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INVESTMENT MANAGEMENT

INVESTMENT STRATEGY LETTER

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SO WE NOW OWN BERKSHIRE HATHAWAY

Those of you with long memories or a penchant for collectibles might recall a previous strategy letter where we went into some detail as to why paying $80,000 per share seemed silly to us. (We like to think big and will use the A shares for this piece. Divide by 30 to get the price of the B shares.) Things of course change; the major change, in this case, being the price of the stock. When that change produced a stock price that was proceeding south of $51,000, we had a change of heart, stepped to the plate and started buying. And now that the media blitz post the May annual meeting is over, some recap may be in order.

Very simply, Berkshire has changed from an investment vehicle run by two very smart guys who happened to own insurance companies to one of the largest and, more importantly, best insurance operations in the world that happens to be run by two very smart guys who invest well. We felt that at $51,000 per share, you were paying for Berkshire as if the equity portfolio were being liquidated and the company was being run as an "average" insurance company, with little or no premium accorded to the investment acumen of the two smart guys who were armed with a nearly free stream of tax-advantaged cash that could be tidily compounded at a double digit rate. More anecdotally, you can also say we were buying one of the world's best and largest insurance companies in a terrible bear market for insurance stocks and the most famous value investor in a terrible bear market for value investing. Throw in a fortress balance sheet and we felt snug in a world fraught with dangerous possibilities. We still do.

When an investor steps to the plate in Berkshire Hathaway, he feels the tug eastward (from the West Coast that is) toward Omaha, Nebraska. So the intrepid RCB Chief Investment Officer recently made the journey to the Berkshire Hathaway annual meeting. What follows is not conceptually another recap of Buffett said this and Munger said that, but a brief mention of some of the more poignant thoughts and how they selfishly support our own positions.

Besides clocking in six hours at the annual meeting, the CIO dutifully made the round of Berkshire's wholly owned and/or endorsed subsidiaries: the big ticket jewelry purchase at Borsheims; the T-bone steak at Buffett's ordained steak house, Gorat's (B+, dreadful wine list); Dairy Queen and the Nebraska Furniture Mart. I did not go to the baseball game where he throws out the first pitch, but he

came back to the hotel afterward and I am pleased to report as a shareholder interested in his longevity that he looked pretty good in pinstripes, a thought obviously shared by the gaggle of women surrounding him looking for autographs and a picture. I did not go to Buffett's dentist, get my hair cut at Buffett's barber or build a shrine and hold a candlelight vigil outside his house, although I'd bet I could have rounded up a few dozen shareholders to join me if I had sounded serious about it.

On to the actual meeting or "show" which began with a fairly funny and kitschy video about various Berkshire-related businesses and pet peeves. But let's be honest: as charming, incredibly bright, self deprecating and erudite as Buffett is and as dry and witty as his partner Charlie Munger is, six hours is a very long time to listen to anyone or two. The meeting is entirely democratic, which translates into the fact that anyone can stand for two hours in line at one of the microphones and ask a question. The result is about 70% "God Bless You, Messrs Buffett and Munger for making me wealthier and here is my generally not terribly pertinent or interesting question." Fortunately, Buffett does a nice job of turning the silliest of questions into an answer about something that he wants to say whether it has anything to do with the question or not.

Buffett immediately trotted into the main issue: Is value investing dead and why don't you buy technology stocks? The main answer, and one with which we mostly agree, is that the problem with technology in general is the lack of predictability of the economics. If you can't rationally layer 10 years of reasonable projections into a discounted cash flow analysis, much less two years for many companies in this sector, then you have something that is not analyzable and a pass is warranted. Buffett and Munger swear they have had long talks with everyone from Bill Gates to Andy Grove and asked them for technologies or companies they think can fit into this mold and the answer comes back, "I don't know who will be around in ten years and what they will look like." We think that's a little black and white and there can be plenty of things to do in some technology service-related companies from time to time (Berkshire owns some First Data, so they have weakened a little), but last I checked I wasn't invited to the podium. Our size relative to Berkshire also enables us to be more flexible and nimble, so that we don't necessarily have to live with potential mistakes for a decade. If we can get five years right, we'd be reasonably pleased. Essentially, Buffett repeated that this style is what made them $20 billion and they are going to stick to it. To quote Samuel Johnson, "I can give you an argument, but I can't give you understanding."

Buffett then paraphrased a very old saying that we have personally used many times and that exactly fits our view about the "era" through which we appear to be rapidly passing. Investing is very simply comparing the bird in your hand (cash) with a guesstimate of how many, if any, birds are in the bush. You must then guesstimate how long it takes to get to the bush and what is the appropriate rate of interest to compensate you for your wait. In an ideal world, we/Berkshire like to invest when we can clearly see a bush full of fat birds and we can walk right up to them and bag them for years to come. If you can't see the bush, much less how many birds it holds, you'll think hard about walking a long distance to see what's there. In other words, it doesn't matter whether you are talking about software, routers, pizzas or industrial valves. A business must generate cash to create wealth. The farther off in the future that day is and the less certain you are of getting there, the less it's worth today. Even after the big comeuppance of the past few months in the "TMT" sector (Technology, Media, Telecom), bird in the hand stocks continue to trade at severe discounts to the vision of fat partridges stuffed in a pear tree.

Buffett made a point, which we also use in presentations regarding investing: "You simply want the math in your favor...if you do enough transactions with the math in your favor, the odds are greatly in your favor that you will make money." Our translation is that if we consistently purchase stable business models that generate free cash, strong returns on capital and buy the stocks of these businesses at prices representing significant discounts to intrinsic value, we will do well over time without getting our heads handed to us. The "time" part has been unusually tricky recently, but we have had enough holdings "mature" for the past few years that we have managed to do nicely without falling into the temptation to do something borderline stupid.

Munger had some interesting comments regarding Berkshire and "value investing." There was the usual "value and growth are joined at the hip" type stuff, then Munger essentially said there are two ways to go about value investing. You can mechanistically screen for cheap stocks that may or may not be good businesses, which then puts you in the position of having to consistently buy low and sell at fair value. "I'd personally rather buy a company

whose business is good enough where you can buy it and then sit on your ass...it's good to be good at that." We are diligently working on a way to fit that into our own client brochure as soon as possible.

There were some relatively decent questions in regard to executive compensation. "If you sit on the Board of Coke and Gillette and are so against the policy of carte blanche executive option grants, then why did Doug Ivestor get the severance package of a lifetime and why are Coke and Gillette as bad abusers of the practice as anyone else?" Buffett essentially fumbled around a bit and basically concluded with, " I didn't sit on the compensation committee, I am never asked to sit on the compensation committee because of my well-known views on the subject and if you belch too much at the dinner table, you're not invited back." Munger added "Corporate executives get sold this stuff by the damn consultants." Berkshire does at least walk the walk on the issue. Compensation rewards specific people on their specific business performance or job subset therein. As stated by Buffet: "Giving all employees options is simply telling employees that you support the lottery, " which led to my favorite line of the meeting, "Compensation policy speaks to employees every day."

On another note, before we became Berkshire shareholders and learned to appreciate it, we had gotten steamed about Berkshire's ability to acquire either entire companies or specific securities on terms that were highly advantageous to Berkshire, but seemed to straddle a corporate governance line of preferential treatment. Clients and regular readers may recall our mini-tirade on Geico, a holding of ours that Berkshire appropriated at what was barely a fair price. Buffett reiterated the "never sell" philosophy and pointed out that it was this "final resting place for the great business" concept that often gave Berkshire an advantage when it came to acquisitions. We still think this is an issue in that the ideal seller to Berkshire is a public company that is majority-owned or nearly so by a controlling shareholder or family, who can basically say "done deal", who cares what the minority shareholders think. So what transpires is a briefly negotiated deal at a price that is "fair", which means fair to Berkshire, versus management undertaking even some modest version of an auction process.

In looking back at the day, it was almost surreal to see how Buffett talked about his businesses relative to the quarterly nonsense drill conducted by most management teams. So if the world is a competitive place and others copy great ideas, there seems to be a giant disconnect in the fact that the rest of corporate America does not adopt many of the management practices of Berkshire and in fact the trends seem to be going the other way. We're not sure why common sense is currently being trashed as "old-fashioned" and "out of touch." A nice dose of it from time to time doesn't hurt.

So was the big Omaha bash fun and worth attending? - 100% yes. I look at it as the equivalent of going to see Babe Ruth play at Yankee stadium. You were stupid if you lived in NY, cared about baseball and didn't bother to go and see arguably the greatest practitioner of the sport. Did I really learn anything additional about Berkshire Hathaway and its investment merits? No. Was it intellectually helpful as a long-term value investor to sit for five hours, listen to The Boss, think about your own investment decisions, style, holdings etc.? I think yes. Am I going to go every year? No. I think it would begin to bore me to tears and frankly, Borsheims would kill my bank account on an annual basis.

Berkshire Hathaway was the "must own" stock through much of the mid-1990s. Like nearly all good ideas in the investment world, there was an inevitable over-reaction, which creates a giddy period of silly valuation and feature articles in the financial press. We are now on the other side of that coin, with the attendant whining and self-doubt. Therein lies part of the opportunity.

We close with a brief clip from the Berkshire video featuring our Chairman Warren E. Buffett singing and accompanying himself on the ukulele to the tune of the Coca Cola jingle, I'd Like to Teach the World to Sing:

I'd Like to Buy the World a Stock,
Called Berkshire Hathaway,
The Nasdaq's down, but We Won't Frown
Because We'll Still Be Around
It's the Real Thing."

The Beginning of a Really Big Thought

As nearly everyone knows, the last few months have generally been less kind to the investor than the preceding months. That is a gross understatement for those who have been over-invested in what we have seen referred to as the TMT world - Technology/Media/Telecom.

This brings up a point that seems obvious to us and regular followers of this letter: if something can't go

on forever, it won't. Not all start-ups are worth $7 billion in their first three months of existence; putting an "e" in front of a corporate moniker does not guarantee a future with your own private island; and the reality of what it really takes to justify price earnings multiples of 100 or more must be depressing to people who have not really taken the time to consider the implication until very recently. Here is our new favorite quote from a friend in the TMT world: "Profitability has gone from being a curse word to a code word to a survival word and we have a month to get there since the money dried up overnight."

This brings up our really big thought. In the past few months, we have seen a number of articles proposing that the economy might not really be affected by a serious downturn in the stock market or a collapse in the bleeding edge world. Let us state this simply: that is so WRONG our hands shake with intellectual vehemence as we type this. Fortunately, we recently came across the chart below which eliminates the need for another four pages of analysis.

There is not an area of the economy or a geographic area of this country where someone can look around and say with a straight face that they cannot see the influence of the enormous creation of wealth derived from stock market gains. We have noted many times the virtuous cycle of a strong economy, strong corporate earnings, strong stock prices, strong consumer spending, strong real estate market, strong IPO market, etc.; and it is impossible to pick the one element from which it began. But make no mistake: they are linked at the hip.

So we sit here and think: we have 8% fixed mortgage rates, an inverted yield curve, the Federal Reserve raising interest rates in 50 basis point increments, the NASDAQ down 40%, and the most attractively priced stocks in the past 6 months - the boring old food and finance sectors - are suddenly outperforming in a big way.

The economy is slowing down. The pendulum is swinging and there is not a great deal of historical support for the hope that it stops somewhere in the middle versus swinging the other way.

The conundrum is that we continue to find a lot of inexpensive stocks that have been in personal bear markets for several years now. It has been our experience that ignoring the headlines and buying what we like at prices we like makes money for our clients and keeps emotionalism at bay. Our risk is that the mess takes the rest of us down with it. It is much better for our clients and frankly more satisfying for us to be up 20% in absolute terms and not get worried that some technology fund is up 412%, than to be up 5% while the technology fund is down 41%. Nonetheless, we'll take it.

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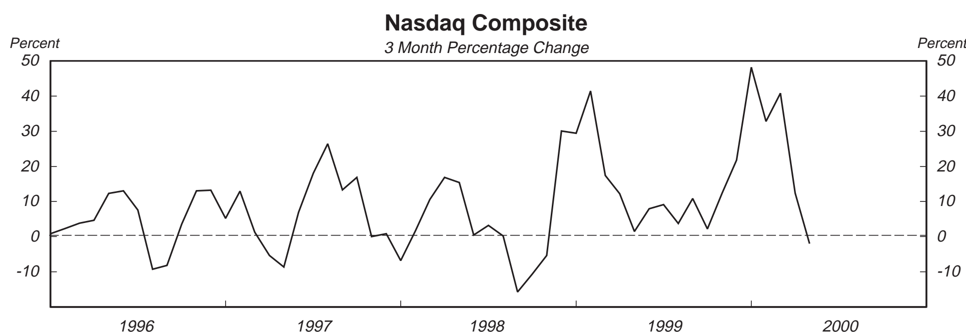

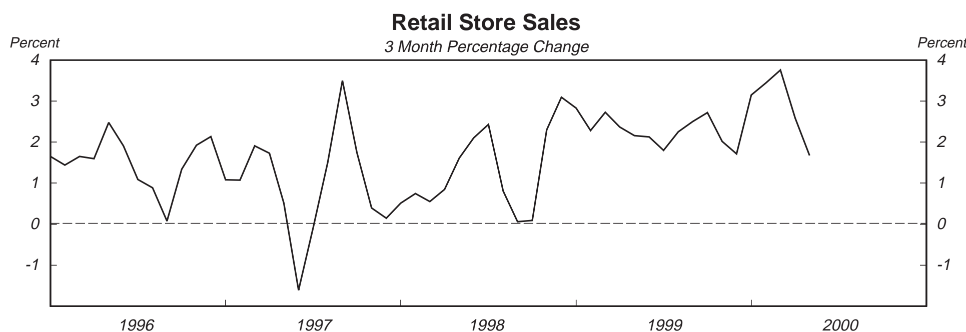

Sources: Nasdaq; Bureau of the Census