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listening in

Berkshire Believer

Stock's Slide, Change in Buffett Valuation Guide Don't Temper Ardor

It's hard to say at this remove — which is probably approaching 20 years — what first attracted me to the work of the fellow on this issue's cover, Chris Bloomstran. But it was probably the obsessive/compulsive depth of his securities research, along with his unwavering fealty to Ben Graham-style fundamental value investing. Or, it might have been his painstaking attention to principled accounting. Then again, maybe it was just that the name of his firm, Semper Augustus Investment Partners, caught my eye in the "glory days" of the internet bubble.

It really matters not. What does is that Chris and his partner Chad Christensen run their St. Louis- and Denver-based investment advisory firm, conservatively, "going where the value is," as they say, but sticking strictly to investing in well-run, well-capitalized businesses with shares trading well below their frankly miserly appraisals of fair value. And, full disclosure, I write that advisedly. Chris and Chad manage a healthy chunk of my husband's retirement assets.

Not surprisingly, given their predilections, Berkshire Hathaway shares hold a position of pride in Semper's portfolios — something I admit giving them grief over as its stock price sagged last year — but they held absolutely firm in their judgment its value was only increasing.

Imagine my surprise, then, when Chris called a few weeks ago, upset with changes in valuation methodologies Warren Buffett slipped into his latest chairman's letter. As Chris complained, this interview — exploring in depth the Semper case for Berkshire — was born. We covered the waterfront.

But don't expect a surprise ending. Chris, a strict constructionist, if ever there was one, doesn't take



Chris Bloomstran

kindly to rules changes, mid-game. So quibble he does, but like the college football player he was, Chris also keeps his eye firmly on the ball. There's no mistaking that Chris' goal is exploiting value — or that Berkshire, at 13 times earnings, is a relative steal, in his eyes.

Listen in, as Chris puts his arguments in numbers.

KMW

Chris, your bona fides as a Buffett fan have long been front and center. Yours is the sort of value fervor that a stock price decline, like Berkshire's 12.5% slide last year, can only be expected to whet. So what moved you to pen a 70-page "deep dive"

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into the company as this year began? It smacks of “he doth protest too much.”

Well, I’ve always wanted to put on paper our thoughts on Berkshire for clients. We’ve owned so much of it for so many years. When I got two pages into talking about why the stock was down 12.5% last year and what little bearing that has on the economics of the business or its economic returns, it dawned on me that now was time. We had naturally fielded a lot of client questions as the stock slid last year, and I realized that if I were going to make the case that the short-term decline in Berkshire’s stock price doesn’t matter — and that it’s the underlying growth in intrinsic value and profitability that *does* matter — I couldn’t just assert it. I had to explain my analysis. And there I was, 70 pages later.

You have many admirable traits, but succinct you’re not. Guilty. I can’t do an hour-long meeting with a client, either.

Still, the ink was barely dry on your masterpiece when Berkshire released its results and chairman’s letter – and upset your apple cart sufficiently that you fired off a letter to the man in Omaha –

I did. I sent about a page-and-a-half letter with the spreadsheets [excerpted tables follow] that I have sent you. The spreadsheets walk through where I saw Mr. Buffett’s reported intrinsic value yardsticks were altered for 2014 and 2015 — and the methodology I think that he used to get there.

In the letter, I didn’t tell him to come right out and make a clarification — I mean, who is Chris Bloomstran to tell Warren Buffett to make a clarifi-

cation? And I’m not sure that he’s going to feel like he needs to —

But you do want an explanation –

Put it this way: There was enough of a change in two of the yardsticks that Mr. Buffett has long encouraged analysts to use when looking at Berkshire’s intrinsic value that I wanted to at least let him know that somebody had picked up on how his changes in methodology affected not only this year’s numbers, but last year’s — and I’m sure I’m not the only one.

Let me guess, these changes to his recommended yardsticks flattered calculations of intrinsic value?

To a degree. My real issue is that he has put these two yardsticks in his letters for 20 years. They really have become integral parts of the financial statements to the users. I mean, he does a great job of laying out how he looks at the business, how the moving parts work. He gives you great tools to value the business.

So when he changes two of those yardsticks with-

out providing a lot of color, it’s disconcerting. My instinct is, “I’d better go reconcile this because I’m not seeing the numbers I expected to see for the current year — I have to wonder, has the thinking inside of Berkshire changed?”

I take it Buffett hasn’t responded to your letter?

I don’t know if I’ll get a response or not. Maybe he will include something in the first quarter report or even say something at the annual meeting. It would be a pretty good discussion point.

Intrinsic value yardsticks aren’t GAAP

“There was enough of a change in two of the yardsticks that Mr. Buffett has long encouraged analysts to use when looking at Berkshire’s intrinsic value that I wanted to at least let him know that somebody had picked up on how the changes in methodology affected not only this year’s numbers, but last year’s – and I’m sure I’m not the only one.”

measures, of course – but changing them after so many years does raise questions. Yet you’ve told me it *doesn’t* change your opinion that Berkshire shares are very undervalued and therefore pregnant with a lot more potential long-term returns than most competitive investments?

Right. We can get into the math on the goal post moving, but you just hit the nail right on the head. Berkshire, to us, is a very large position — upwards of a third of our capital — and, relative to the opportunity set of the S&P 500, or any other names we could buy, it is still a remarkable business — albeit a completely different business than it was almost 20 years ago.

Before we get into why you’re still such a big fan, let’s get into how Buffett changed those yardsticks. I take it you’ve been using them for quite some time?

Our research on Berkshire began back in 1996, when the company first issued its “B” shares — accompanied by some extraordinarily candid disclosures in the prospectus saying neither Mr. Buffett nor Mr. Munger would buy the company’s “not undervalued” shares at the offering price.

I remember that – and that it didn’t seem to dampen investor interest in the offering.

No, but it did mine. I was just a young money manager in a bank trust department, but after I went through Berkshire’s financial statements, I had to agree the stock was too expensive to buy at the offering price. I was, however, intrigued by the business — and its leaders — and started following it avidly. Finally, in 2000, I got an opportunity to begin establishing our position at attractive prices —

Okay, but again, the yardsticks that have just been changed are something you’ve used all along to gauge Berkshire’s value?

We actually employ a whole host of methodologies. But yes, what’s become known as Buffett’s “two-pronged” way of estimating Berkshire’s intrinsic value has been integral to our analysis from the beginning. And those prongs are what have been altered.

How?

Some background may help. Back in its 1995 annual report, Berkshire presented two simple columns of data [below] to help shareholders objectively understand the economics of the business and how the management viewed its valuation. The data, presented for 10-year increments from 1965 to 1995, highlighted the growth in Berkshire’s marketable securities per share and pre-tax earnings per share, exclud-



ing all income from investments — and, in effect, provided a simple back-of-the-envelope tool for valuing the company. It also highlighted the degree to which investments in marketable securities had contributed to its value creation over time.

In other words, management was telling shareholders that capitalizing pre-tax earnings at a reasonable multiple and then adding the value of its securities made perfect sense as a shorthand way to value Berkshire. It has updated those numbers in most years since, and we’ve used them, with some adjustments, in our own analysis. It’s worked pretty much like a charm — until this year.

What happened?

The estimates I made, when writing my 70-page opus to clients — for both Berkshire’s operating earnings and the value of marketable securities for year end 2015 — turned out to be too low. And since I hadn’t changed my methodology, I started digging and reconciling the numbers to understand what happened.

We’ve now got a pretty good handle on where the methodology has changed and perhaps on how management now looks at these two yardsticks of value — but I still can’t get the numbers to completely tie out, which is why I sent that letter off to Omaha — though I know he’s not too keen on interacting with the investment community.

Yardsticks, Circa 1995

Year	Marketable Securities Per Share	Pre-tax Earnings Per Share Excluding All Income from Investments
1965	\$ 4	\$ 4.08
1975	159	(6.48)
1985	2,443	18.86
1995	22,088	258.20
Yearly Growth Rate: 1965-95....	33.4%	14.7%

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Intrinsic Value Yardsticks – Changes 2014 - 2015
Both Marketable Securities and Pre-Tax Earnings Inferred to be Restated Upward for 2014
Pre-Tax Earnings Now Include Underwriting Gain - Presented in Dollars Per-Share and Per-Share

Pre-tax Earnings (Without Investment Income) - PER-SHARE					
	2014 Reported	2014 Inferred Restated (2.1% '14 to '15)	2014 Using \$2.668 billion / 1,624 per share	2015 Reported	Growth y/y
Pre-tax earnings (without investment income)	10,847	10,847	10,847	11,186	
Underwriting Gain		1,204	1,624	1,118	
Pre-tax earnings (with underwriting gain)		12,051	12,471	12,304	
Growth rates year/year					
Original presentation (no investment income; no underwriting)	10,847			11,186	103.1%
Inferred Restated with underwriting		12,051		12,304	102.1%
Using \$2.668 billion / 1,624 per share underwriting for 2014			12,471	12,304	98.7%

Pre-tax Earnings Per-Share (Without Investment Income) - In DOLLARS (Millions)					
	2014 Reported	2014 Inferred Restated (2.1% '14 to '15)	2014 Using \$2.668 billion / 1,624 per share	2015 Reported	
Pre-tax earnings (without investment income)	17,827	17,827	17,824	18,381	
Underwriting Gain		1,978	2,668	1,837	
Pre-tax earnings (with underwriting gain)		19,805	20,492	20,218	
Growth rates year/year					
Original presentation (no investment income; no underwriting)	17,827			18,381	103.1%
Inferred Restated with underwriting		19,805		20,218	102.1%
Using \$2.668 billion / 1,624 per share underwriting for 2014			20,492	20,218	98.7%

So what do you think changed?

My explanation is that there was a different approach to putting together both pre-tax earnings and marketable securities numbers for 2015, which compelled a restatement of the numbers were that were presented for 2014. It is not so much that this changes how we value the whole business, but it does mean that we're going to have to change the way we look at some components of the business, just to be consistent in how we analyze Berkshire's five different groups of operating subsidiaries. I sent you some spreadsheets that run through what I had to do to reconcile the numbers —

Let's walk through them —

The first change is that Berkshire is now including underwriting gains in its calculation of pre-tax earnings [above]. Again, my intent here is not to go war with Omaha —

Asymmetric warfare isn't your style?

No! I think that to presume that you have insight

above and beyond what's going on in Omaha is probably a bad idea. But it is interesting that they are looking at these numbers a little bit differently.

The first change that jumped out — and this one was flagged in Mr. Buffett's latest chairman's letter — but for years, the pre-tax earnings that went into the intrinsic value yardstick *excluded* investment income, and this year he said he is now going to *include* underwriting gains for the first time in his pre-tax earnings numbers. Essentially, this was explained as an acknowledgement that the ongoing sustained underwriting profitability of the insurance operations is probably more predictable going forward than it was in the past. You've had 13 years in a row in which it has generated an underwriting profit. The business is taking on less cat (catastrophic insurance) exposure, which is where you'd really see volatility, if you got a big hurricane or an earthquake or a terrorist attack. It's simply relying more on more knowable lines.

You're worried including the underwriting

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gains flatters the pre-tax numbers?

It's not that so much — underwriting results can be volatile in both directions — even if Berkshire's haven't been, for quite a while. What stopped me was that Mr. Buffett wrote that he was including underwriting gains *for the first time*. Because I remember that when I first started following Berkshire — and when he started providing the yardsticks, back in 1995 — those numbers *included* its underwriting gains. In fact, I went back and dug out the old yellow pads I used when I first started doing this — and for the years '95 to '99 Berkshire did provide these dual yardsticks of value — marketable securities and pre-tax operating earnings, excluding investment gains and losses. And the numbers for those first five years *included* underwriting gains and what turned out to be an underwriting loss in 1999.

Well, the yardsticks stopped appearing explicitly in the annual in 2000 to 2004, which happened to mostly be pretty awful years in the underwriting cycle — post Berkshire's acquisition of GenRe. But by the time the 2005 annual came out, Berkshire had posted a couple of years of underwriting profits — and the intrinsic value yardsticks reappeared in the annual.

It's not exactly shocking that voluntary disclosures happen when they look good.

No, and I have to admit that my analytical pride swelled when it became apparent that the pre-tax earnings yardstick he started providing again in 2005 *excluded* underwriting results (it wasn't explicitly explained, but he did restate the 1995 figure, for purposes of a 10-year comparison in a way that eliminated underwriting profits).

That made you proud?

A bit. Because one of the two major adjustments I had been making in applying those yardsticks to estimate Berkshire's intrinsic value, was to strip

Intrinsic Value Yardsticks – Changes 2014 - 2015

Both Marketable Securities and Pre-Tax Earnings Inferred to be Restated Upward for 2014
Marketable Securities 2014 to 2015 - Presented in Dollars (millions)

	2014 Reported	2014 Inferred Restated (8.3% '14 to '15)	2015 Reported	growth y/y
	230,285	242,448	262,571	108.3%
Insurance and Other				
Cash and cash equivalents	57,974	57,974	61,181	
Fixed Maturity Securities	27,397	27,397	25,988	
Equity Securities #	115,529	115,529	110,212	95.4%
Other (Warrants, Preferreds WWY,DOW,BAC,RBI)	16,346	16,346	15,998	↗
Investments in Heinz/Kraft Heinz (Fair Mkt Value)*	11,660	11,660	32,042	Total Return (2.7%)
Minus Cash From MSR *	-5,765	-5,765	-6,807	
Subtotal Insurance and Other (no MSR cash)	223,141	223,141	238,614	
Finance and Financial Products				
Other (Warrants, Preferreds WWY,DOW,BAC,RBI) **	5,978	5,978	5,719	
Investments in equity and fixed income securities **	1,299	1,299	411	
	7,277	7,277	6,130	
ORIGINAL TOTAL	230,418	230,418	244,744	106.2%
Plus				
Cash from MSR		5,765	6,807	
Cash from Railroad, Utilities and Energy		3,001	3,437	
Cash from Finance and Financial Products		2,294	7,112	
		11,060	17,356	
Reconciled Total ^		241,478	262,100	108.5%

2014 per-share investments: \$140,123 equals \$230.285 billion
2014 RESTATED/INFERRED investments: \$147,548 per share equals \$242.448 billion
2015 per-share investments: \$159,794 per share equals \$262.571 billion

* Investments in Heinz and Kraft Heinz not at balance sheet value (cost) but fair value from fair value table; MSR cash from Chairman's Letter

** Assets from Finance and Financial Products stated as excluded in 1999 and 2005 Chairman's Letter
Growth y/y excludes dividends, net purchases and time weighting. Ballpark estimate of total return loss of \$3.1 billion, 2.7%

^ Reconciled totals are off (low) by \$970 million for 2014 and by \$471 million for 2005. Number of shares in denominator or other assets?

out those underwriting results — because, as I said, they can be very volatile from year to year, particularly for long-tail lines like cat. Instead, at that time I made the conservative assumption that the insurance business would write at breakeven over time — a stance I've modified and now expect them to operate at a 95% combined ratio over the long term. The other adjustment I made was to discount the value of the securities to reflect an estimate of how overpriced we figured they were.

Does it really matter if underwriting results are blended into pre-tax earnings or not? As long as it's identified?

Not tremendously, and he did say in his letter that “We think this is much more predictable now than it used to be.” I don't disagree with that at all. And the amount of underwriting gain that was included for 2015 wasn't great, in any event. It was fine, but they only made 2%. They had a 98% combined ratio.

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Key Business Information 2015 (Estimated)

Berkshire Hathaway Energy (89.9% owned)		MSR Businesses	
Revenues	\$18.6 B	Revenues	\$107 B
EBIT	\$3.5 B	Pre-tax Income	\$7 B
Pre-tax Income	\$3.0 B	Net Income	\$5 B
Net Income (reported)	\$2.3B	Profit margin	5.70%
Net Income (adjusted for cash taxes)	\$2.7 B	Working Capital (\$ 6 billion cash)	\$16 B
Earnings Applicable to Berkshire	\$2.4 B	Total Debt	\$5.5 B
Equity (estimated)	\$54 B	Equity	\$58 billion
ROE (includes \$9.6 billion goodwill)	4.9%	ROE (incl. estimated goodwill of \$31.5 billion)	8.6%
ROE (excluding goodwill)	6.1%	ROE (excluding goodwill)	18.9%
Estimated Value	\$35-40 B	Estimated Value	\$100-110 B
Implied P/E	15	Implied P/E	20
BNSF		Finance and Financial Products	
Revenues	\$22.5 B	Equity	\$21 B
EBIT	\$7.5 B	EBT w/ \$400M derivative amort	\$2.4 B
Pre-tax Income	\$6.6 B	Net Income w/ derivate amort	\$1.7 B
Net Income (as reported)	\$4.2 B	Normal Average ROE	8.5%
Net Income (adjusted for cash taxes)	\$5.1 B	Estimated Value	\$25-30 B
Equity (estimated from STB and GAAP filings)	\$38 B	Implied P/E	15
ROE (includes \$14.8 billion goodwill)	13.4%		
ROE (per STB annual R-1)*	10.8%		
Estimated Value	\$70-80 B		
Implied P/E (on net adjusted for cash taxes)	14		

* Excludes goodwill and most debt

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The thing about it is that, as you see in the lower right of the spreadsheet, they basically said that 2015 pre-tax earnings per share grew 2.1% year over year. That's the \$12,304 for 2015 relative to what last year's number would have been — but the chairman's letter didn't tell you explicitly what that number was.

And you love solving mysteries —

Well, 2014's number as reported, which did *not* include underwriting gains, was \$10,847 per share. So you would *infer* that 2014 underwriting gains were \$1,204 — and this may be getting a little deep in the weeds but stick with me for a minute — but that would also imply that 2014's pre-tax earnings, *with* the underwriting gains, came to \$12,051. That's the base that 2.1% growth he did report would have been based on.

The thing I *can't* make reconcile is that last year's underwriting gain was reported as \$2.668 billion, which was the \$1,624 a share that I show in the

third column from the right, above. When you add up that column using this current methodology and including underwriting gains you get pre-tax earnings for last year of \$12,471 — a total that actually implies that Berkshire's pre-tax earnings *declined* year over year in 2015, by 1.3% (That's what my spreadsheet implies where it says 98.7% on the right.) Apples to apples, it looks like it would have been lower — so there's certainly no an inference that he was trying to mask a decline in profitability. He could have just left underwriting results excluded from his pre-tax earnings yardstick — which is what we will do anyway, in our analysis, to avoid their volatility.

I just can't reconcile the \$2,668 billion underwriting gain. In my letter to Mr. Buffett, I basically wondered if it doesn't have to do with some kind of reserve developments, if last year there was a redundancy — meaning Berkshire was more conservative upfront when they calculated their estimated losses for the year than it turned out that they actually had to be. I mean, you'd always rather be conservative and wind up making more money than you thought you were going to make — that's been the case at Berkshire for a long time. Though it's not the case for most insurers — if you go through their loss development tables, they're pretty choppy. They're way too sunny and rosy in too many years, which is why you get the industry losing money, on an underwriting basis, over time.

Anyway, I'd like to know how 2014's reported underwriting gain of \$2.668 billion became a lower number, \$1.978 billion. I realize that when we're talking about \$600 million in the grand scheme of a business that is worth close to \$500 billion, it's probably a rounding error, but it doesn't reconcile. So we'll continue to look for the answer.

I'd think \$600 million would be sufficient to catch even Warren Buffett's attention. What's the other yardstick change that disturbs you?

It has to do with Berkshire's reporting of its marketable securities. This one was a little more eye-catching. Last year, the marketable securities number reported in the annual report was \$230,285 per share. Do you see that on the first column on the upper left?

Yes.

Okay, reading down from there, you can see my reconciliation of that number, using numbers I pull from the balance sheet. I pull in cash and cash equivalents from the insurance and other category

— which includes the bonds, includes the stocks, includes the warrants and preferreds for Wrigley, Dow, Bank of America and Restaurant Brands. It includes Kraft Heinz at fair market value.

Then I back off the cash from the MSR (manufacturing, services, retail) group, because the cash is kept within those subsidiaries. Part of the case I make for valuing the MSR businesses at 20 times earnings is that essentially they are unlevered. They operate debt-free; with very modest amounts of net cash. If you instead stripped out that \$6 billion in cash from a business with \$58 billion in equity, you'd end up with a levered enterprise — only moderately leveraged, I grant you, but still 10% levered. While it might earn more as a levered enterprise, to me, that cash belongs in those businesses, so I go through the exercise of pulling it out in my reconciliation of this yardstick.

Then to get to the \$230,000 per share in marketable securities reported for 2014, you would have to include the other investments Berkshire holds held within its finance and financial products arms — and a portion of those — Wrigley, Dow, Bank of America and Restaurant Brands — are preferreds and warrants appear in both places. And you also pick up very modest amount of investments in stocks and bonds. And what do you know, it all reconciles, closely enough, anyway, not to worry about.

So what's your problem?

When this year's yardstick came out, he said that marketable securities were \$262,571 a share — which was *way more* than I had been estimating. I mean I know what the insurance company assets are at; I tracked the stock portfolio on a daily basis — there's not enough going on to get to that number, so immediately I tried to figure out where it came from.

Where'd you start?

Well, he stated that the growth rate, year over year, that produced that number was 8.3%. Well, that

Key Insurance Business Information 2015 (Estimated)

Insurance Operations		Insurance Investments (September 30, 2015)	
Premiums Earned (\$41 Billion in 2014)	\$40 B	Equity Securities (Excluding Kraft Heinz Equity)	\$106 B
Statutory Surplus (Equity) 2014 Value	\$129 B	Fixed Income Securities	\$27 B
Book Value (GAAP Estimated) 2014 Value	\$150 B	Preferreds, Warrants, Kraft Heinz	\$49 B
Float (\$84 Billion 2014)	\$85 B	Cash	\$43B
Losses Paid 2014	\$22.7 B	Total Investment Assets 2014: \$231 B	\$225 B
Normalized Underwriting Margin: 5% Pre-tax	\$2 B	Investment Income and Earnings (to reconcile)	
Normalized Underwriting Net Profit	\$1.3 B	Dividends (3.3% div yield)	\$3.5 B
Capitalized Value from Underwriting	\$20 B	Retained Earnings of Common Stocks	\$4.8 B
		Total Earnings of Common Stocks (12.8 P/E; 7.8% ey)	\$8.3 B
		Interest and Dividends on Preferreds	\$900 M
Insurance Estimated Value			
Total Investment Assets	\$225 B	Kraft Heinz Preferred Dividend	\$720 M
Capitalized Value from Underwriting	\$20 B	Kraft Retained Earnings (normalized)	\$260 M
Estimated Value	\$245 B	Kraft Dividends @2.30 annual rate	\$750 M
		Total Kraft Heinz Earnings *	\$1.73 B
		Total Pre-Tax Earnings of Investments	\$10.9 B
		Optionality of Cash > One-Year Losses Paid	\$1.2 B
		Pre-tax Earnings with Optionality of Surplus Cash **	\$12.1 B
		Paid and Hypothetical Taxes	\$1.5 B
		Investment Net Income	\$10.6 B

inferred that last year's number was really \$242,488, not \$230,000. Do you see how I got that, in the third column from the right [page 5]?

Sure, in black and white.

So then I went through the same picking up of the securities from the balance sheet that we did before. But what you find is that on an apples-to-apples basis you get to \$244,744 — you don't get to the \$262, 571 reported in the chairman's letter.

What do you make of the discrepancy?

The only thing that I could come up with was he must have picked up the cash from all of the other operating subsidiaries — from MSR, from the rail, utilities and energy units and from finance and financial products. That's an extra \$17 billion which gets you — roughly — close to that \$262,571 a share of marketable securities that he presented.

You're implying that Buffett essentially went through Berkshire's couch cushions

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Extrapolating the Future for Berkshire Shareholders

	2014	2015	2016		2025 8% ROE and growth				2025 10% ROE and growth			
			No Change	Down 10%	13x	15x	18x	20x	13x	15x	18x	20x
Market Cap	\$371 B	\$325 B	\$325 B	\$292.5 B	\$702 b	\$810 b	\$972 b	\$1080 b	\$845 b	\$975 b	\$1170 b	\$1300 b
Net Income	\$23 B	\$25 B	\$27.5 B	\$27.5 B	\$54 b	\$54 b	\$54 b	\$54 b	\$65 b	\$65 b	\$65 b	\$65 b
P/E	16.1x	13.0x	11.8x	10.6x	13x	15x	18x	20x	13x	15x	18x	20x
Earnings Yield	6.2%	7.7%	8.5%	9.4%	7.7%	6.7%	5.60%	5.0%	7.7%	6.7%	5.60%	5.0%
Price Change		-12.5%	0%	-10%	116%	147%	199%	229%	160%	200%	260%	300%
Annual Gain/Year					8.0%	9.5%	11.6%	12.7%	10.0%	11.6%	13.7%	14.9%

vacuuming up all the spare change he could find?

He did. And I think that even makes sense because he had to finance this Precision Cast Parts acquisition in the first part of the year. He'd said he was going to borrow \$10 billion to finance it, which meant he had to come up with another — call it \$21 billion. I think he probably dividended some money out of the insurance operations to the holding company. Somewhere, an extra \$5 billion in cash just appeared in finance and financial products — and I can't get that to tie to any asset sales or maturities from last year.

I totally get it, if you're getting ready for the Precision deal to close. But to me, the cash of the MSR businesses is the cash of the MSRs. I mean, could you operate these businesses with less working capital? No doubt about it. But that would meaningfully reduce the multiple I'd be willing to pay for them. The finance and the financial products businesses generally have assets that are pledged against liabilities, and he has specifically said in at least a couple of his chairman's letters that he did not upstream assets from those units because they're generally pledged against liabilities.

So you saying Berkshire is stretched thinner than you'd like?

No. My question is more whether something has changed in the structure of the business to make it more over-capitalized than it was? Mr. Buffett hasn't said anything about it. So I'm curious. I'd like to know if I've puzzled it out correctly.

But I also think that anyone who has been using Berkshire's two-pronged yardsticks as an integral part of their valuation process now has to reconsider what multiples they attach to them. I wouldn't apply the same multiples to the numbers that I would have before — because now they're including components from various of the other operating sub-

idiaries. And I'm either going to lower the valuation of the various operating subs to reflect this new lack of cash or I'm going to go ahead and just assume that Berkshire is just going to run with less cash. And that might be the right answer.

How do you mean?

In reality, when I've talked to some of the folks who run some of Berkshire's operating businesses, it has been clear that Omaha leaves these guys alone and they invest their own cash. Up to now there has not been a sweep mechanism, where Omaha invests all of the operating subsidiary's cash. So maybe now he is going to optimize the cash structure of the firm.

After all, your nickels in the sofa added up to a lot of money at \$17 billion worth of nickels.

Would that my furniture were so giving! Still, I can't see a positive spin on monkeying with valuation gauges Berkshire has long encouraged its shareholders to use –

I don't know, is it yardstick moving? Is it providing shareholders the proper lens by which to measure the business? I think he genuinely doesn't want to see shareholders make an ill-informed reactionary decision because last year the stock price slipped 12.5% and decide, "I better jump out of it." I think he's well-intentioned enough to want the aggregate of the shareholder body to experience the growth of Berkshire's value over time.

Could the disclosures of the yardsticks this year have been more beefed up? I think they could have come with a little more explanation. But I was able to figure it out, I think. And is there an obligation to present these numbers in the chairman's letter? Absolutely not. They aren't part of GAAP financials — he does a marvelous job of providing way more information than he's compelled to do, so I won't fault him on that front. I just wish he'd pro-

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vided more color. Changing the yardsticks makes it a little more difficult for the average investor to estimate Berkshire's intrinsic value, but it's certainly doable. So I don't think he's committed any mortal sins here at all.

Gosh, you are a Buffett fanboy. How about explaining why you find Berkshire so utterly compelling despite your issues with its recent goal post changing –

Easy. You've got a business that compounded book value at 19-ish% per year for a long time — and while those days are gone (and have been, for a long time) — the remarkable thing is how different it is from the aggregate market. What I mean by that is that Berkshire is a business with incredible economics, the accounting is better than you're going to find anywhere on Wall Street —

That's setting an awfully low bar –

It truly is. Last night I was working out some broad-brush numbers on operating earnings versus reported earnings for the S&P, so we could talk about it. But then I did a quick update on pension math — and the quality of the accounting is just terrible today.

By contrast, in Berkshire, you've got a 51-year history of impeccable accounting. You don't see write-offs and write-downs in every cycle, you don't see prodigious uses of employee stock options or restricted stock, you don't see excessive executive compensation schemes — it's just as clean a business as you're going to get.

But, as you intimated, it's a very different

business than the one on which Buffett made his reputation.

No question. With the changes that have been put in place in the last 18 or so years, it's a much more durable, diversified franchise now than it was when insurance drove the bus. Though, with insurance driving the bus, Berkshire's investments in common stocks served it very well for a long time. Really, from the stock market low in 1975 through the General Re acquisition in '98, Berkshire lived on its stock portfolio, and on the leverage that it gets from the float that's created in its insurance operations.

Not to mention on the tailwind of a secular bull market of truly historic proportions.

Oh, it was a massive bull market — the S&P compounded at upwards of 17% per year. But the stock portfolio inside of Berkshire did remarkably better. And a lot of it had to do with when Buffett bought his great franchise businesses — buying Coca-Cola right after the market crash in '87, buying Wells Fargo for the first time in the wake of the S&L crisis in 1990. He bought Geico way back after the bear market in '73-'74. He bought The Washington Post in '73, probably a year early. But all of those big names outperformed the S&P *by a lot*.

So you had a stock portfolio that was probably earning close to 20% per year — maybe 3 or 4 points better than the S&P — and also was doing it on a very levered basis, because of the float in the insurance businesses. Stocks as a percentage of Berkshire's overall book value were more than 100% for the better part of 20 years.

Until 1998 –

	Per-Share Pre-Tax Earnings			Per-Share Investments			Per-Share Investments + everything else				Market Cap		
	10x	12x	13.5x	plus 10x	plus 12x	plus 13.5x	shares out	at 10x	at 12x	at 13.5x			
2005	2,441	24,410	29,292	32,954	74,129	98,539	103,421	107,082	1.541	151,849	159,372	165,014	
2006	3,625	36,250	43,500	48,938	80,636	116,886	124,136	129,574	1.543	180,355	191,542	199,932	
2007	4,093	40,930	49,116	55,256	90,343	131,273	139,459	145,598	1.548	203,211	215,883	225,386	
2008	3,921	39,210	47,052	52,934	77,793	117,003	124,845	130,726	1.549	181,238	193,385	202,495	
2009	2,250	22,500	27,000	30,375	90,885	113,385	117,885	121,260	1.552	175,974	182,958	188,196	
2010	5,926	59,260	71,112	80,002	94,730	153,990	165,842	174,732	1.648	253,776	273,308	287,958	
2011	6,990	69,900	83,880	94,365	98,366	168,266	182,246	192,731	1.651	277,807	300,888	318,199	
2012	8,085	80,850	97,020	109,148	113,786	194,636	210,806	222,934	1.643	319,787	346,354	366,280	
2013	9,116	91,160	109,392	123,066	129,253	220,413	238,645	252,319	1.644	362,359	392,332	414,812	
2014	10,847	108,470	130,164	146,434	140,123	248,593	270,287	286,558	1.643	408,438	444,082	470,814	
*2015(e)	11,562	115,620	138,744	156,087	136,918	252,538	275,662	293,005	1.643	414,920	452,913	481,407	
*2016(e)	12,718	127,182	152,618	171,696	147,871	275,053	300,490	319,567	1.643	451,913	493,705	525,049	

*Per-share earnings for 2015 and 2016 are Semper Augustus estimates from our sum of the parts analysis (\$19 billion for 2015) and higher than presented by Berkshire
 *Per-share investments are also estimates by SAI
 # Two-Pronged basis intrinsic value excludes capitalized value for ongoing insurance underwriting profitability, currently valued at \$20 billion, or \$12.169 per-share

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By then, his stocks were very expensive, around 40 times normalized earnings — and Berkshire Hathaway's shares themselves were very expensive. But instead of selling those stocks and paying taxes at a 35% rate on gains, Berkshire used its own massively inflated shares to buy a very good global reinsurer with a big fixed-income portfolio, thus diversifying the combined portfolio away from stocks at no tax cost. Plus, buying Gen Re using his stock as currency immediately diversified Berkshire's investment portfolio, so stocks declined from 115% book down to 69% of book, and he bought the business using shares that we thought were probably 100% overvalued; that needed to fall by 50% to be fairly priced. In other words, he got Gen Re for closer to \$11 billion because he used \$22 billion of his inflated shares as currency.

Great timing, in retrospect. While the internet bubble didn't peak until 2000, the blue chips in Berkshire's portfolio peaked in '98. Exactly, fast-forward from that '98 peak in the blue chips to now, and the S&P has only clipped along at about 4% a year — and I don't think Berkshire's stock portfolio has done any better than that. It has come off very expensive levels in '98 and is today trading at a pretty reasonable multiple. The whole

Berkshire stock portfolio is trading at about 13 times earnings, which is a far cry from 40 times. While you've had some underlying earnings growth, you've had a huge contraction in multiples, which you've not seen with the S&P.

The difference today is — Berkshire itself is very undervalued — trading for 13 times earnings — while you've got the S&P trading for a very, very expensive price again. I don't think we're quite back to where it was in 2000, but depending on what you think normalized free-cash profits are — even using operating earnings, just as reported on the S&P — the market is trading at 20 times, which gets you a 5% earnings yield. But the case can be made that the market is trading for closer to 29 or 30 times.

The S&P is again being skewed significantly by the valuations of a few tech darlings.

It is. I wrote a bit on the FANGs in my February client letter, pitting Berkshire's valuation against the FANGs. It was a fun exercise. There's Berkshire doing \$220 billion in sales, which is slightly larger than all the FANGs, combined. Yet the market cap of those four businesses, at \$1.2 trillion, is four times that of Berkshire. FANG is 53 times earnings, 5.9 times sales. Berkshire, meanwhile, is trading for 13 times earnings and 1.5 times sales. And Berkshire's normalized profits are running at \$25 billion-plus, versus about \$23 billion for all four of the FANGs, combined.

A lot of things have to go right when you pay 53 times earnings and \$1.2 trillion for a group of four businesses. It will be interesting to see how it shakes out over the next 10 or 15 years. But you're paying a lot for fancy growth that may not materialize.

Clearly. But it's also quite clear that the glory days for Berkshire's growth rate are very likely in the past.

It's a shadow of itself. That's why I said you've got to look at it in a rela-

Simple Per-Share Price to Book Value Basis- "A" Share Data

	BVPS	Avg BVPS	1x BVPS	1.2x BVPS	1.75x BVPS	2x BVPS	High	Low	Range vs Avg BVPS	
1994	11,875		11,875	14,250	20,781	23,750	20,800	15,150		
1995	14,025	12,950	14,025	16,830	24,544	28,050	30,600	20,250	236%	156%
1996	19,011	16,518	19,011	22,813	33,269	38,022	38,000	31,000	230%	188%
1997	25,488	22,250	25,488	30,586	44,604	50,976	48,600	33,000	218%	148%
1998	37,801	31,644	37,801	45,361	66,152	75,602	84,000	45,700	265%	144%
1999	37,987	37,894	37,987	45,584	66,477	75,974	81,100	52,000	214%	137%
2000	40,442	39,214	40,442	48,530	70,774	80,884	71,300	40,800	182%	104%
2001	37,920	39,181	37,920	45,504	66,360	75,840	75,600	59,000	193%	151%
2002	41,727	39,824	41,727	50,072	73,022	83,454	78,500	59,600	197%	150%
2003	50,498	46,112	50,498	60,598	88,372	100,996	84,700	60,600	184%	131%
2004	55,824	53,161	55,824	66,989	97,692	111,648	95,700	81,150	180%	153%
2005	59,337	57,580	59,337	71,204	103,840	118,674	92,000	78,800	160%	137%
2006	70,281	64,809	70,281	84,337	122,992	140,562	114,500	85,400	177%	132%
2007	78,008	74,144	78,008	93,610	136,514	156,016	151,650	103,800	205%	140%
2008	70,530	74,269	70,530	84,636	123,428	141,060	147,000	74,100	198%	100%
2009	84,487	77,508	84,487	101,384	147,852	168,974	108,450	70,050	140%	90%
2010	95,453	89,970	95,453	114,544	167,043	190,906	128,730	97,205	143%	108%
2011	99,860	97,656	99,860	119,832	174,755	199,720	131,463	98,952	135%	101%
2012	114,214	107,037	114,214	137,057	199,874	228,428	136,345	113,855	127%	106%
2013	134,973	124,594	134,973	161,968	236,203	269,946	178,900	136,850	144%	110%
2014	146,186	140,580	146,186	175,423	255,826	292,372	229,374	163,039	163%	116%
2015(e)	155,160	150,673	155,160	186,192	271,530	310,320	225,820	192,200	150%	128%
2016(e)	170,676	162,918	170,676	204,811	298,683	341,352	?	?	?	?

* Berkshire authorizes share repurchases below 1.2 times BVPS
1.643 million shares outstanding at 2015; \$271,530 per share equals market cap of \$446 billion at 1.75x BVPS at 2015

tive context. But the way we value this thing — from a very top-down 40,000 feet — you’ve got a business that’s got a tangible GAAP book value of a little over \$250 billion that’s earning more than \$25 billion in normalized profits, so you’ve got a 10% return on equity — a number I think is sustainable for a long time.

Why?

Starting with the Gen Re acquisition, there was a concerted inflection point at Berkshire. A shift away from the stock markets, away from — to a large extent — property/casualty insurance, and to this growing diversified portfolio of very diverse earning streams. Massive investments in the railroad — the Burlington Northern Santa Fe. A big portfolio of energy and pipeline companies and electric and gas utilities. A group of manufacturing, service and retail (MSR) businesses with \$107 billion in sales — generating about \$5 billion in profits. Alone, that MSR group would be among the top-50 businesses, by revenues, in the world. It is just a very disparate stream of earnings. There also is a leasing business. It’s remarkably diversified — and remarkably predictable.

And yet the stock fell 12.5% last year –

Which is where we started our client letter, because as we look at Berkshire’s profitability, we think profits grew about 10% last year. And, because they don’t pay a dividend, effectively, whatever they’re earning on equity becomes the growth rate at which book value per share is compounding — holding the number of shares outstanding constant — which is realistic if they’re not out buying back a bunch of stock (as Buffett has said he’d do) at less than 120% of book or if they’re not issuing shares for acquisitions.

Berkshire went into 2015 with a market cap of \$371 billion. They were earning about \$23 billion in normalized profits, so the stock was trading at 15.9 times earnings — that was a 6.3% earnings yield. Then, because the stock declined by 12.5%, yet the earnings grew by 10%, you ended 2015 at a \$328 billion market cap on \$25-plus billion in profits and at a P/E of 13.1. So now it has a 7.6% earnings yield.

It’s hard to be excited about an increase in estimated value, when your stock’s price has taken a hit –

I’ll grant you that, but this exercise [table below] demonstrates that you shouldn’t be concerned about short-term volatility in stock prices — not just Berkshire’s, but any business’. If you don’t have a diminution in the value of the underlying fundamentals of the business and you’ve got continuing growth

Net Income Basis 2015 expected #				
	Pre-tax		After-tax	
BH Energy	\$3.0B		\$2.4 B	
BNSF	6.6		5.1	
MSR Businesses	7.0		5.5	
Finance Businesses	2.4		1.7	
	19.0		14.7	
Capitalized underwriting	2.0		1.3	
	21.0		16.0	
Investment Income	12.1		10.6	**
	\$33.1B		\$26.6 B	*
Investment Portfolio value derived through investment income				
P/E:	Multiple to pre-tax		Multiple to after-	
	10x	\$331 B	13x	\$346B
	11.5x	381	15x	399
	14x	463	18x	478
* Implies an aggregate cash tax rate of 19.6%, not 35% # Earnings are GAAP adjusted by Semper Augustus				
** Included optionality premium on cash > \$24 billion and all earnings on Kraft Heinz assumed for all of 2015				

and profitability, then a lower stock price becomes an opportunity. I put a couple of columns in my spreadsheet that basically show what would happen a year from now if the stock dropped again and earnings continued to compound at the same rate as return on equity, or at about 10%. So if you saw a further, let’s say, 10% decline in the stock by the end of 2016, you’d take the market cap down from \$325 billion to \$292.5 billion, but profits would grow from \$25 to \$27.5 billion and your P/E would decline from some 13 to 10.6 times — but you’d be looking at an earnings yield of 9.4%.

I also extrapolated that out to 10 years from now — there’s a lot of thinking that goes into what Berkshire can earn on a sustainable basis on its equity capital. We’re pretty confident in the business being able to earn 10% on its equity, but in a worst case, maybe that could shrink to 8%. So I painted two scenarios for Berkshire in the table, looking out 10 years using those two ROEs and growth rates — and in doing so, today’s \$25 billion in normalized profits become \$54 billion at 8% and \$65 billion at 10%.

Illustration of Price to Value Change

	Dec. '14	Dec. '15	Dec. '16 no change	Dec. '16 down 10%
Market Cap	\$371 B	\$328 B	\$328 B	295.2
Net Income	\$23 B	\$25 B	\$27.5 B	\$27.5 B
P/E	15.9x	13.1x	11.9x	10.7x
EY%	6.30%	7.60%	8.40%	9.30%

From there, it's an easy extrapolation. If you hold the P/E constant at today's 13 times, you're pretty much going to make the earnings yield. So if the ROE is 10%, you're going to make 10% a year. If the ROE is 8%, you're going to make 8% a year. And at 13 times you can still have a prospective earnings yield of 7.7%. But obviously if you've got a business that's earning 10% on equity and growing at the same 10%, you will probably get some P/E expansion, and then you're going to get a premium return. At 15 times earnings, you make 11.6% a year; at 18 times earnings — which is pretty much where we have fair value — you make 13.7% a year; and at 20 times earnings, where the stock has traded in the past, you're looking at a compound annual return from today's level of almost 15% a year — 14.9%.

But that analysis fits not just Berkshire: that's anything. How are you going to make money over time in stocks? You're either going to get a change in multiple or you're going to get a change in earnings. You mesh those two and try to figure out how fast any asset is going to grow and where your earnings are going at some point in the future. And then you figure out what to pay for those earnings.

That's all fine, but suppose Mr. Market doesn't come to his senses?

I think just think there's a very reasonable chance that the world at some point in the next 10 years will be willing to pay more than 13 times earnings for Berkshire Hathaway.

But suppose multiples contract, instead?

Well, if earnings compound at 8% annually to \$54 billion 10 years out, but the P/E collapses to 7 times, the level at which the S&P's multiple troughed in 1982, Berkshire's market cap would still expand from today's \$325 billion to \$378 billion, a remarkable gain, giving the near-halving of the multiple — but a meager 1.5% a year. At 10% earnings growth, the market cap would grow to \$455 billion, a 3.4% compound rate of return — not sexy, but higher than the return on a 30 year Treasury.

The real question isn't your numbers, but why you are so sure Berkshire will earn 10% annually from here to eternity —

I'm not going to go out to eternity —

So I was exaggerating a little. Ten years might as well be, though, for lots of investors these days.

Explaining why we think it's so undervalued took most of the 70 pages of my February report. I systematically broke down Berkshire into all its parts and all the different ways that we look at the business —

all the different valuation techniques we use to come up with intrinsic value — all the different ways we can support what we think the business can earn on equity, what its assets earn, what it's paying on the liability side of the balance sheet.

Where do you start?

With the two-pronged approach that Mr. Buffett first presented in 1995 — where he's just moved the goal posts — and which is illustrated in the table [on page 9]. But a very simple price-to-book analysis also is useable — it's about our least favorite way of looking at Berkshire, but you can look at the range of where the stock has traded relative to book over long periods of time — certainly over the last 51 years [table, page 10].

How do you prefer to value it?

By breaking down what the individual moving parts are each worth, both on a sum-of-the-parts basis and by looking through that to what the normalized profitability is of each of the big moving-parts subsidiaries.

We then mesh it all together and use each of those methodologies to reconcile our results to each other coming up with a number that we think the business is worth.

Which is?

Well, the stock is up this year, 5.5% — so the market cap is \$340-ish billion, but we think fair value is very close to \$500 billion.

And you really come up with that same number every which way you slice it?

Well, we do. You might suspect that we're massaging our inputs to make sure our models all reconcile to each other, but that would be counterproductive. The point of the exercise is to look at the business from every angle — make sure you're not missing anything. As an analyst, you want to look at cash flow versus net income — try to find disparities over time — try to sift out the profitability of each balance sheet component — understand how they're being financed and taxed. At the end of the day, the modeling is about figuring out what you're paying for a dollar of profits in each of the businesses. What it's worth.

You haven't mentioned looking at the market caps of comparable businesses —

We hate using publicly traded comps. Take the Burlington Northern, for instance. It doesn't look terribly different from the Union Pacific, that's true. They are almost identical in size, though we think Burlington Northern is probably a better franchise,

simply based on geography.

The problem is that a year ago Union Pacific traded for \$120 a share and now it is \$80, so its stock price has dropped by one-third. But we would never in a million years say, “Well, the Burlington should have the same market cap as the Union Pacific, because that’s what the market’s willing to pay for it.” No, no, no. We try to figure out how much the Burlington earns on capital; what its normalized profitability is. And we pay what we think is a pretty conservative multiple of 14 times free cash earnings for it. It doesn’t matter to us what the UNP is trading for.

If we’re going to have a third of our capital invested in anything — or even if we’re going to have 2% of our capital in something with a lot of moving parts — we dig in and do as much work as we have to understand how each of the moving parts work.

We own stakes in a number of businesses with multiple industry representations and we spend a lot of time with each of those because they’re not easy. But there’s no doubt Berkshire is especially challenging from an analytical standpoint, because it is in so many businesses — and that’s also a reason you see very little Wall Street coverage of it — not that we tend to read what the Street writes.

What insights have you gleaned lately from all your numbers crunching?

Well, I would argue that now, for the first time since its 1967 acquisition of National Indemnity, the non-insurance operations of Berkshire are probably worth slightly more than the insurance businesses. This is a signal event in the history of this company, because ever since Buffett diversified out of his original core textile business, insurance has been driving the bus.

All of these other diversified businesses now are more valuable to the core of Berkshire than the insurance operations. This doesn’t mean the insurance operations don’t have value — they sure do — but Berkshire’s diversified investments are growing and they’re growing in scale. And they’re lending durability to Berkshire’s ability to earn 10% on equity for the next 10-15 years.

You’ve got earning streams that are far more *knowable* than they would have been if this thing were hitched just to property/casualty insurance and the stock market.

I take it your analysis takes in the impact of Berkshire’s latest big acquisition – of Precision Cast Parts –

Giant acquisitions are just the nature of Berkshire — its cash reserves build up and they don’t have history of sitting on cash for long. So it’s hard, as an analyst, to get to comparable points in time because these big investments are made. You had a material increase last year in their investment in what was Heinz — now Kraft Heinz — when those businesses merged. The Precision Cast Parts acquisition is integral, going forward, but it didn’t close until January 29, so we didn’t *largely* include it in the numbers. But what we do when valuing the invested cash of the business is include some optionality for Berkshire’s unlikelihood of leaving more than one-year’s insurance losses laying around as cash.

How does that work?

Well, if normalized one-year insurances losses are \$24 billion, we’re going to take some of the surplus cash that’s there and assume that at some point — probably sooner rather than later — they’re going to buy some asset or some business with it — and it happened that the price Buffett paid for Precision was *basically* the sum we were using in the calculation of our optionality premium.

In other words, Berkshire at yearend had more than \$71 billion in cash, and \$20 billion of that is going to go to buy Precision. Last year, it had \$63 billion in cash and cash was earning zero. Well, if the discounting mechanism for the valuation of any asset involves trying to figure out what the present value of the future streams of earnings is, you could safely plug in some future stream of earnings on that cash that was north of zero — and so now Precision is there to provide that.

Then you like the PCP acquisition?

As you know, we actually had made a small, 1% investment in Precision for our partnership last year — we put 1% of our capital to work in it at \$205 a share. We had fair value calculated at about \$260, and Buffett is paying \$235, so he’s paying a decent price for a great business that largely supplies the aircraft industry — manufactures forged engine components.

But we like to make our 1% positions larger when a stock’s price drops after we buy — as long as we don’t see a fundamental problem in the business —

Sum of the Parts Basis 2015 expected #	
BH Energy	\$35-40 B
BNSF	70-80
MSR Businesses	100-110
Finance Businesses	25-30
	230-260
Insurance Underwriting	20
	245-275
Investment Portfolio	225
Total	\$470-500 B
Total per A share	\$286,000 - \$304,000
Total per B share	\$191 - \$203
Current Market Cap	\$325 billion
Market Cap to Fair Value	69%

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and we were very close to doubling the size of our position at \$195 last summer when Berkshire came along and offered to buy the whole company at \$235 a share. I mean, they're getting a deal.

What attracted you to PCP, other than its stock price?

We'd followed the company for a long time and we think they're very clean — run a great set of books. There conceivably are some risks to the core business over time — obsolescence of some of their technologies, some forged products. But Berkshire has basically just paid \$32 billion for a business that does \$10 billion in annual sales — and has the potential within a year or two to be generating \$2 billion in free cash.

Berkshire's trailing earnings for 2015 were on the order of \$25 billion, and its 10% ROE implies you'd be looking for \$27.5 billion in profits for the current year. But with Precision on its books for the majority of the year — for 11 out of the 12 months — it's entirely conceivable that Berkshire's profits at the close of '16 — will be even higher than the \$27.5 billion that we were looking for when I put the report together.

Let's dig a bit into what you think Berkshire's multiple parts are worth.

All right, our two favorite ways to value the business are sum of the parts and on an adjusted GAAP net income basis, which really are almost the same. Except that in one case you're breaking down the investment components of the marketable securities — but both involve sifting through the data on the major operations in the business.

Go for it.

Let's start with the group of what Berkshire calls regulated capital-intensive businesses. These consist of Berkshire Hathaway Energy, which originally was their Mid-American Energy business, and the Burlington Northern Santa Fe. Management lumps them together for analytical purposes because they're both very capital-intensive with regulated pricing and allowed returns on investment. But we very much prefer to break those out. They're such big entities on a standalone basis.

You've talked a little about the railroad already —

The thing is, we can go to Surface Transportation Board filings — and we do — to untangle the railroad's results from the energy company's. The rail does about \$22 billion in sales, generates pre-tax income of about \$6.6 billion — and Berkshire

reports its profits as \$4.2 billion. But we think they are closer to \$5 billion, because they're paying taxes at a far lower rate than reported.

How so?

That brings up the interesting topic of Berkshire's hidden sources of earnings — one of which is its use of accelerated depreciation on some of what I call their growth cap-ex. They've got a lot of deferred tax liabilities from the use of accelerated depreciation. The upshot is that Berkshire has invested about \$37 billion in equity in the rail business, and on that is actually earning almost an 11% annual return. We'd estimate that BNSF has a fair value of \$70-\$80 billion, giving it an implied P/E of only 14 times.

How in the world do you get to those numbers on a regulated railroad?

It's actually a terrific case study on the economic benefit of accelerated depreciation and regulated returns on what can be huge capital outlays in the capital intensive rail industry — and BH Energy, by the way, offers the same lessons in the utilities industry.

But these are lessons that took a while to dawn on me. When he first bought the railroad, I was very critical — thought that he'd materially overpaid. He paid, in part, with Berkshire shares, which at the time weren't especially overvalued, as they were in the GenRe deal. As we saw it, he basically bought a business that had done an 11% return on capital in its best year before the financial crisis, which was 2007 — for twice capital, meaning Berkshire was getting a roughly 5.5% best-case return business, with some upside. And we also weren't thrilled that Burlington had a very large underfunded pension plan, that we figured would cost Berkshire maybe a half percentage point of that return down the line.

That doesn't sound terribly inspiring —

But we completely agreed with Berkshire's take on all of the advantages that were going to come out of its purchase of BNSF. Moving freight by rail is three times more fuel-efficient than via trucking, making rail both more cost efficient and environmentally efficient. BNSF had 23,000 miles of track, since expanded to 32,500 route miles in 28 western states and three Canadian provinces. Its location in the west is an advantage as the population shifts westward and trade with Asia expands faster over time.

But most importantly, the capital-intensive nature of rail comes with a regulated return. My good friend, Daniel West, in reading through the minutes of a Surface Transportation Board (STB) meeting several years ago, noted that the STB changed its allowable

return on invested capital to a capital asset pricing model formula (CAPM) for Class 1 rails. Bill Gates figured this out early on. The takeaway from Daniel's observation was that BNSF's allowed returns were going to go up, and indeed they have.

Okay, so the rail business is now allowed a decent rate of return, along the lines of electric and gas utilities. Where's the sizzle?

What I didn't realize until about two years ago was the degree to which capital spending north of depreciation was going to drive tax rates lower through the use of accelerated depreciation. The numbers are staggering.

The light went on about two years ago, when I was thinking about Berkshire's evolving income tax footnote and reconciling it to the financial statements.

When Berkshire noted in its 2010 annual report that, "owning the rail will increase Berkshire's "normal" earning power by nearly 40% pre-tax and by well over 30% after tax," I hadn't thought much of it, except that BNSF's tax rate was higher than the tax rate at consolidated Berkshire. When Berkshire immediately followed on by noting how much cap-ex the railroad would need to invest to grow, it likewise didn't surprise me. Rails had a history of spending vast sums on cap-ex but only earning mediocre returns on capital. I logically concluded that Berkshire would be spending substantial growth cap-ex in excess of depreciation at the railroad, just as they had been in their MidAmerican Energy business since 1999. And we assumed that excess growth cap-ex would earn regulatory allowed rates of return approaching as much as 12%, thus making the acquisition trend toward mediocre to acceptable over time, despite starting at 5.5%.

That doesn't seem like much of a startling revelation –

The light didn't come on until I was digging in Berkshire's tax footnote about two years ago. The footnote breaks out the amount of current taxes in each year that are *actually paid* from the amount that is deferred.

We had always operated under the assumption that the accumulated deferred tax liability on the balance sheet — always a big number — was mostly attributed to the unrealized gains on the investment portfolio in the insurance businesses. Indeed, before Berkshire acquired MidAmerican Energy, and subsequently BNSF, that is exactly where the liability resided.

But when first, Mid-American, and then BNSF started spending growth capital in earnest, the nature of the aggregate deferred tax liability changed, and so did its location on the balance sheet. As the deferred tax liability for property, plant and equipment grew over the past decade, I eventually realized that growth cap-ex above depreciation charges works to increase the deferred tax liability — and to *lower* the amount of *cash* taxes payable in that year. As the deferred liability grew each year in tandem with cap-ex outstripping depreciation, we concluded the deferred tax liability wasn't going to shrink but would only grow larger. The liability has a similar durable characteristic to investment float.

The difference between reported tax rates and actual cash outlays is now huge, particularly at BNSF. The railroad has a reported tax rate each year (derived from figures reported in Berkshire's annual) between 36-37%. But it is really paying at a cash tax rate well below 20% currently, and the difference is all free cash flow. Since Berkshire added MidAmerican and its host of additional utility and energy assets, and also BNSF, the cap-ex at those two businesses swelled the deferred tax liability related to property, plant and equipment to \$34.6 billion.

The businesses are functioning as a huge tax shelter?

Well, the upshot, in Berkshire's case is that there are not a lot of live capital gains taxes being paid. Maybe some numbers from the balance sheet BNSF files with the STB will help clarify this. It shows total assets of \$62.7 billion vs. total liabilities of \$23.2 billion (because most of the railroad's \$19.2 billion in debt is excluded from the regulatory balance sheet) but what's significant is that fully \$15.7 billion of the \$23.2 billion of liabilities listed are deferred income tax liability.

As long as BNSF continues to invest in qualifying fixed assets, the deferred tax liability will functionally never be paid. Future depreciation charges on aging assets will be lower in later years, but as long as the railroad deploys increasing amounts of growth cap-ex, higher depreciation charges on new and improved assets makes the liability a growing constant.

Basically, we consider the deferred tax liability largely as equity, and any increases in that liability each year as free cash.

You're saying it's functionally equivalent to the cornucopia of insurance float that has long been recognized as supercharging Berkshire's returns?

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Valuation, Every Which Way

	Market Capitalization	Price Per A Share	Price Per B Share
Two-Pronged Approach	\$501.4 billion	\$305,119	\$203
Sum of the Parts Basis	485.0	295,134	197
GAAP Adjusted Financials	478.0	290,875	194
Simple Price to GAAP Book Value	446.2	271,530	181

Very roughly, yes. Both sources of free cash are incredibly important to understanding Berkshire. The railroad's STB filing shows \$908 million as a provision for deferred income taxes. But because this amount is deferred, is not cash, and is unlikely to be actually paid as cash, free cash at BNSF was closer to \$4.8 billion, not the \$3.9 billion Berkshire reported as its net income. Figured on the STB data, the railroad's return on equity for 2014 came in at 11.9% on net shareholder's equity. Now, I realize that goodwill related to Berkshire's acquisition of the railroad does not appear on the STB balance sheet, which means that Berkshire's actual ROE on it is a bit lower — but still far higher than I ever imagined when the deal was done.

Another big advantage that the railroads and utilities have because they're part of Berkshire's fold is that they're not paying out dividends, like rival regulated utilities generally have to do, which increases the netted assets on which they get their regulated returns.

Okay, won't Berkshire eventually have to pay those deferred taxes?

Theoretically, they will be paid at some point, but to the extent that they're not being paid now, I think it's fair to look at them as an interest-free loan from the government. So yes, Berkshire bought a tax shelter, but it also bought a way to deploy capital at better than an 8% a year return for a long, long time.

By performing well for their customers and the regulators, Berkshire is throwing off \$17 or \$18 billion in free cash each year that has to go somewhere. And plowing cap-ex into the regulated businesses is one way to achieve healthy returns on it — at a time when the stock market isn't a terribly attractive place to put that money to work. In its regulated capital-intensive assets, Berkshire has businesses with survivability in extreme monetary conditions, with predictable earnings streams — and the utilities are virtually recession-resistant.

Have you quantified the tax benefit, overall, that Berkshire is getting from accelerated depreciation on the cap-ex it's pouring into its rail and utilities businesses?

Since Berkshire has had the Burlington they have

spent \$23.5 billion in cap-ex against \$9.7 billion in depreciation. So they've spent almost \$14 billion more than depreciation, and with the healthy regulatory environment of recent years, I

think a large chunk of those cap-ex dollars are qualifying for beneficial accelerated depreciation tax treatment. As you know, there's an argument that railroads and the utilities exist in part for the public good. And Congress introduced accelerated depreciation (instead of straight-line depreciation) in 1954, really as a nod to the societal need for additional power generation in this country.

Meanwhile, the utility businesses — going back to 2004 when Mid-American was consolidated — alone have spent \$38 billion in cap-ex against \$14.7 billion in depreciation: so they've exceeded depreciation charges by \$23 billion.

Spending that has essentially lowered their taxes by a similar amount?

Yes, the tax benefit of cap-ex creating deferred tax liabilities is huge, that's what I am saying.

Accelerated depreciation equates to lower cash taxes paid and more free cash left in the business. Since 2004 Berkshire spent \$74.7 billion in cap-ex against \$38.1 billion in depreciation, a difference of \$36.6 billion (\$30.6 billion of which was at the rail and energy businesses). The deferred tax liability for PP&E has grown from \$1.2 billion to \$34.6 billion.

Berkshire's cumulative, pre-tax GAAP earnings since 2005 total to \$182.4 billion. Income tax expense sums to \$54.4 billion, which to the casual observer equates to a tax rate of 29.8%. But of that reported tax expense, \$16.7 billion was deferred and added to the balance sheet as a liability. Actual cash paid for taxes was only \$37.7 billion, which makes the actual cash tax rate only 20.7% over the past 10 years. It's even better more recently.

Because?

The free cash and tax situation gets better as the cap-ex at the railroad and in the energy businesses grows. I calculate that the actual tax rate they paid in 2014 was only 11.8%, not the 28.3% as reported. For 2013, the cash tax rate was 17.8%. This means free cash is far higher than reported earnings. It pays to understand tax footnotes. For the latest year, 2015, the tax number you'll find on the income statement is \$10.5 billion, but I figure they only paid cash taxes of \$5.4 billion, a cash rate of 15.5%. An extraordi-

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nary benefit.

This conversation will go on for days, if we go into every part of Berkshire in this detail, but the whole shebang, you figure, is worth about \$500 billion, no matter what valuation methodology you use?

Pretty much. I gave you a summary table [page 16], but the “sum of the parts” method we prefer results in a market cap of \$485 billion and intrinsic value of \$295,134 for the A shares and \$197 for the B shares. And our position is that Berkshire’s diversity of profitable income streams and its balance sheet strength combine to minimize risk in our substantial holdings in the company. But remember, we define risk as a permanent loss of capital, not as volatility. That said, no investment is without risk — but we are confident that Berkshire recognizes its risks better than we do and works incessantly to minimize any potential hits to the franchise’s durability.

And your qualms about Berkshire moving some of its valuation goal posts doesn’t tarnish its allure?

Not in the least. I have never encountered another business with a better appreciation for or understanding of value and value creation. What you get in Berkshire is a seriously overcapitalized business with multiple profitable earnings streams across a wide array of industries. Many of Berkshire’s subsidiary businesses are far better off operating under Berkshire’s umbrella than they would be as stand-alone businesses.

They’re not fast-growers –

Without a doubt, much of Berkshire is mature, but in

it, you get a business likely to return 8%-10% on equity for many years, if not decades. You get a business where much of the right side of the balance sheet finances much of the left side at negative cost. With Berkshire you get a business that uses its capital opportunistically. At times they have purchased assets from others during desperate times for a song.

So you’re quite comfortable with your concentrated exposure to Berkshire?

Quite. Our Berkshire shares trade at 70% of fair value, giving us 45% upside to there. As a base return expectation we should at least earn today’s earnings yield of 7.7% for many years. With a little multiple expansion from 13 times normalized earnings, our expected returns become even greater. Like Berkshire, we will reduce our position size as the share price approaches fair value and above, and we will add to the position when we have liquidity at prices far below. Every purchase we have made over the years in Berkshire’s shares, beginning in February 2000, was at a price sufficiently below fair value to allow us good returns over time.

Your takeaway is that the thing is so diversified — with all these different moving parts that are so well-capitalized — the accounting on which is so conservative — that this earnings stream that we have growing at 10% is about as knowable as anything can be in the investment world. That you can buy it today for only about for 13 times earnings is pretty remarkable, considering the multiple being paid for the S&P. I really do think Berkshire, over the next 10 years, doubles the return of the S&P 500.

Thanks, Chris. From your lips...

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