Sanlam Investments

SIM Global
Market review

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50 years … and 16 years

In May 1965 Warren took control of Berkshire Hathaway. In the 50 years since, he compounded the shareholders capital (as measured in net asset value per share) at the phenomenal rate of 19.5%.

It remains impossible to fully grasp the significance and impact of this feat, only when one compares it to an investment in the S&P500 (Standard & Poor 500 Index[1]) or an investment in government bonds does one start seeing what an extreme outlier this is.

Table 1: $1 million invested in Berkshire Hathaway (1965 – 2014)
[When the Warren Buffett partnership took control and Charlie Munger turned 41]

	Berkshire Hathaway (Share)	Berkshire Hathaway (NAV)	S&P500	Treasury Bond (10yr)
Rate	21.7%	19.5%	9.9%	6.8%
Age 41	1	1	1	1
Age 61	103	57	4	3
Age 91	18,149	7,519	113	27

Source: *Company Financials; US Federal Reserve; Factset*

The questions this leads to is:
- How did he do it?
- What can I learn from this?
- Would he invest in Emerging Markets and if so,
- Would he follow the same investment strategy?

Bear in mind when considering the "How did he do it?" that Berkshire Hathaway changed enormously over the 50 years. It resulted from excessive smoking (Warren took too many puffs on the cigar-butt[2]) with the result that, unintentionally, he became the controlling shareholder of a dying textile mill. This became the vehicle for his investment trust which in itself saw a shift in focus over the years from **listed** equities to **fully owned** unlisted companies. However, throughout the 50 years the underlying principles on which he based decisions remained the same, whilst his understanding, **insights** and practices evolved.

What were the principles behind the phenomenal returns, and more importantly, are they applicable today?

In my opinion the **foundation** upon which Berkshire and its subsequent performance was built is the **combination of Trust and Integrity** and going hand in hand with that: **Consistency and Transparency**. Berkshire wouldn't have succeeded without the trust between Warren and Charlie. It was the trustworthiness of Warren that attracted the owners of good businesses to him when they contemplated selling. Finally, and most importantly, by only dealing with, and investing in people he could trust, he improved the odds of successful long-term investing considerably.

No wonder then that when fielding questions about career advice Charlie's answer normally is:

"Remember that reputation and integrity are your most valuable assets and can be lost in a heartbeat."

And Warren in his testimony to Congress about staff *(Salomon Brothers Case 1991)*:
"Lose money for the firm and I will be understanding, lose a shred of reputation for the firm and I will be ruthless."

1 The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ

2 See footnote 4 (Page 2) for more details

Besides Trust and Integrity…

In terms of underlying principles and factors, in this Market Review I've reflected on two key factors that are applicable for investors today:

Understanding Probabilities AND Ignoring the Macro

Understanding Probabilities

Understanding Aesop's "**A bird in the hand is worth two in the bush[3]"** was fundamental to the way Buffett allocated capital, i.e. his ability to understand the probability and pay-offs associated with positive or negative outcomes of a decision. He jokingly says that **most investors prefer a blind date to the girl next door**.

However, his business partner and friend Charlie Munger played a fundamental role in the lengthening of Warren's horizon. Charlie understood the higher risk (poorer odds) associated with continuous short-term bets on poor quality businesses versus the higher probability of success investing for the long-term in companies with enduring qualities. In so doing, Charlie took Warren off the treadmill of cigar-butt investing[4] and taught him the value of letting companies work for him: **"Paying a fair price for a wonderful company is better than paying a wonderful price for a fair company".**

It's a good quote but I really think it **understates the significance of successful long-term investing**. Buying cheap companies (and selling them when the value has been realised) involves continuous effort, whereas investing in a good, cash generating company brings the benefit of **simply sitting back and enjoying the fruits** (cash flow) that the investment generates.

As Warren increasingly focussed on companies in sectors that he understood and where he had the highest probability of being right over the long-term, the nature of Berkshire Hathaway changed and his investments had a low risk of requiring further activity. The moats and managements would protect future profits against inflation and competition.

This strategy sounds easy, but CEO's/management teams who have the combination of operational excellence **and** understand the importance of allocating capital correctly are rare. I can attest to that having interviewed many, many managements in many different countries over many years!

As always, luck did play a role although they didn't see it that way at the time. Their initial investment structures were very complex via a number of investment vehicles and cross-holdings. A SEC investigation (1975) into their practices shook them up and made them think and also played a role in helping to create the current efficient and simple structure (later including Wesco into Berkshire Hathaway). Be it as it may, Charlie's influence **laid the foundations for a highly efficient Berkshire Hathaway and the benefit of that in my opinion has been under-appreciated.**

[3] This expression means that it is better to have an advantage or opportunity that is certain than having one that is worth more but not as certain.

[4] **Extract from Berkshire Hathaway Shareholder Letter 1989**: If you buy a stock at a sufficiently low price, there will usually be some hiccup in the fortunes of the business that gives you a chance to unload at a decent profit, even though the long-term performance of the business may be terrible. I call this the "cigar butt" approach to investing. A cigar butt found on the street that has only one puff left in it may not offer much of a smoke, but the "bargain purchase" will make that puff all profit.

Ignore macro-economic forecasts

David Wildasin, Professor of Economics, University of Kentucky said: *"The First Law of Economics is: For every economist, there exists an equal and opposite economist. Second Law of Economics is: They are both wrong."*

Again, Warren and Charlie realised that the probability of getting macro-economic forecasts right is low, and hence preferred the bird in the hand: "*We've never let concerns about the macro outlook keep us from buying a good company."*

True, investors like George Soros have done exceptionally well from exploiting big macro mismatches (i.e. when the pound was being fixed to the Deutsche mark whilst the underlying fundamentals were diverging). Buffett has occasionally tried macro trades, (he took a big bet on silver) but his view is that these opportunities are infrequent and the risks of being right in the end but wrong for too long is too big.

This doesn't mean he is not "macro-aware" but that he judges a price in the context of existing expectations relative to long-term reality.

He demonstrated this when he invested large amounts of capital in 2009 buying stakes in Bank of America, Goldman Sachs and Harley Davidson, but got it wrong when he moved outside his circle of knowledge buying Irish banks in 2007 for their high dividend yields.

"Investing in shares should be the same as investing in a farm: Once you've done your homework on the quality of the land, the long-term rainfall pattern and the probable yield, and you then get the opportunity to buy a good farm in the area, you're not going to look at the rainfall predictions for the next few months, nor, after having purchased, are you going to let yourself be affected by watching the daily prices of the surrounding farms." [Warren Buffett]

Why did Warren invest so little in Emerging Markets?

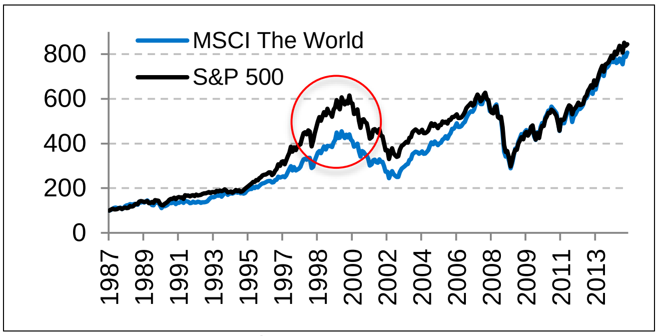
Table 2: The World in 1980

	Population (mil)	GDP per Capita (USD)	GDP (bn USD)
China	987	313	309
India	682	266	181
Indonesia	147	707	104
Japan	117	9,313	1,087
UK	56	10,039	566
US	228	12,576	2,862

Source: IMF

The large size and liquidity of the US equity market meant that he had a large enough pond to fish in and so Warren seldom invested outside the US. Graph 2 shows that measured by the MSCI World Index vs. the S&P500 Index (US), it seemed not to matter if you'd invested solely in the US! *(Note the US tech bubble in the year 2000).*

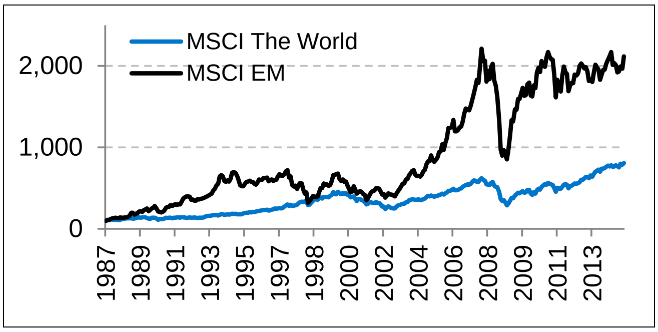
Graph 2: MSCI World and S&P500



Source: Factset

But the MSCI World index comprises of 23 developed countries. Graph 3 (Page 4) however shows that he potentially did miss out not investing in Emerging markets (EM), as they comprehensively outperformed the MSCI World index even though the period includes the Mexico tequila crisis in 1995 and 1997/98 EM crash when Thailand, South Korea, Indonesia, Russia, Turkey and Brazil (2001-2002) had to be rescued by the IMF.

Graph 3: MSCI World and MSCI Emerging Markets



Source: Factset

So: Why did Warren not invest bigger in EM's

Based on everything we know the answer is simple: **Certainty, Sufficient Opportunity and Complexity**

He likes to stay inside his circle of competence, and felt that in the US he had enough investment opportunities with a high probability of generating a good return. No need to take the risk of "swinging for the fences". Besides, investing in EM's added complexity. Each emerging market is different, often with different factors driving their economic cycles (refer examples in Graphs 4 to 7). Further each has different regulators and central banks with their own regulations and currency controls. This all adds an extra operational burden and means managing cash flows tax efficiently becomes more difficult.

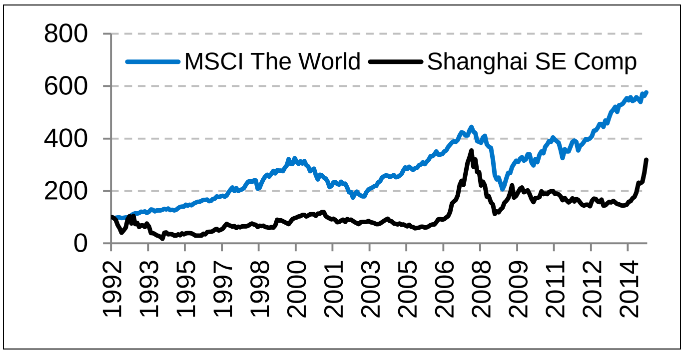
Investors often think simplistically about investing in Africa or Asia but the danger is similar to assuming that investing in Greece is the same as investing in Germany because both are in Europe.

Investing in EM's does bring volatility (very noticeable in Graph 3), but Warren doesn't care about share price volatility as long as long-term shareholder wealth is created.

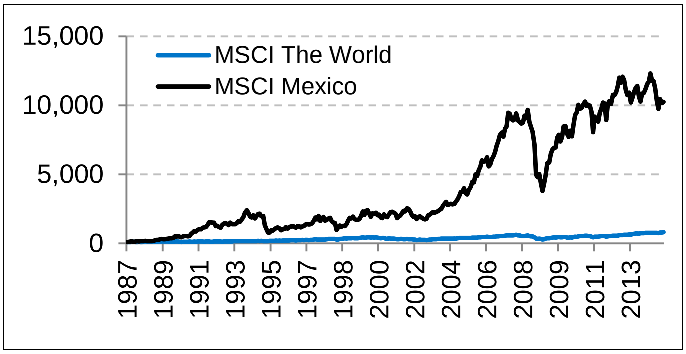
"Risk comes around because you do not understand things, not because of beta." [Warren Buffett]

So far he has treaded carefully with only four big investments: PetroChina (bought in 2002 and sold 2007), Iscar (Israel, 2005), BYD (China, 2008 bought via BH subsidiary MidAmerican Energy Holdings) and Detlev Louis Motorrad (Germany, 2015) proving that he is prepared to invest in companies outside the US if offered the opportunity **and** they have good managements proven by a long enough track record.

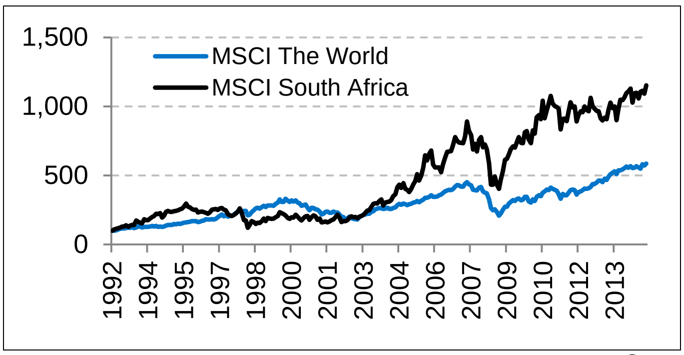
Graph 4: China vs MSCI World (from 1992)



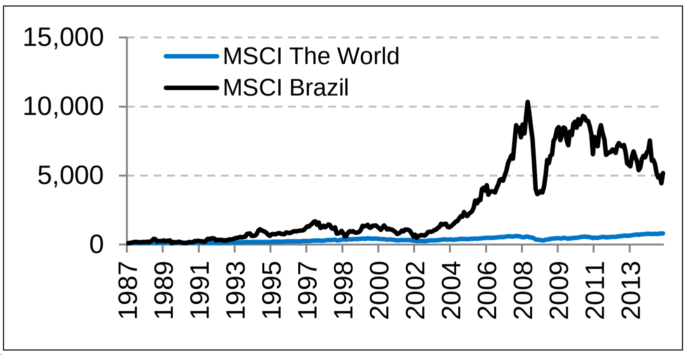
Graph 5: Mexico vs MSCI World (from 1987)



Graph 6: South Africa vs MSCI World (from 1992)



Graph 7: Brazil vs MSCI World (from 1987)



Source: Factset

Should Warren (and other investors) invest in EM's now?

Table 3: A changing world order

	Population 1980 (mil)	Population 2014 (mil)	GDP Per Capita '80 (USD)	GDP Per Capita '14 (USD)	GDP 1980 (USD)	GDP 2014 (USD)	Forecast GDP 2020 (USD)	Mkt Cap (bn USD)	Current MSCI All Country World Weightings Index
China	987	1,368	313	7,589	309	10,380	16,157	5,603	2.3%
India	682	1,260	266	1,627	181	2,050	3,640	1,263	0.7%
Indonesia	147	251	707	3,534	104	889	1,307	380	0.3%
Japan	117	127	9,313	36,332	1,087	4,616	4,933	3,101	7.2%
UK	56	65	10,039	45,653	566	2,945	3,731	2,980	7.1%
US	228	319	12,576	54,597	2,862	17,419	22,489	19,434	52.4%
Germany	77	81	11,004	47,590	850	3,860	4,105	1,224	3.0%

Source: IMF, Bloomberg

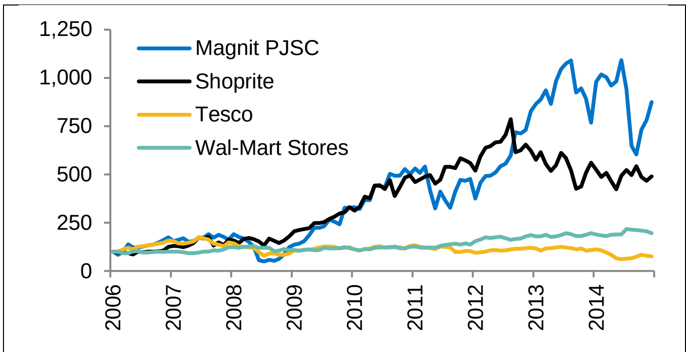
It is a question we grapple with a lot: How much potential outperformance is one prepared to forego by ignoring emerging markets. Are EM's still a blind date / two birds in the bush with too many risks and complications? A very important consideration is that whilst one could have ignored EM's in the past, by 2020 the 2nd and 5th largest economies in the world will be emerging market economies (Table 3).

Secondly, there are a large number of extremely well managed companies with proven track records in emerging markets that could be classified as "Warren Buffett companies", but few have the liquidity/size he is looking for.

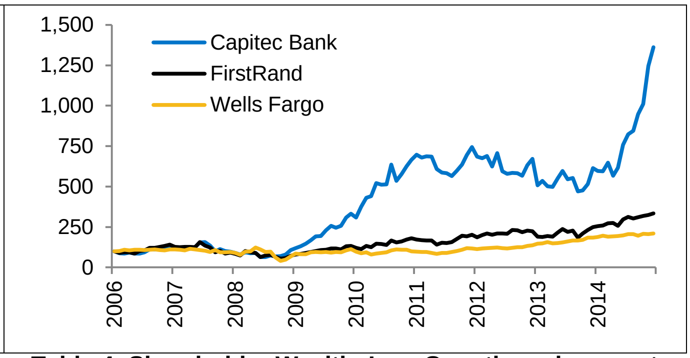
Especially the retailers and banks have benefitted from growth in consumer demand (Graphs 8 & 9), and the probability is high that looking into the next 10 years, growth in consumer demand will remain strong.

For the record I must warn that caution is the word at the moment. Ben Graham said; "price is what you pay, value is what you get" and Graphs 9 and 10 highlight the high probability that current investor expectations seem to have become irrational in their search for quality and growth (both in developed markets (DM) and EM's). Higher interest rates could bring the valuations down quickly. On the other hand Table 4 shows how lack of growth drove many DM banks and insurers into value destroying acquisitions, but these are now priced as if they'll continue destroying shareholder value.

Graph 8: Magnit, Shoprite vs Walmart, Tesco (US$)



Graph 9: Capitec, Firstrand vs Wells Fargo (US$)



Graph 10: Naspers vs Google (US$)

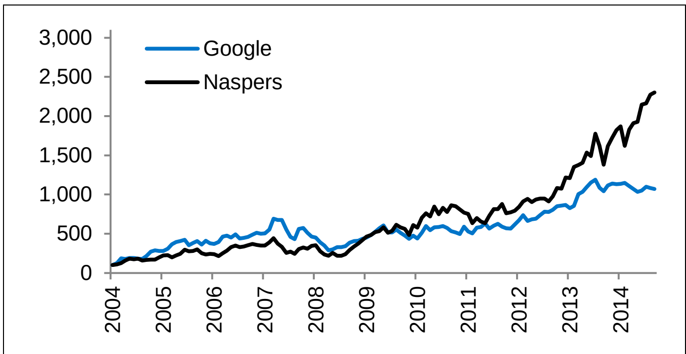


Table 4: Shareholder Wealth: Low Growth environment leads to value destruction

	NAV per Share		Compound Growth rate
	2004	2014	
AIG	548	77	**-86%**
Citi	120	57	**-53%**
Bank of America	13	14	11%
Royal Bank of Scotland	16	3	**-78%**
Wells Fargo	8	27	13%
Axis Bank (India)	21	188	25%
Bank Rakyat Indonesia	539	3,953	22%

Source: Company Financials, SIM Global

Graphs Source: Factset | Total Return in USD

Polluted ponds

Writing Market Reviews always forces retrospection, and this one has been no different. It forced me to think about "how would Warren invest in EM's?"

Warren says there are normally 10 filters or so that he goes through when he hears an idea. *"The first is, can I understand the business, not just today, but 5 to 10 years from now."* This rules out quite a few emerging markets. There are emerging markets that are like ponds fed by polluted rivers allowing you to trade in and out of them, but never to sit back and allow the company to compound shareholder wealth for you. The unpredictable policies of some governments mean the investment odds keep changing. This is very frustrating for us in the case of Russia as companies like Tinkoff Credit Systems, Magnit and Moscow Exchange are very well run, in a growth segment and have proven their ability. But the unpredictability of what Putin does next means you always have to sit close to the exit and that doesn't sound like "the Warren Buffett way!"

There are vast differences between the structure Warren has created and the mutual fund industry. Yet, every year I find I benefit from thinking about our mistakes and his principles. But this Market Review is about Berkshire Hathaway. We'll write about ourselves again in the following Market Reviews.

Conclusion

Consistent strategy

Many investors achieve sub-optimal returns because:

- They don't fully appreciate the long-term importance of quality in terms of returns,
- They place too much reliance on macro-economic forecasts,
- and they forget the negative drag of complexity.

A lot of this has to do with the combination of the media industry feeding our behavioural traits of "fear-of-missing-out" (FOMO) and over-confidence.

The lesson from the 50 year BH history is the focus on buying good companies, run by honest and competent managements, and not to overpay for them.

$1 invested today can grow to $100. But you've got to be consistent and ignore the flashy lights and sirens of the markets. Measure your success by how well the companies you are invested in have done. The market will take the share prices up and down according to the different winds that blow at different times. The winds will make some look good and some look bad and then reverse the order. But those who consistently stick to their formula prevail in the long run." ***[SIM Global May 2013 Market Review]***

Kokkie

Kokkie Kooyman
28 May 2015

I have attached my takeaways from attending the Berkshire Hathaway AGM over the past 16 years. Another interesting read is the Mungerisms blog with some of Charlie's wisdoms (click below to follow link): ***Mungerisms: Wesco 2007 Annual Meeting Notes***

Distributor Details

If you would like to receive this document electronically please contact:
Nora Geldenhuys
Tel: +27 21 950 2633
Fax: +27 21 950 2526
e-mail: norag@sim.sanlam.com

Appendix A

Berkshire Hathaway: A few highlights from my 16 years.

By Kokkie Kooyman

I've been fortunate enough to attend the past 16 shareholder meetings and here are a few of the moments that stood out for me:

- **May 2000**: the height of the tech bubble. The press was writing Warren off as a has-been, "*he's lost touch, a dinosaur, belonging to a previous age*". Shareholder after shareholder pleading with him: *"Mr Buffett, please just invest a % of Berkshire Hathaway in tech shares"*
- And then at the 2001 meeting: *"Mr Buffett, we thank you for not investing the capital we've entrusted to you in tech shares in 1999/2000."*
- **May 2008**: The world was falling apart, you could smell the panic in the air. But Buffett was unperturbed. *"We never try predict what the market or the economy will do. We know there will be good years and bad years, but we don't know the order which they'll occur. Good businesses often come through crises stronger."*
- *"This is a good time to invest in wonderful businesses at wonderful prices."*
- **May 2012**: BH shares had underperformed for a few years and many shareholders were agitated *"Mr Buffett, Mr Munger, please buy back shares, pay a special dividend, sell underperforming assets, do something to convince the market that you think the Berkshire Hathaway share is undervalued.*"
- **Warren and Charlie patiently explained:** "over the past 47 years there were years when the market rated the stock too expensively and times when it was too cheap. To us, and to you, it shouldn't matter where the market rates it now, except if you want to buy more. If the businesses we own keep adding value, the market will eventually recognise it. More important, the actions suggested would all just be temporary and not create sustainable value or a permanent rerating."
- Towards 2pm when questioners kept repeating the same question in different disguises Charlie lost it and said bluntly: **"you shouldn't be in the same room as us, in fact you're not very welcome in this room if 6-9 month value creation is what turns you on".**

The Salomon's affair:
Each shareholder meeting starts with a movie making fun of the past year. However, one constant in each years' movie is Warren's testimony to Congress when he accepted the temporary position of CEO of Salomon Brothers when it was on the point of going down (1990's "Lehman's moment"). "My message to all Salomon employees is: Lose money for the firm and I will be understanding, but lose a shred of reputation for the firm and I will the ruthless."

This paragraph summarises all of Warren and Charlie's actions and dealings. Integrity has been key. He has always preferred the ability to do a deal on a handshake, and "if I can't do a transaction based on one page contract, I shouldn't want to go into business with you."

Some of the Footnotes I made over the years.

Kokkie Kooyman

1. When you're old you'll have the reputation you deserve (Charlie Munger, 2015)
2. Independent thinking and when solving problems "Invert, always invert".
3. **"Paying a fair price for a wonderful company is better than paying a wonderful price for a fair company"** is one of his well-known sayings. Less known is that his grandfather Ernest Buffett used to say: **"Good meat priced right is better than poor meat priced cheap".**

4. Emotional strength to stick with principles and philosophy when everybody seems to disagree (See the addendum: **Highlights from an extra-ordinary 50 years)**
5. *Be careful of a cheerful consensus*
6. The integrity of the person you employ and those you do deals with are vital. *"I've never done a good deal with a bad person." "If you can't do a deal on a one page agreement without lawyers it's not worth doing."*
7. The fact that the BNSF (a railroad company) is now Berkshire's largest investment (28% of 2015 pre-tax earnings) has not been fully appreciated by investors.
8. When Mrs Blumkin agreed to Warren buying into Nebraska Furniture Mart he didn't concern himself with whether the US was heading into a recession or not. He knew Nebraska Furniture Mart's cash flows would generate a good return on his capital over time regardless of what the US economy would do (*"I know there will be good years and bad years, I just don't know the sequence they'll follow"*, which means he builds bad years into his required return).
9. Warren: ***"All you have to do is sit there and wait…there's no easier game than stocks. You have to be sure you don't play too often."***
10. The relationship between Buffett and Munger. Disagreements are normally ended by Munger with: *"Warren, think it over and you'll agree with me, because your smart and I'm right."*
11. **Focus on what he knew he is good at:**

    As an aside, he focused on what he knew he was good at, and hence never invested in businesses that needed his intervention. But he also developed the skill of recognising skills in others, and lately has been investing alongside Jorge Paulo (3G Capital) and encourages his Berkshire managers to do bolt-on acquisitions – always with the main proviso that reputation and integrity counts above everything else.
12. **Ignore the index**

    He obviously totally ignored any index and backed his philosophy and process to beat the index over time
13. He understood the characteristics of successful companies. He needed only 20 – 30 minutes to tell you if he was interested in investing in a company. Operationally he kept his business simple so he could devote most of his time to investment activities.
14. The real genius was recognising the value of "floats" in insurance companies and ensuring he had a captive and growing pool of assets, enabling him to think long-term when investing. This also enabled him to gear his portfolio (estimate is by 10%).
15. As Berkshire Hathaway grew they built it into a highly tax and cash flow efficient machine with minimal operational friction costs.
16. **Talking heads, popular press and the tyranny of the temporary**

    Today's fast moving investment world makes one feel guilty when you're doing nothing. The communication media constantly bombard investors with investments that have done well on the day, making it appear as if these random returns were predictable. The media and sell-side research do their best to create excitement and generate turnover. The tyranny of the temporary can effect even the most talented investors. Whilst Warren listens to them for content, he never allows himself to be influenced by the constant sirens of the short-term thinkers: "buy, buy, buy, sell.
17. **Greece being allowed into the Eurozone:** *"Like going into partnership with an irresponsible drunkard family member. You just wouldn't dream of it."*
18. The best story of this year's 2015 visit was Tony Cottrell's chat to the doorman at The Hilton (across the street from AGM venue). He is 76 years old, still doing a 40 hour stint per week at the The Hilton plus a further 40 hours per week at the casino. He inherited 25 Berkshire Hathaway A shares about 20 years ago and is now a multi-millionaire, but decided to rather keep doing what he enjoys – working at The Hilton and casino.