Key Takeaways from Berkshire Hathaway's Annual Meeting

Warren Buffett spent about 15 minutes talking about Berkshire Hathaway's financial performance for 2017 FY and 2018 Q1, and used a single slide to illustrate each of his points. He then opened up the floor to questions, where we were able to get better insight into Berkshire's investment philosophy.

In our humble opinion, their investment philosophy is built upon two critical and interconnected components: The Science of Investment and The Art of Investing.

In this Thinking Man (our third one about Berkshire), we re-introduce key tenets of value investing, explore Berkshire's Science and Art approach to investing, and analyze the company's most recent investment into Apple. Berkshire Hathaway has been one of BigSur's core holdings across client portfolios for years, and Apple represents our single largest equity holding[1].

Value Investing

There's no doubt that both Warren Buffet and Charlie Munger have been influenced by Benjamin Graham, the king of Value Investing. As Graham describes in The Intelligent Investor, "Mr. Market" is a temperate and reasonable fellow most of the time, but some days is gripped by irrational fear or greed. Investors should use their own independent and unemotional judgement of value instead of relying on the often manic-depressive behavior of financial markets. In practice, Buffet and Munger believe this can be done primarily by investing in companies that provide a margin of safety, which is frankly more about a mindset than it is about any specific algorithm, model, or set of precise inputs. It is about the temperament to know how to avoid stocks at risk of a permanent loss of capital. The potential for a total loss manifests in three ways: financial statement manipulation, fraud, and financial distress or bankruptcy. These are each different risks, but closely related and frequently found together.

The Berkshire method can't be learned in a University classroom or even on Wall Street. Berkshire quickly eliminates the big universe of what not to do, and follows up with a fluent, multi-disciplinary approach on what remains – based on the margin of safety. They then act decivesly when, and only when, the right

The Thinking Man's Approach

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Ignacio Pakciarz | CEO
Ricardo Outi | Head of Real Estate
Salvador Juncadella | Senior Analyst

- Simple Framework: Believe in America and its People, Know the Industry, Trust and Support Managers
- Margin of Safety: Apply conservative underwriting and always pay less than the intrinsic value of the business.
- Power of Compound: Deploy capital and watch its cash flow grow at a compounded rate – reason why Berkshire never invests in non-productive assets.
- Patience: When you have over $100 billion of capital to be deployed, you wait and wait, and if no attractive deals comes in, you continue waiting
- Discipline: One of Mr. Buffett's most famous quotes is to stay within your circle of competence.
- Long-Term View: For Berkshire, 10 years is considered short term.

For more on how we are positioning our portfolios, please contact your investment advisor or email:

ideas@bigsurpartners.com

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circumstances appear. Munger says: "To us, investing is the equivalent of going out and betting against the pari-mutuel system. We look for a horse with one chance in two of winning and which pays you three to one. You're looking for a mispriced gamble. And you have to know enough to know whether the gamble is mispriced." Price is an important component of a margin of safety, but a multifaceted approach that incorporates the business model, capital structure, and management integrity is preferable.

This approach will be focused on error elimination. Thus, Munger's famous quote, "a great business at a fair price is superior to a fair business at a great price." This is what made Berkshire realize the need to focus on investing in great businesses with unparalleled MOATs, versus just being deep value investors buying mediocre companies at cheap prices. The last evaluation is more philosophical than mathematical – ultimately a "feel" emerges, a function of both the analysis itself and their accumulated experience and skill in recognizing patterns. That is why we call it not only a Science, but also an Art. Both of these approached are touched upon below in greater detail, and then we provide an example of their investment methodology applied to Apple.

The Science of Investment

Simple Framework: Believe in America and its People, Know the Industry, Trust and Support your Managers

- "Almost 90% of our investments are made in the U.S. – America's economic soil remains fertile

Margin of Safety: Apply conservative underwriting and always pay less than the intrinsic value of the business.

- "We seek durable competitive strengths, able and high-grade management, good returns on the net tangible assets required to operate the business, opportunities for internal growth at attractive returns, and finally, a sensible purchase price."

Power of Compound: Once a deal matches the two criteria points above, deploy capital and watch its cash flow grow at a compounded rate. That's why Berkshire never invests in non-productive assets such as gold or cryptocurrencies.

- "At year-end, Berkshire held $116 billion in cash and U.S. Treasury Bills, up from $86.4 billion at year-end 2016. This extraordinary liquidity earns only a pittance, and is far beyond the level Charlie and I wish Berkshire to have. Our smiles will broaden when we have redeployed Berkshire's excess funds into more productive assets."

The Art of Investing

Patience: When you have over $100 billion of capital to be deployed, you wait and wait, and if no attractive deals comes in, you continue waiting without taking pressure. This is a skillset that only a few possesses.

- "In this game there is no penalty for not taking a risk, and it is a better option than a forced "swing" that will usually never develop into something good. "
- "Both of us believe it is insane to risk what you don't have in order to obtain what you don't need."

Discipline: One of Mr. Buffett's most famous quotes is to stay within your circle of competence. For example: They acknowledged that they made a mistake not investing into Amazon and Google, but at the end of the day, there is absolutely no regret from their end because everyone knows that they have had more wins than losses, period.

- "Despite our recent drought of acquisitions, Charlie and I believe that from time to time, Berkshire will have opportunities to make very large purchases. In the meantime, we will stick with our simple guideline: The less prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own."

Long-Term View: For Berkshire Hathaway, 10 years is considered short term.

- "In the next 53 years our shares (and others) will experience declines. No one can tell you when these will happen. The light can at any time go from green to red without pausing at yellow. When major declines occur, however, they offer extraordinary opportunities to those who are not handicapped by debt. That's the time to heed these lines from Kipling's If:
    - If you can keep your head when all about you are losing theirs . . .
    - If you can wait and not be tired by waiting . . .
    - If you can think – and not make thoughts your aim . . .
    - If you can trust yourself when all men doubt you . . .
    - Yours is the Earth and everything that's in it.

Apple Investment

Just a few weeks ago, Warren Buffet announced that Berkshire Hathaway had acquired 75 million additional shares of Apple, taking its stake to roughly 240 million shares – now worth some $44 billion (about 5% of Apple's market capitalization). Below, we describe Berkshire's investment philosophy for selecting this particular investment.

Apple has the world's most valuable technology platform with 1.3 billion active devices, and is well positioned to capture more of its users' time in the years to come. Berkshire's investment reflects the famed investor's belief in Apple's value as a consumer products company. After so many years of steering clear of the technology industry, Buffett says he sees the company as a consumer products company now that it has matured, and also given how the world we live in has evolved with technology playing an important role across all industries.

Apple can be considered a consumer products company given its global brand recognition for providing premium products and services, and the unparalleled ecosystem for supporting them. Apple's products have high switching costs and one of the highest levels of customer loyalty. Warren Buffet focuses on the "stickiness" of Apple's products and ecosystem. A recently published survey from Morgan Stanley reiterates this point, stating that the iPhone's retention rate is 92%, compared to 77% for Samsung phones, and up from 86% the previous year.

Each of these factors plays a role in establishing a strong economic moat for Apple's future success. In a 1999 interview, Buffet spoke in detail about economic moats, stating: "the key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."

In the news, many analysts had been warning about Apple having reached its peak, speculating that there would be a slowdown in phone sales, that Apple would cut or limit its share buyback program going forward, and that the company had lost its mojo in terms of innovation capabilities. This was all prior to their strong earnings announcement, which forced analysts to backtrack their faulty analysis and quickly jump back onboard.

Sales for the iPhone were up 14% year-over-year, and the company announced that it would repurchase an additional $100 billion of its own shares, and research & development growth (specifically investment into artificial intelligence, virtual reality, health and auto industries) outpaced revenue growth, which demonstrates a sustainability for long-term growth as well as a future pipeline of products and services.

These factors, combined with Berkshire's stamp of approval, have driven Apple's stock to new record highs. They clearly align with the consumer brand that Apple has established, as well as the rationale behind Berkshire's investment. Once again, we see Berkshire Hathaway's contrarian approach at play when it comes to selling when others are greedy, and buying when others are fearful.

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