The Financial Navigator – April Newsletter

In this issue we discuss the recent performance results from Warren Buffet's firm Berkshire Hathaway. Mr. Buffet is often viewed as one of the few stock market investors that has consistently 'beaten the market'; therefore, his views and investments are monitored closely by the financial community. Below we summarize his 2011 annual shareholder letter which always has some interesting observations on the market and the world economy. We also discuss the 2011 payroll tax holiday, which gives us all a temporary raise and the opportunity to catch up on retirement savings.

Please feel free to forward this newsletter to any individuals that you think might be interested or call if you have questions on the information provided.

Sincerely,

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Deconstructing Berkshire Hathaway

Berkshire Hathaway released its 2010 annual report last month, including the letter to shareholders from Chairman Warren Buffett that is always eagerly awaited by the investment community. We are gratified to find that Mr. Buffett's legendary ability to simplify complex issues remains undiminished and his trademark wit is as sharp as ever.

Financial journalists, eager for clues that might reveal Buffett's thoughts on where markets are headed, focused on Buffett's optimistic outlook for the future ("America's best days lie ahead") and his appetite to make further large acquisitions ("my trigger finger is itchy").

We prefer to focus on a number of issues touched on in the letter that offer investment wisdom that should be just as useful ten years from now as it is today.

- As of year-end 2010, Berkshire held positions in excess of $1 billion in fourteen common stocks; five of these were non-U.S. firms: BYD Company Ltd. (China), Munich Re (Germany), POSCO (South Korea), Sanofi-Aventis (France), and Tesco plc (UK). Five years ago a similar list of twelve companies contained just one non-U.S. firm, and ten years ago there were none. In his comments about the future of America, Mr. Buffett remarked that "human potential is far from exhausted" and that, despite many setbacks, the American system "has worked wonders for over two centuries." Judging by Berkshire's portfolio, it appears this notion applies with equal force throughout the world.
- Berkshire has willingly shouldered some unusual risks over the years. It acquired building products maker Johns Manville in 2000 despite the stigma of asbestos-related liabilities, invested over $15 billion in various financial firms in the tumultuous weeks following the Lehman Brothers bankruptcy in 2008, and once insured an internet firm against the possibility of awarding a $1 billion prize associated with a marketing promotion. Many investors might assume that such adventurous and unconventional thinking in stocks would be matched by an equally unorthodox

approach in fixed income. On the contrary, Buffett's strategy for investing Berkshire's cash ($38 billion at year-end) is so conservative that some might accuse him of excessive caution. We suspect any institutional money manager with a balanced account mandate who maintained most of the fixed income assets in Treasury bills despite yields approaching zero would be fired for lack of imagination. Such an approach only makes sense if the role of fixed income is to preserve liquidity and limit the potential damage associated with riskier equities, rather than to generate satisfying returns. Mr. Buffett cites an observation from financial writer Raymond DeVoe that *"more money has been lost reaching for yield than at the point of a gun."*

- For those who ponder why it is that stocks are expected to provide a positive rate of return even if they pay no current dividend, one number cited in the letter offers a clue: $1 billion. That is the approximate amount of cash that shows up in Berkshire's mailbox each month from its collection of seventy-six businesses. Mr. Buffett's job is to invest that cash in new projects that carry an attractive rate of return, and history shows that these may come in a variety of shapes and sizes. Last year, for example, Berkshire spent $50 million to buy Alabama's largest brick manufacturer and $22 billion to complete its acquisition of the nation's largest freight railroad. Mr. Buffett reports that the rail acquisition is working out "even better than I expected," and to the extent any chief executive can invest a firm's retained earnings more profitably than we can, dividends are not just unnecessary, they are undesirable.

Since taking control of a floundering Massachusetts textile mill in 1965, Warren Buffett has assembled an extraordinary record of business success. His oft-stated goal has been to grow Berkshire's book value at a faster rate than the total return of the S&P 500 Index, and he has certainly succeeded. While many have focused on his facility with numbers and his ability to identify attractive business opportunities, it seems to us there is a lot more to the story. Mr. Buffett may never forget a number you give him, but he also appears to be an astute judge of character and has a knack for quickly sizing up individuals whose business acumen and management style will make for a good fit within the Berkshire confederation.

What are the investment implications of this appealing story? Should we be confident that Berkshire shares will continue to outperform the market, at least as long as Mr. Buffett is at the helm?

To address this question, we should consider to what extent Mr. Buffett's skills are already reflected in Berkshire Hathaway's stock price and whether the S&P 500 Index is the most useful basis of comparison. Let us first acknowledge that Berkshire's long-run price performance relative to almost any benchmark is sensational—over the last 25 years it has compounded at 16.9% per year compared to 9.93% for the S&P 500 Index with reinvested dividends. The margin of superiority relative to the S&P 500 narrows for more recent time periods, however, and disappears altogether in comparison with broader-based equity strategies. Over the last fifteen years, for example, Berkshire shares have still outperformed the S&P 500 by 276 basis points per year, but fall a smidgen behind a globally diversified Dimensional Balanced Equity Index (16 basis points). Over the last ten years, Berkshire shares have underperformed the Balanced Index by an even larger amount: 295 basis points per year. Some might be tempted to conclude from these results that Mr. Buffett's legendary skills are waning, but if markets are working properly the numbers should come as no surprise and are no reflection on Mr. Buffett's talents. Berkshire's book value has grown from $48 million in 1965 to $157 billion in 2010, making it larger, by this measure, than oil giant Exxon Mobil. Mr. Buffett has gone from piloting a speedboat to commanding an aircraft carrier; the ever-increasing amount of capital Berkshire oversees makes it difficult to earn above-average returns. Moreover, Berkshire Hathaway is not a mutual fund, but a public company with a share price that reflects expectations for the future. Now that Mr. Buffett's admirable qualities are understood and acknowledged by so many market participants, it seems likely that his perceived value is already reflected in Berkshire's stock price, just as Apple's current stock price reflects the genius of founder Steve Jobs.

Berkshire Hathaway Inc. 2010, 2005, and 2000 shareholder letters. Available at http://www.berkshirehathaway.com (accessed February 27, 2011).

Dimensional Equity Balanced Index: Dimensional Fund Advisors

Payroll Tax Decrease – Your 2011 'Raise'

Last year's tax deal to extend the 'Bush Tax Cuts' two more years included a 2% decrease in payroll (Social Security) taxes; however it is just for 2011. The payroll tax in 2011 is reduced for employees from 6.2 % to 4.2 %; note employers will still have to pay their 6.2 %. In effect, we all just got a raise courtesy of Uncle Sam. If you make at least the $106,800 (the maximum individual earnings subject to the payroll tax) your 2011 take home pay will be $2,136 higher compared to 2010. For high earner couples, that's another $4,000 plus of disposable income at your fingertips. For a typical worker, with taxable income of about $50,000 a year, the payroll tax holiday means a $1,000 bump over the course of the year.

The $120 billion (the reported cost of the payroll tax holiday) question is: What are you going to do with that extra money? One consideration might be to ensure you max out your retirement plan contribution if you aren't doing so already. You won't even notice contributing that 2% directly into your plan as your paycheck will see no impact. With Washington intent on avoiding the looming Social Security deficit, you can be sure you will be funding most of your retirement through that workplace plan; any contributions now can only help.

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.