build
- Share repurchases (if the stock drops to 1.2x book or below; it's currently at 1.43x)

# RISKS: WHO WILL REPLACE BUFFETT?

- When Buffett is no longer running Berkshire, his job will be split into two parts: one CEO, who has not been named (likely Greg Abel and/or Ajit Jain, both of whom were just added to Berkshire's board), and a small number of CIOs (Chief Investment Officers)
  - A CEO successor (and two backups) have been identified, but not publicly named
  - Two CIOs have been named already, Todd Combs and Ted Weschler, both of whom are excellent investors
- Nevertheless, Buffett is irreplaceable and it will be a significant loss when he no longer runs Berkshire for a number of reasons:
  - There is no investor with Buffett's experience, wisdom and track record, so his successors' decisions regarding the purchases of both stocks and entire businesses might not be as good
  - Most of the 80+ managers of Berkshire's operating subsidiaries are wealthy and don't need to work, but nevertheless work extremely hard and almost never leave thanks to Buffett's "halo" and superb managerial skills. Will this remain the case under his successors?
  - Buffett's relationships and reputation are unrivaled so he is sometimes offered deals and terms that are not offered to any other investor – and might not be offered to his successors
  - Being offered investment opportunities (especially on terms/prices not available to anyone else) also applies to buying companies outright. There's a high degree of prestige in selling one's business to Buffett (above and beyond the advantages of selling to Berkshire). For example, the owners of Iscar could surely have gotten a higher price had they taken the business public or sold it to an LBO firm



# AREN'T WE CONCERNED ABOUT THE UNCERTAINTY OF BERKSHIRE AFTER BUFFETT?

Answer: Not really, for three primary reasons:

1. Buffett isn't going anywhere anytime soon. We think it's at least 75% likely that Buffett will be running Berkshire for five more years
  - Buffett turned 87 on Aug. 30<sup>th</sup>, 2017, is in excellent health, and loves his job
  - There are no signs that he is slowing down mentally – in fact, he appears to be getting better with age
  - A life expectancy calculator (<http://calculator.livingto100.com>) shows that Buffett is likely to live to age 93 – and we'd bet on the over
2. The stock is undervalued based on our estimate of intrinsic value, which does not include *any* Buffett premium
  - We simply take investments/share and add the value of the operating businesses, based on a conservative multiple of their normalized earnings
  - The value of the cash and bonds won't change, and Wells Fargo, Kraft Heinz, Coke, American Express, Burlington Northern, GEICO, etc. will continue to generate robust earnings even after Buffett is no longer running Berkshire
3. Buffett has built a powerful culture that is likely to endure

# WHY DOESN'T BUFFETT IDENTIFY HIS SUCCESSOR NOW?

We agree with Buffett's decision not to name his successor for three reasons:

1. It would place enormous pressure and expectations on this person, which is unnecessary and counterproductive;
2. It might be demotivating for the candidates who were not chosen; and
3. Who knows what will happen between now and the time that a successor takes over (which could be more than a decade)?
  - Maybe the current designee falls ill, leaves Berkshire, performs poorly, or makes a terrible mistake (e.g., David Sokol)
  - Or what if another candidate (perhaps one of the two backup successors today) performs incredibly well, or Berkshire acquires a business with a fantastic CEO, and Buffett and the board decide that another candidate is better?
  - By not naming Buffett's successor now, Buffett and the board will be able to switch their choice without the second-guessing and media circus that would occur if the successor had been named

# THE REAL BUFFETT RISK

- Buffett is often asked (as are we): "What would happen to the company (and stock) if you got hit by a bus (i.e., die suddenly)?"
  - If it happened tomorrow, our best guess is that the stock would fall 15% (which might give Berkshire the opportunity to buy back a lot of stock)
  - But this isn't likely. Not to be morbid, but most people don't die suddenly from something like an accident or heart attack, but rather die slowly: their bodies (and sometimes minds) gradually deteriorate
  - A far greater risk to Berkshire shareholders is that Buffett begins to lose it mentally and starts making bad investment decisions, but doesn't recognize it (or refuses to acknowledge it because he loves his work so much) and the board won't "take away the keys", perhaps rationalizing that a diminished Buffett is still better than anyone else
  - Buffett is aware of this risk and has instructed Berkshire's board members, both publicly and privately, that their most important job is to "take away the keys" if they see him losing it
  - We trust that both Buffett and the board will act rationally, but also view it as our job to independently observe and evaluate Buffett to make sure we're comfortable that he's still at the top of his game. Today, we think he's never been better

# BERKSHIRE'S CULTURE IS POWERFUL AND UNIQUE: “A SEAMLESS WEB OF DESERVED TRUST”

- Berkshire operates via extreme decentralization: though it is one of the largest businesses in the world with approximately 377,000 employees, only 26 of them are at headquarters in Omaha
  - There is no general counsel or human resources department
- "By the standards of the rest of the world, we overtrust. So far it has worked very well for us. Some would see it as weakness." – Charlie Munger, 5/14
- "A lot of people think if you just had more process and more compliance — checks and double-checks and so forth — you could create a better result in the world. Well, Berkshire has had practically no process. We had hardly any internal auditing until they forced it on us. We just try to operate in a seamless web of deserved trust and be careful whom we trust." – Munger, 5/07
- "We will have a problem of some sort at some time...300,000 people are not all going to behave properly all the time." – Warren Buffett, 5/14
- "Behavioral scientists and psychologists have long contended that 'trust' is, to some degree, one of the most powerful forces within organizations. Mr. Munger and Mr. Buffett argue that with the right basic controls, finding trustworthy managers and giving them an enormous amount of leeway creates more value than if they are forced to constantly look over their shoulders at human resources departments and lawyers monitoring their every move." – NY Times, 5/5/14

# WE THINK BERKSHIRE AFTER BUFFETT WILL BE LIKE APPLE AFTER JOBS

- The most comparable example of a business that, like Berkshire, is closely associated with its legendary founder and CEO is Apple
  - As Steve Jobs' health began to fail, he assumed fewer day-to-day responsibilities, passing them to top lieutenants
  - Jobs resigned as CEO on Aug. 24, 2011 and died exactly six weeks later
  - Apple's stock declined less than 1% on the first trading days after both his retirement and death, and has more than tripled since then as this chart shows:



# OTHER RISKS

- The single biggest risk is that as Berkshire gets larger and Buffett gets older, investors value the stock at a lower and lower multiple of earnings and book value, such that even if intrinsic value continues to grow, the stock goes nowhere for an extended period
- A recession impacts Berkshire's earnings and stock portfolio materially
- A market decline leads to losses in shorter-duration derivatives such as credit-default swaps and/or equity index puts
- A very large investment goes awry
- A major super-cat event costs Berkshire many billions

## CONCLUSION: BERKSHIRE HAS EVERYTHING WE LOOK FOR IN A STOCK: IT'S SAFE, CHEAP AND GROWING AT A HEALTHY RATE

- Extremely safe: Berkshire's huge hoard of liquid assets, the quality and diversity of its businesses, the fact that much of its earnings (primarily insurance and utilities) aren't tied to the economic cycle, and the conservative way in which it's managed all protect Berkshire's intrinsic value, while the share repurchase program provides downside protection to the stock
- Upside: trading 12% below intrinsic value (without giving any credit to immense optionality), with 24% upside over the next year
- Downside: 16% downside to 1.2x book value, which is where Buffett would buy the stock, thereby putting a floor on it.
- Growing: Intrinsic value is growing at roughly 6-8% annually

# APPENDIX



KASE LEARNING



# EARNINGS BY YEAR

Earnings before taxes*	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>	<u>2017</u>
<b><u>Insurance Group:</u></b>														
GEICO	970	1,221	1,314	1,113	916	649	1,117	576	680	1,127	1,159	460	462	-310
General Re	3	-334	526	555	342	477	452	144	355	283	277	132	190	-685
Berkshire Reinsurance Group	417	-1,069	1,658	1,427	1,222	250	176	-714	304	1,294	606	421	822	-2,963
Berkshire H. Primary Group	161	235	340	279	210	84	268	242	286	385	626	824	657	719
Investment Income	<u>2,824</u>	<u>3,480</u>	<u>4,316</u>	<u>4,758</u>	<u>4,896</u>	<u>5,459</u>	<u>5,145</u>	<u>4,725</u>	<u>4,454</u>	<u>4,713</u>	<u>4,357</u>	<u>4,550</u>	<u>4,482</u>	<u>4,902</u>
<b>Total Insurance Oper. Inc.</b>	<b>4,375</b>	<b>3,533</b>	<b>8,154</b>	<b>8,132</b>	<b>7,586</b>	<b>6,919</b>	<b>7,158</b>	<b>4,973</b>	<b>6,079</b>	<b>7,802</b>	<b>7,025</b>	<b>6,387</b>	<b>6,613</b>	<b>1,663</b>
<b><u>Non-Insurance Businesses:**</u></b>														
Burlington Northern Santa Fe							3,611	4,741	5,377	5,928	6,169	6,775	5,693	6,328
Berkshire Hathaway Energy	466	485	1,476	1,774	2,963	1,528	1,539	1,659	1,644	1,806	2,711	2,851	2,973	2,584
McLane Company	228	217	229	232	276	344	369	370	403	486	435	502	431	299
Manufacturing			436	733	686	813	992	3,911	4,205	4,811	4,893	6,211	6,861	
Service & Retailing	1,787	1,921	3,297	3,279	3,014	1,028	3,092	3,675	1,272	1,469	1,546	1,720	1,820	2,083
Finance and financial products	<u>584</u>	<u>822</u>	<u>1,157</u>	<u>1,006</u>	<u>771</u>	<u>653</u>	<u>689</u>	<u>774</u>	<u>1,393</u>	<u>1,564</u>	<u>1,839</u>	<u>2,086</u>	<u>2,130</u>	<u>2,058</u>
<b>Total Non-Insur. Oper. Inc.</b>	<b>3,065</b>	<b>3,445</b>	<b>6,159</b>	<b>6,727</b>	<b>7,757</b>	<b>4,239</b>	<b>10,113</b>	<b>12,211</b>	<b>14,000</b>	<b>15,458</b>	<b>17,511</b>	<b>18,827</b>	<b>19,258</b>	<b>20,213</b>
<b>Total Operating Income</b>	<b>7,440</b>	<b>6,978</b>	<b>14,313</b>	<b>14,859</b>	<b>15,343</b>	<b>11,158</b>	<b>17,271</b>	<b>17,184</b>	<b>20,079</b>	<b>23,260</b>	<b>24,536</b>	<b>25,214</b>	<b>25,871</b>	<b>21,876</b>

Note: In 2017, Berkshire consolidated General Re and Berkshire Reinsurance Group, so the breakdown is estimated based on the prior year's split.

\* In 2010, Berkshire changed this table from "Earnings before income taxes, noncontrolling interests and equity method earnings" to "Earnings before income taxes".

\*\* Non-insurance businesses were recategorized in 2014, so figures prior to 2012 are not comparable.

# BERKSHIRE'S SHARE REPURCHASE PROGRAM (1)

- On September 26, 2011, Berkshire announced the first formal share repurchase program in Berkshire's history, and only the second time Buffett has ever offered to buy back stock
- It's unusual in three ways:
  1. There's no time limit
  2. There's no dollar cap
  3. Buffett set a price: "...no higher than a 10% premium over the then-current book value of the shares. In the opinion of our Board and management, the underlying businesses of Berkshire are worth considerably more than this amount..."
- On December 12, 2012, Berkshire increased the limit to 1.2x book and announced that it had repurchased \$1.2 billion in one transaction
- Book value per share at the end of 2017 was \$211,750
- Thus, a 20% premium means that Buffett is willing to buy back stock up to \$254,100, 16% below the current price

# BERKSHIRE'S SHARE REPURCHASE PROGRAM (2)

- It confirms that Buffett shares our belief that Berkshire stock is undervalued
  - He wouldn't be buying it back at a 20% premium to book value if he thought its intrinsic value was, say, 30% above book
  - On the first page of the 2015 annual letter, he wrote "Berkshire's intrinsic value *far* exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as 120% of book value. At that level, purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders."
- Buffett put a floor on the stock: he was clear in numerous interviews after the program was announced that he is eager to buy back *a lot* of stock – and he has plenty of dry powder to do so:
  - Berkshire has \$99 billion of cash (excluding railroads, utilities, energy, finance and financial products), plus another \$20 billion in bonds (nearly all of which are short-term, cash equivalents), which totals \$119 billion
  - On top of this, the company is generating well over \$20 billion in free cash flow per year – in other words, the better part of ~\$2 billion is pouring into Omaha every *month*
  - The Sept. 2011 press release noted that "repurchases will not be made if they would reduce Berkshire's consolidated cash equivalent holdings below \$20 billion," so that leaves \$99 billion to deploy, equal to 20% of the company's current market cap
    - It's unlikely, however, that Buffett would repurchase anything close to this amount, as some of the cash and bonds are held at various insurance subsidiaries, plus Buffett likely wants to keep plenty of dry powder to make acquisitions and investments
  - In summary, Buffett could easily buy back \$75 billion of stock *and* still have plenty of dry powder for other investments

# DON'T OVERLOOK MUNGER – HE IS A GENIUS IN HIS OWN RIGHT (1)

## Favorite Mungerisms

- The more hard lessons you can learn vicariously, instead of from your own terrible experiences, the better off you will be...So the game is to keep learning.
- What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form. You've got to have models in your head. And you've got to array your experience – both vicarious and direct – on this latticework of models.
- Most people are trained in one model and try to solve all problems in one way. You know the old saying: To the man with a hammer, the world looks like a nail. This is a dumb way of handling problems.
- Our experience tends to confirm a long-held notion that being prepared, on a few occasions in a lifetime, to act promptly in scale, in doing some simple and logical thing, will often dramatically improve the financial results of that lifetime. If you took our top 15 decisions out, we'd have a pretty average record.
- As Jesse Livermore said, “The big money is not in the buying and selling...but in the waiting.”
- There's always been a market for people who pretend to know the future. Listening to today's forecasters is just as crazy as when the king hired the guy to look at the sheep guts.
- All I want to know is where I'm going to die, so I'll never go there.

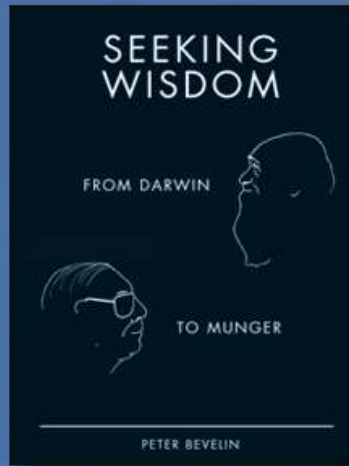
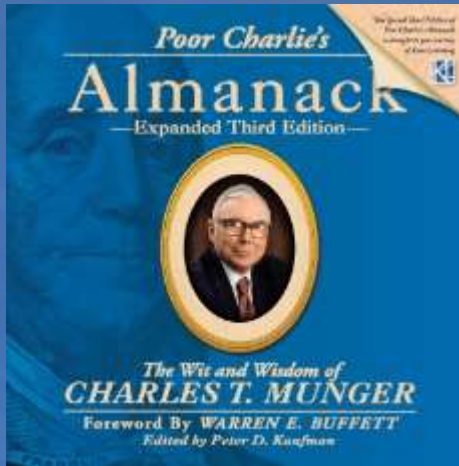
# DON'T OVERLOOK MUNGER – HE IS A GENIUS IN HIS OWN RIGHT (2)

## Favorite Mungerisms (continued)

- No wise pilot, no matter how great his talent and experience, fails to use his checklist.
- In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time – none, zero.
- We have never given a damn whether any quarter's earnings were up or down. We prefer profits to losses, obviously, but we're not willing to manipulate in any way just to make some quarter look a little better.
- To say accounting for derivatives in America is a sewer is an insult to sewage.
- We think there should be a huge area between what you're willing to do and what you can do without significant risk of suffering criminal penalty or causing losses. We believe you shouldn't go anywhere near that line.
- Our approach has worked for us. Look at the fun we, our managers, and our shareholders are having. More people should copy us. It's not difficult, but it looks difficult because it's unconventional.
- If you rise in life, you have to behave in a certain way. You can go to a strip club if you're a beer-swilling sand shoveler, but if you're the Bishop of Boston, you shouldn't go.
- Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts. Slug it out one inch at a time, day by day. At the end of the day, if you live long enough, most people get what they deserve.

# DON'T OVERLOOK MUNGER – HE IS A GENIUS IN HIS OWN RIGHT (3)

- To learn more about/from Munger, I highly recommend two books:
  - 1) [Poor Charlie's Almanack](#) (I wrote Chapter 3 and provided many of the transcripts)
  - 2) [Seeking Wisdom: From Darwin to Munger](#)





KASE LEARNING