

## Berkshire Hathaway: Added Value for US Equity Exposure

Led by the legendary investor Warren Buffett, Berkshire Hathaway (BRK) Inc., is a holding company that owns subsidiaries engaging in diverse business activities across various industries. For clients looking for added value to their US Large Cap core holding, we suggest substituting part of this exposure with Berkshire Hathaway stock. The BigSur model portfolio for a moderate client has 15% in US Large Cap stocks. BRK stock provides an excellent complement or a partial substitute to the S&P 500 because of 2 main reasons: (1) Better portfolio positioning from BRK to play the US economic recovery (financials, housing and railroads); (2) Offers a transparent, liquid and “low cost” access to the world’s leading investor’s portfolio of private companies.

### Performance

As reported in this year’s Annual Shareholder Letter, the historic performance of Berkshire Hathaway vs. the S&P 500 has been tremendous.

Annual Percentage Change	Berkshire Hathaway (per share book value)	S&P 500 (with dividends)
From 1965 - 2012	19.7%	9.4%

### Diversified vehicle with different exposures than SPY

Berkshire Hathaway owns 56 subsidiaries in different businesses including rail transportation; utilities and energy; finance; manufacturing; service; retail and homebuilding businesses. The main four segments of the business are described as follows:

Four main segments of Berkshire’s Core Operating Businesses

Insurance:

- GEICO: car insurer
- General Reinsurance: one of the largest global reinsurers
- Berkshire Hathaway Reinsurance Group: writes large and unusual risks

Railroad, Utilities & Energy

- MidAmerican: utility and energy holding company
- BNSF: second largest operator of railroad systems in North America

## The Thinking Man’s Approach



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Ignacio Pakciarz | CEO

In this month’s Thinking Man’s Approach, we discuss our view on Berkshire Hathaway as a complement to a client’s US Equity portfolio. Legendary investor Warren Buffett’s holding company has had strong performance and is well-positioned to benefit from the housing recovery, strength in financial sector and uptick in consumer demand. Access to a high quality private equity portfolio, managed by a seasoned and knowledgeable team make this investment interesting for clients who are looking to add value to their current positions in US Equity.



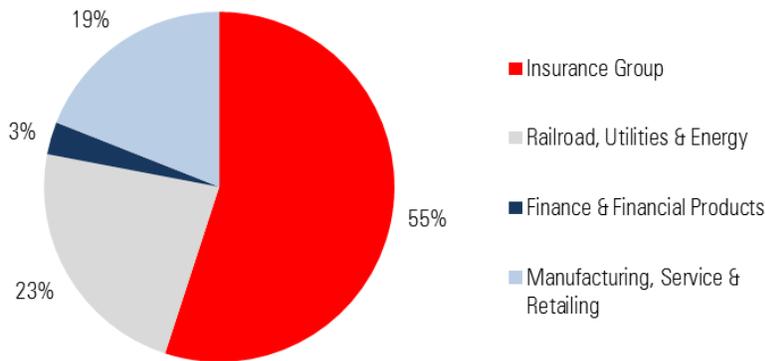
Manufacturing, Service & Retail

- Manufacturers in apparel, building, & consumer products
- Retailers of jewelry, home furnishings,
- Food and grocery distribution
- Service companies including private jet rental, aviation training

Finance and Financial Products

- Mostly consists of Clayton Homes, the largest company in the manufacturing housing industry and includes a financing business

Contribution to Fair Value Estimate by Segment



Source: Morningstar Institutional Equity Research Estimates

How much exposure does Berkshire Hathaway have to each of these segments? The exposure to the insurance business accounts for over 50% of it's value. Investors holding SPY (S&P 500 ETF) have only 4.3% exposure to the Insurance sector. Additionally, railroads (BNSF) account for 17% of fair value estimate for Berkshire Hathaway; SPY only offers its investors 1.7% to the

transportation sector.<sup>1</sup> Despite the fact that the majority of fair value is concentrated in the insurance segment of the business, the contribution to earnings of Berkshire Hathaway is split more evenly; almost evenly three ways between Insurance (34%); Manufacturing, Service & Retailing (31%) and Railroads, Utilities & Energy(31%). The remaining 4% of earnings is derived from the Finance & Financial Products segment.<sup>2</sup>

Well positioned for themes in next few years

Berkshire Hathaway has different positioning than the S&P 500 and there are a few themes the company will be able to take advantage of over the next few years- including a recovering housing market in the US; stabilizing economy and stronger finance sector.

Housing Recovery

As the US housing market continues to recover, the housing related businesses of BRK, which have faced years of significant headwinds, are likely to generate increased improved results for Berkshire. The greatest exposure of BRK is Clayton Homes - the largest company in the manufactured housing industry, which has its own financing business. After several years of shrinking revenues, in 4Q11, revenue growth turned positive and has remained positive since. BRK

<sup>1</sup> Morningstar Institutional Equity Research, Bloomberg

<sup>2</sup>Morningstar Institutional Equity Research



has four other housing-related companies also positioned to benefit given a stronger housing market and increased construction in the US, including: (1) Acme Brick - manufactures clay bricks, concrete block & cut limestone; acquired Benjamin Moore which manufactures and sells house paint in North America; (2) Shaw Industries - the world's largest carpet manufacturer; (3) Johns Manville- manufactures insulation and roofing materials and (4) MiTek - leading supplier of products and equipment for building components.

### Consumer Businesses

Consumer spending drives most of the growth for businesses in BRK's Manufacturing, Services and Retail segment. These companies have shown strong growth in 2012, and it is expected that they will continue to report healthy earnings growth as the US economy steadily improves. With improving employment data and consumer confidence, demand from consumers should increase, benefitting many of BRK's companies in this segment. The companies which are most sensitive to consumer spending include: (1) Jewelry retailers: Helzberg Diamonds, Borsheims, Ben Bridge Jeweler; (2) Home furnishing retailers : Nebraska Furniture Mart, R.C. Willey Home Furnishings, Star Furniture, and Jordan's Furniture; and (3) Luxury services/goods: NetJets (private jet rental), The Pampered Chef (high quality kitchen tools).

### Financials Sector

While there is little exposure to financial companies in BRK's private company portfolio; the publicly traded equity portfolio has a significantly large exposure to the financial sector including very important positions in Wells Fargo, American Express, and US Bank. The overall exposure to the financial sector in BRK's publicly traded equity portfolio (34.7%) is more than double that of the S&P 500 (16.4% in SPY).<sup>1</sup> Financials are still well below their peak in 2008, and are positioned to do well with a continuing housing recovery and stable economy.

### Access to a private equity portfolio

Much of the easily available and frequently headlined information on BRK is related its publicly traded equity portfolio. The private equity portfolio, however, is the core of the business- it is estimated that in 2013, 70% of BRK's earnings will come from this private portfolio, and only 30% from the publicly traded equity portfolio.<sup>2</sup> BRK has over 56 operating companies, ranging from insurance giant GEICO to underwear manufacturer Fruit of the Loom. While these companies are very different businesses, they share the same attractive characteristics which passed through Warren Buffet 's investment process: "value" companies with long-term potential and "simple" businesses. In another Thinking Man's Approach Note (#4, on the topic of the Berkshire Hathaway/3G acquisition of Heinz) , we discuss the benefits of becoming a Berkshire Hathaway company- guidance by seasoned managers/investors who have successfully and nimbly created efficient and highly profitable companies. Once a company comes under the BRK umbrella they are given tools to bring their businesses to the next level. Below we discuss four very different companies which illustrate some of the attributes of Berkshire Hathaway companies. While some

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<sup>1</sup> GuruFocus

<sup>2</sup> Morningstar Institutional Equity Research



(such as See's Candies or Brooks) may not be the most important companies to revenue, we like to see that even the smaller companies in the portfolio are "golden nuggets."

## NETJETS

NetJets has the largest private jet fleet in the world. Customers of NetJets can buy a portion of a specific private jet- and as an "owner" they are guaranteed access for a certain number of hours. Costs are significantly lower than purchasing, maintaining and staffing a comparable private jet. NetJets financial performance has meaningfully improved since the last recession as the company reduced the number of aircrafts in its fleet by roughly 20% since the end of 2008 and lowered its cost structure to better match customer demand. Despite slow sales of new planes, NetJets is now solidly profitable.

## See's CANDIES

A specialty candy and chocolate maker based in California, See's was acquired by BRK in 1972. See's Candies are especially popular in California and the West Coast- and strong brand loyalty allows them to increase prices by 5% per year. Buffett has consistently referred to See's as one his favorite types of companies- it does not require a huge investment, has fast moving inventories, and runs with low overheads. See's has expanded to other regions of the US with airport stores; and in 2012 announced plans to expand with stores in a few place son the East Coast, including Florida and Washington DC.

## BNSF RAILWAY

BNSF is one of the largest railroad network spanning 32,500 miles (See .Currently BNSF carries about 15% (measured by ton-miles) of all inter-city water, air or pipeline. BNSF continues to expand its market; focus on efforts in cost efficiency.



systems in the U.S with a visual of BNSF's rail lines) freight including truck, rail, increasing pricing; and make

## BROOKS

Brooks designs and manufactures high performance men's and women's running shoes, apparel and accessories worldwide. The company has created different breakthrough advancements in running footwear- with different cushioning systems and lightweight fabrics. In 2012, Brooks' sales volume was up 34%, another strong year after a sales volume growth of 34% in 2011.

Source: NetJets, Barclays Research, Berkshire Hathaway, Annual Shareholder Letter 2012, CNN Money, "The secrets of See's Candies"

### Risks

Succession of leadership has been a chief concern of many investors; Warren Buffet (82) and Charlie Munger (89), the primary decision makers, won't live forever. In recent years, however, they have increasingly involved more team members in managing the portfolio in an effort to groom successors. With a large part of BRK in the insurance business, a super catastrophe (ie large natural disaster) could significantly hurt the company's revenues. Over the past few years, however, BRK's non-insurance segments have gained more importance; and in 2012 generated about two-thirds of earnings. Market and economic downturns are risks factors most companies have to deal with, and BRK is no different- however, they are in a unique position to capitalize in that type of environment. In the wake of the 2008 crisis, three companies (Goldman Sachs, Bank of America and GE) offered BRK incredibly attractive investment opportunities. Why? They believed if investors saw Warren Buffet buying exposure to their companies, it would be seen as a stamp of approval and give their brands a vote of confidence at a time of uncertainty. Buffett negotiated extremely favorable terms in each of these situations, and BRK has profited handsomely.

### Conclusion



While BRK has outperformed the S&P500 by more than double since 1980, our recommendation to substitute 10% of investors' S&P500 exposure with BRK, is based on the better positioning of BRK to take advantage of the US economic recovery, especially in financials, housing and railroads. In addition, we think the private equity portfolio of BRK is a catalyst of value for shareholders.



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