

# INVESTMENT STRATEGY LETTER

*Investment Management Since 1959*

*Volume 50, Issue 2 / March 2010*

## Taking the Man at His Word

In April of 2000, we first stepped to the plate and bought Berkshire Hathaway (BRK) and made it one of our larger holdings, where it has remained until last month, when we sold half our position. After a few romantic days alone with the 2009 Berkshire Hathaway Annual Report, and several emails to people we know in the insurance world to confirm for the 32nd time in 20 years what we know and don't know about insurance accounting, we admit to mixed feelings about both the half we sold and the half we retained. As anyone with even modest investing experience can honestly attest, sometimes it just ain't easy. What follows is our thought process.

In a nutshell, our decision to sell half our position in Berkshire was predicated on a variety of factors, which we will attempt to thoroughly list below. The key driver of our decision is that the stock is at best fairly valued at \$83ish per share for the "the little guy" on any number of measures including a sum of the parts basis; a price-to-book value for the whole Omaha enchilada; and a reasonable assessment of normalized "look-through" earnings. There are those who suggest that BRK is still 20% undervalued, but we believe this work contains several flaws, which include discounting Berkshire cash flows at unusually low cost of capital hurdles (Buffett premium, see below), double counting a material percentage of the operating businesses (the majority of which are housed within the insurance companies, not the holding company), and some very fancy assumptions in the valuation of float or the free money that can be generated by the insurance companies and invested profitably. Additionally, some analysis tends to value all Berkshire earnings streams as equal, which is a huge question mark when you consider the current and historical differences between the multiples accorded to financial vs. industrial companies. (On that basis, we should have a 10% position in GE, which is its own complex mix of financial and industrial businesses.)

It is not terribly difficult to value Berkshire's utility operations and its collection of industrial businesses, so let's just use what Berkshire paid for Burlington Northern Santa Fe (BNI) as its intrinsic value. In attempting to value the Financial Products business, we simply used a derived book value for the derivatives plus a modest multiple for the "operational" finance businesses. Thus the key analytical device that accords Berkshire a higher valuation as a whole is the assumption of a premium multiple for the insurance companies. Geico is essentially a proxy for Progressive Insurance and vice versa, and that can be run intelligently and valued on its own petard. The rest (and it's a big, complicated "rest") is and has always been a big fat leap of faith in the abilities of insurance guru Ajit Jain and Mr. Buffett. As per the set of points immediately below, we have always been prone to give Buffett the deserved benefit of the doubt, which invariably translates into a generous valuation, and we know we are far from being alone on this point. One should also note that we are looking well past the dismal state of the current valuation of public insurance companies to come up with our current assessment of value. One can easily come up with much lower values for this segment if the analysis removes some of the Buffett premium that many have been pleased to attach over the past few decades.

Which brings us to the next and related issue. Warren Buffett is 79, Charlie Munger is 86 and Ajit Jain is 60. If the collection of resident geniuses at Berkshire has correctly produced a company that has and should trade at a premium multiple, then mathematically speaking, there is some algorithm that models the decay rate of the Buffett premium as time inexorably passes on, and I am sure some out of work mortgage quant is working on it right now. Having spent some time recently on the valuation of long-term warrants, I would suggest this decay rate is in no way linear, but it is inexorable, and in this case, there is the uncertainty of

the “expiration” date. In many ways, this is *the* key variable in the purchase of Berkshire Hathaway today and at today’s prices. If the odds are good that all present and accounted for today will be present and accounted for in ten years, then the chart presented later in this letter might be all you need to know. For the record, according to the *Harvard Health Letter*, the average life expectancy in the United States is 77.6 years. Furthermore, old age begets older age. If you reach 65, then you should expect to live to 81.6. If you reach 85, you can expect to live to see 90. I think that’s bullish.

Morbid thoughts aside, who the next person to run Berkshire and in what form is a matter of legitimate concern to an investor. There is a long history of legacy problems following the retirement/replacement of a larger than life CEO - GE and AIG being just two of the latest casualties. Is BRK a company that only Buffett can head and be given a fair value? Ask Jeff Immelt at GE, who hasn’t done much terribly wrong in the past ten years other than to inherit a highly valued stock. We also think that Berkshire’s structure of having almost everything piled into the insurance company is problematic for the successor as it limits optionality in a post-Buffett world. It is a perfect structure for Buffett as cash flow begets investment which begets more capital strength which begets more capacity for the insurance companies to undertake massive, unusual and richly priced (for Berkshire) deals that few can do. It may not be ideal for the next generation of Berkshire management, which, dare we say, might involve a “less is more” strategy to maximize shareholder value. Oh, and is that really the aim of Berkshire Hathaway anymore?

The issue of Who’s Next is also relevant in that Mr. Buffett has made a career of seeing and getting the deal that the rest of us can’t. Will people desire to park their corporate works of art in the Berkshire museum as willingly if the museum has a new

curator? In a world of hundreds of billions of dollars looking to provide capital, will Berkshire continue to get the call to invest in Goldman Sachs and GE, or will Berkshire post-Buffett simply be another group of guys with money? The world of big funds looking to do opportunistic and/or distressed deals has grown tremendously over the last twenty years, and if you do not get the first and private call for an investment, the returns seem to fall proportionately to the amount of public interest.

This leads neatly into the deal that everyone could see and anyone could conceptually do, but Berkshire did. The Burlington Northern acquisition was “fair” for

BRK shareholders at best and its spirit of not getting a bargain, using equity as currency, and splitting the stock to make it more widely held suggests something else is afoot than pure shareholder value considerations. It was also a classic Buffett “do as I say, not as I do” deal as he was concurrently busy and correctly busting the chops of Kraft CEO Irene Rosenfeld for contemplating the use of more equity to buy Cadbury while the debt markets are open

enough to finance even California.

The BNI deal, the largest BRK has ever done, reeks of legacy building and an attempt to position Berkshire as so large and diversified an operating company that Warren Buffett doesn't matter anymore. This leads to the sheer size of BRK and the obvious problems with the ability to move the needle with future deals, as Berkshire’s investable assets to shareholder equity ratio continues its long downward path to almost a one-to-one ratio. Unlike say Wal-Mart or Costco, which can centrally improve operations and thus benefit from a minor change in margin and efficiency spread over an enormous top-line, BRK is decentralized to the extreme, unable to benefit from scale. Buffett himself admits that if he can move the needle in-line with the S&P 500, that would be satisfactory. Just to be contrary, and it is a reasonably

| <b>A Very Fair Valuation of Berkshire Hathaway</b><br><i>(\$ in millions, except per share amounts)</i> |                          |                       |
|---|--------------------------|-----------------------|
| <b>Operation</b>  | <b>RCB Estimate</b>      |                       |
|   | <b>Total</b>             | <b>Per Share</b>      |
| Value Financial Products  | \$ 6,974                 | \$ 2.8                |
| Value of Insurance Business   | 103,705                  | 42.0                  |
| Value of Non-Insurance Business   | 31,463                   | 12.7                  |
| Value of MidAmerican Energy   | 16,748                   | 6.8                   |
| Burlington Northern Santa Fe  | 34,193                   | 13.8                  |
| Total Firm Value  | <u>193,082</u>           | <u>78.2</u>           |
| Less: Est. Corporate Debt   | (12,349)                 | (5.0)                 |
| <b>Equity Value</b>   | <b><u>\$ 180,733</u></b> | <b><u>\$ 73.2</u></b> |
| A Shares Outstanding  |                          | <b>1,646,174</b>      |
| B Equivalent  |                          | <b>2,469,261,000</b>  |

thoughtful point, we have seen an argument that suggests that since Berkshire has nearly become the S&P 500, it will trade like the S&P 500, which is valued a lot higher than the 1.5 times book value at which Berkshire trades.

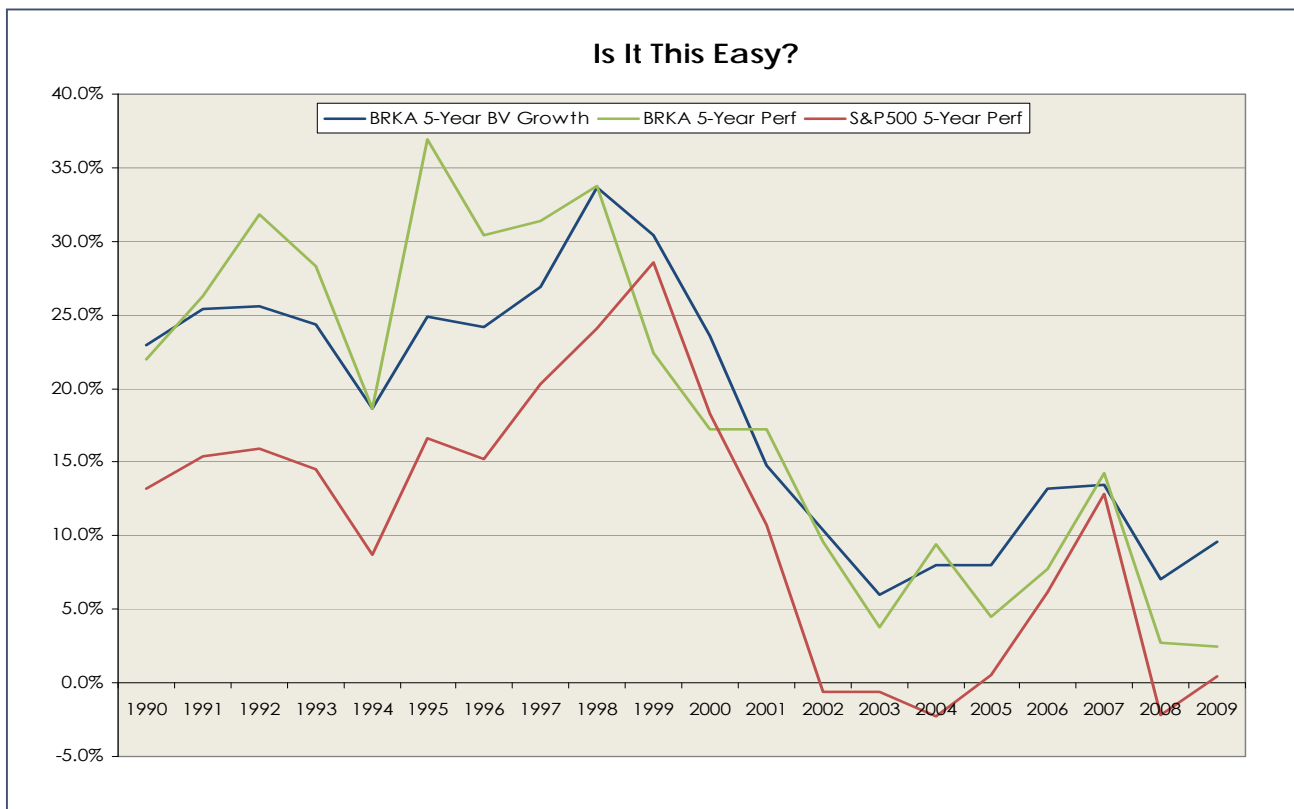
By splitting Berkshire's stock, which enabled its entrance into the S&P 500, Berkshire now enters the world of indexed money, which means its stock will often trade without regard to an analysis of its fair value, but merely as one of 500 pieces of paper to be tossed about by advanced degrees from the finest business schools. This has been of assistance in the last sixty days, and nudged us to take the tactical decision to halve our position, but we find it difficult to see any benefit from this new state of affairs. In fact, one of the historical attractions of Berkshire was the perception that it is somewhat off to the side and tightly held by a group of long-term, "I get it" investors, and thus likely to outperform in a down market.

So in the enlightened conceit of any self-respecting value manager, we think we can do better elsewhere with the proceeds at current levels, but the future remains uncertain. Solution: we sold half and live to think another day. We recognize in a choppy or down market, we would expect BRK the stock to outperform (?) - although we were disappointed in 2008 in this regard.

We also recognize BRK is more economically cyclical and would have a much bigger tailwind in an improving economy than it has in the past. The stock also tends to be seasonally strong into the annual meeting. But there is no rule that the correct posture for an investor to take is to squeeze every last dollar of potential profit out of an investment without a consideration of risk. We will take the man at his word: "The past growth rate in Berkshire's book value per share is not an indication of future results and our book value per share will likely NOT increase in the future at a rate even close to its past rate."

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March 2010

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Berkshire Hathaway Inc. has two classes of common stock designated Class A and Class B. A share of Class B common stock has the rights of 1/1,500th of a share of Class A common stock except that a Class B share has 1/10,000th of the voting rights of a Class A share (rather than 1/1,500th of the vote). RCB owns the Class B shares in client accounts.

## Why Reed Conner & Birdwell?

- Independently operated and majority owned SEC registered investment advisor.
- Over 50 years of experience providing highly personalized investment services in long-term relationships.
- Value-oriented investment process which has produced solid long-term returns for clients in both up and down markets.
- Extremely intensive internal research and stock-picking process which identifies values overlooked by Wall Street.

## General Information

- Reed Conner & Birdwell (RCB) has been an investment advisor to private and institutional clients since 1959.
- Long-term tenure of investment team: averaging 25 years of investment industry experience and 18 years with RCB.
- RCB currently manages \$1.7 billion. Of this, 49% is for private clients and 51% is for institutional clients.
- RCB manages separate accounts in All Cap Value, Large Cap Value, Small Cap Value, International Value, Global Value, and Balanced strategies and one mutual fund, the CNI Charter RCB Small Cap Value Fund (ticker: RCBSX). RCB also serves as a sub-advisor to the Masters' Select Small Companies Fund.
- The Firm is in compliance with the Global Investment Performance Standards (GIPS®) and has been verified by Beacon Verification Services for the period 12/31/1995 - 12/31/2009.

## Investment Process

RCB's value-oriented styles apply a fundamental, bottom-up stock selection process to the universe of public companies. We screen for such criteria as dominant market position, sustainable high return on capital, free cash flow, balance sheet integrity and management commitment to shareholders. We combine this with ideas from more qualitative sources, such as industry research, trade shows and company visits, to identify a focus universe of potential investments. The focus universe is monitored for valuation opportunities and the presence of a catalyst which will provide the impetus to close the valuation gap, with a goal of 50% upside return over a two to three year period. Our portfolios are concentrated with between 25-35 positions and our long-term focus leads to lower portfolio turnover.

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