



Letter to the Investment Committee

By Emilio Vargas
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The following is a thousand words on investing that will irritate most every investment professional. Most forms of active portfolio management incur fees, transaction costs and taxes. Whole industries exist due to these costs, and their proponents will argue that they are adding value. In aggregate they cannot; they are all costs. That I am proposing an investment that could take food from the mouths of the children of an army of accountants, brokers and investment professionals will, no doubt, cause them to find flaws in what follows.

Passive management (read: indexing) can solve much of the cost problem, but it introduces other problems. The market weighting of portfolios will overweight past winners and, by construction, underweight future ones and investments set to rebound. At best, one is settling for an average return, and at worst, one is engaging in momentum investing.

What passes for growth investing is speculation. One pays a very fancy price for investments that are believed to be the winners of the future. To be sure, investing with great managers can be a good deal, but it is very difficult to identify these people prospectively.

And while value investing has its virtues, is very hard to do. The reality is, few people have the temperament. The process requires the client and the manager periodically to underperform, do nothing or endure ridicule. That is nearly impossible when others are making money.

Especially in today's environment, value managers are challenged (as are all managers) by the fact that the rules are changing. Regulations, taxes and monetary policy alter the landscape of winners and losers. Value managers in particular must be patient and depend on regression to the mean to create the small amount of value-add their style allows. (Like fees, the advantage may be small in the short run but can compound into a meaningful amount).

I am making no judgment here. Public policy keeps entities alive that otherwise would fail, which limits the investment opportunities for value managers and inhibits regression to the



mean (that is, keeping failed companies in business hurts the profits of the successful businesses). Most value investors have not enjoyed the historic benefits of their style the last five years. It is unclear if or when the trend will reverse.

This still leaves people and institutions with the question of where to invest their money. There is, I believe, a solution that is simple and eloquent. Buy the common stock of Berkshire Hathaway.

One is obtaining a diversified portfolio of roughly 80 wholly owned businesses, a substantial investment portfolio of publicly-traded companies and a world-class insurance company. The low portfolio turnover reduces transaction cost, which is very tax efficient. This investment largely solves the problems of active and passive management, and importantly, there is no management fee.

This collection of businesses is exceptionally managed, shareholder-friendly and long-term oriented. A greatly underappreciated fact is the wholly owned businesses (roughly 60% of investment portfolio at stated book) operate without employee stock options. This has the benefit of eliminating the dilution experienced by outside shareholders of most public companies. Management is encouraged to focus on shareholder value (not reported earnings), can invest for the long term and does not waste time on shareholder relations or Sarbanes-Oxley.

Is it any wonder that managements seek out Berkshire Hathaway when they are looking to be acquired? I could end the discussion here – the savings from fees and reduced dilution from stock options alone will compound into a significant advantage – but it gets better.

The collection of businesses is built to last – not every one of them, but most of them. The original textile business is effectively no more, and the profits from The Buffalo Evening News are no doubt diminished by new technology. That said, most of these businesses have been selected because there is a long-term need for their products or services, they require little or no R&D and they often have a competitive advantage that will be difficult for others to overcome. As great a company as Apple is today, can you say that about its products?

This is not to say Berkshire Hathaway is without blemish. I can dissect the issues of goodwill, accrued tax liabilities and the near-free \$70 billion float from the insurance operation. Management succession gets a good deal of press and deserves a response. The issue is not unique to Berkshire Hathaway, and the current management is extraordinarily proactive and open on this issue. One should examine the board of directors; it is an extraordinary group of people who meet Warren Buffett's criteria set out in the 2002 Berkshire annual report. They have business savvy and are shareholder oriented. From top to bottom, Buffett has assembled an extraordinary management team.



The question is whether this collection of businesses is attractively priced. First, I have no idea what the stock price is likely to do in the short run. If one is engaged in an annual performance derby and looking to Berkshire Hathaway, I can be of no assistance. But if you have the patience and temperament of a true value investor, I have good news. The current price is close enough to intrinsic value (a slippery number, but one the 2011 Berkshire Hathaway annual report attempts to shed light on) to warrant investment. Clearly, I would prefer to buy it cheaper. And markets being fickle, I may just get a chance to do so. If that day comes, rather than being upset that my account balance is diminished, I will be thrilled to add to my position.

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