NASHVILLE NOTES

Compounding cash for Berkshire is a tough proposition

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Warren Buffett's annual letter to Berkshire Hathaway Inc. shareholders is the only annual letter that as far as I can tell is widely read. Some years he pens a better read than others, but there is always a theme that speaks to some enduring investment principle that has contributed to Berkshire's success.

The recently released letter included in Berkshire's 2019 annual report touched on two key value drivers: price paid and compounding retained earnings.

The old saying "the market saw bought right is half right" speaks to price paid. The one return on investment variable that investors have absolute control over is price paid. Buffett is price sensitive, but his (and partner Charlie Munger's) focus on the long-term earning power of a business has resulted in an investment process that is flexible. Berkshire can invest when prices and earning power are woeful as was the case when large investments were made in Bank of America Corp. and Goldman Sachs Group Inc. during the financial crisis, and Berkshire can invest when price and current earnings are not depressed (but presumably get better) as has been the case with the more recent Apple Inc. investment.

Nonetheless, occasionally Buffett and Munger will whiff. For several years Buffett has lamented that he overpaid in 2015 for Kraft, which is now part of The Kraft Heinz Co. and in which Berkshire owns almost 27% of the common shares. During the first half of 2017 the shares traded around $90 per share. The shares closed near $27 on Feb. 21 the day before the 2019 annual letter was released, which valued the 325 million share position at $8.9 billion compared to $10.5 billion at year-end 2019 and far higher several years ago.

Kraft Heinz is one of many equity investments Berkshire has made over the years. The market value of the 15 largest non-control common equity investments excluding Kraft Heinz as of year-end was $248 billion, so the loss in value is disappointing but not a make or break situation.

Buffett also extols the virtues of businesses reinvesting retained earnings to compound value. The implicit assumption is that capital can be reinvested at an attractive rate. The common equity portfolio according to Buffett on a weighted basis is producing a return over 20% on tangible equity capital. That is not bad and implies capital doubles about every four years assuming returns hold. Plus, the value of the high return companies increases while the laggards become a smaller piece of the portfolio even if no decision to sell is ever made.

The reinvestment question is interesting, I think, for an insurance company that holds large positions in leading U.S. banks at a time when interest rates are microscopic. Returns from reinvested capital at the banks will fall as net interest margins contract, perhaps by much more than Street analysts envision. Plus, credit costs are very low and one day will rise. Of course, the banks have reinvested very little the past few years as most earnings have been used to fund share repurchases and dividends given sluggish loan growth and an absence of material acquisitions.

Berkshire also has its own reinvestment issue. Buffett likes the property and casualty insurance business because premiums are collected today and claims are paid later. Good underwriting can produce great returns and an increasing amount of premiums to invest as "float." The float at year-end 2019 was $129 billion, about double the amount at year-end 2010 and 5x that of 2000. However, float has been devalued to an extent as rates have fallen the past decade.

The net result that I see is that Berkshire is exposed to falling rates in both its core operations and equity portfolio. I do not know how much of the cash hoard at Berkshire's various insurance units represents excess capital that could be passed to the parent company as a dividend to be reinvested in equities, but presumably some of it.

Further, Berkshire as a holding company for various insurance and non-insurance investments is flush with lots of liquidity and little debt. As of year-end the parent company had over $40 billion of cash and investments in U.S. Treasury Bills compared to $26 billion at year-end 2018. Debt totaled $20 billion compared to $425 billion of equity.

It is a fortress balance sheet, but what does Buffett et al do with the cash? He has talked periodically about finding an elephant to buy, but none can be had at a reasonable price. And price is one of three key variables that must be met to acquire a business. (The other two are businesses that produce good returns on tangible capital and that are run by "able and honest" management.)

So, excess capital continues to build at Berkshire even though the company regularly buys stocks and perhaps aggressively so when markets hit an air-pocket. Thus, it is not surprising then that Berkshire repurchased $4.9 billion of stock in 2019 compared to $1.3 billion in 2018 and none in 2017. Look for many more repurchases in 2020 unless the market produces real bargains. In a not so subtle message, the chairman's letter includes the name and phone number of the Berkshire employee to contact for shareholders who own at least $20 million of A or B shares and have an inclination to sell.

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