HORIZON RESEARCH GROUP

Berkshire Hathaway, Part II

Originally Published in the Distressed Securities Research Report Compendium, October 2008

PCS RESEARCH SERVICES

Exclusive Marketers of
The Distressed Securities
Research Report

PCS Research Services
125 Maiden Lane, 6th Floor
New York, NY 10038
(212) 233-0100
www.pcsresearchservices.com

HORIZON

Horizon Research Group

Steven Bregman, Thérèse Byars, Peter Doyle
Michael Gallant, Matthew Houk, David Leibowitz
Eric Sites, Fredrik Tjernstrom, Steven Tuen

Murray Stahl

This report is based on information available to the public; no representation is made with regard to its accuracy or completeness. This document is neither an offer nor a solicitation to buy or sell securities. All expressions of opinion reflect judgment at this date and are subject to change. Horizon Research Group and others associated with it may have positions in securities of companies mentioned. Reproduction of this report is strictly prohibited. © Horizon Asset Management, Inc. 2010.

Essay: Berkshire Hathaway and Value Investors
Part II

A frequently asked question is, "When does one recognize that an investment mistake has been made?" In other words, what quantifiable loss rate would be necessary to establish an investment thesis as fallacious? In order to explore this question, let us assume that one purchased shares of Berkshire Hathaway on December 31, 1972 at a modest 11.3% premium to stated book value. The investment thesis might well have been that the Berkshire approach to value investing was likely to produce substantial growth in net asset value. Furthermore, intrinsic value might have been higher than stated book value. For instance, the Berkshire investment in the Illinois Bank and Trust Co. of Rockford produced a then exceptional 2.2% return on average deposits, and Cornhusker Casualty was producing growth far in excess of industry standards. Furthermore, Berkshire Hathaway had just borrowed $20 million from twenty institutional lenders at 8% with a maturity date of March 1, 1993. One might well have anticipated the inflation that was about to significantly reduce the maturity value of this loan.

As reasonable and correct as this investment thesis obviously would have been, the investment community of that era did not agree. Berkshire Hathaway shares lost 10.1% of their value in 1973, 43.7% of their value in 1974, and another 5% of their value in 1975. It should be observed that the S&P 500 lost 14.8% in 1973, 26.4% in 1974, and produced a return of 37.2% in 1975. Thus, the hypothetical investment in Berkshire Hathaway in 1972 would have produced a 51.9% loss at the end of three years. In contradistinction, the S&P 500 recorded a 14.0% loss in the same time period.

Berkshire Hathaway stock also underperformed the S&P 500 in 1972 when the shares produced a return of 14.5% versus an 18.4% gain for the index. During this time period, Berkshire Hathaway recorded a 63.9% gain in book value. In fairness to investors of the era, the selling pressure upon Berkshire Hathaway was logical, if nevertheless incorrect. Berkshire Hathaway produced a 4.7% gain in book value in 1973 and a 5.5% gain in book value in 1974.

In 1973, one could have purchased a very low risk 5-year Treasury bond with a yield in excess of 6%, and as high as 7.63% in August 1973. In 1974, one would have experienced no difficulty in capturing a yield well in excess of 8%. Consequently, it must have been reasoned at the time that Berkshire Hathaway needed to trade at a price that reflected a proper risk premium. Hence, if Berkshire Hathaway earned 5.5% on its book value, it must trade at a substantial discount-to-book value in order to produce a "fair" value with an appropriate equity risk premium. Therefore, at the end of 1974, Berkshire Hathaway traded at a 48.7% discount to book value. Given the appropriate adjustment, the 5.5% return on book value was then equal to a 10.72% yield on book. Viewed in this light, the discount-

HORIZON
© Horizon Asset Management, Inc. 2010

to-book value appears entirely reasonable. In principle, it is no different from buying a bond with a 5.5% coupon at a discount to par value.

The 1973 Berkshire Hathaway shareholder letter contains the following excerpt that one can only presume was disturbing to investors when they read it in 1974.

> On the investment side of our insurance operation, we made substantial additional commitments in common stocks during 1973. We had significant unrealized depreciation -- over $12 million -- in our common stock holdings at year-end, as indicated in our financial statements. Nevertheless, we believe that our common stock portfolio at cost represents good value in terms of intrinsic business worth. In spite of the large unrealized loss at year-end, we would expect satisfactory results from the portfolio over the longer term.

The 1974 shareholder letter contains absolutely no remarks about common stock investments. The 1975 annual shareholder letter reveals that at December 31, 1974, the net unrealized loss in the common stock portfolio amounted to $17 million. The tone of the 1974 letter is decidedly pessimistic. The 1975 shareholder letter revealed that there was $15 million worth of unrealized equity appreciation in the stock portfolio on March 31, 1976. The following statements were made in that letter with regard to investments:

> Our equity investments are heavily concentrated in a few companies which are selected based on favorable economic characteristics, competent and honest management, and a purchase price attractive when measured against the yardstick of value to a private owner.
>
> When such criteria are maintained, our intention is to hold for a long time; indeed, our largest equity investment is 467,150 shares of Washington Post "B" stock with a cost of $10.6 million, which we expect to hold permanently.
>
> With this approach, stock market fluctuations are of little importance to us—except as they may provide buying—but business performance is of major importance. On this score, we have been delighted with the progress made by practically all of the companies in which we have significant investments.
>
> We have continued to maintain a strong, liquid position in our insurance companies. In last year's annual report, we explained how variations of 1/10 of 1% in interest rates result in million dollar swings in the market value of our bonds. We consider such market fluctuation of minor importance, as our

HORIZON
© Horizon Asset Management, Inc. 2010

> liquidity and general financial strength make it highly improbable that bonds will have to be sold at times other than those of our choosing.

This was the Berkshire Hathaway position in terms of investment philosophy at year-end 1975. As those words were being written, Berkshire Hathaway traded at a 60% discount-to-book value. Consequently, in order to address the question posed at the beginning of this essay, one might present an assertion. It should be self-evident that an investor that made use of market value fluctuation as a guide to portfolio action would have sold Berkshire Hathaway. Moreover, a manager of Berkshire Hathaway other than Warren Buffett would have sold equities as they began to produce market value losses in 1973. Phrased alternatively, Berkshire Hathaway should not have commenced acquiring shares of the Washington Post in early 1973. It should have sold short the Washington Post in 1973, covered its short at the low price and then established a long position.

Of course, as is now well known, Berkshire Hathaway continued to add to its Washington Post position. It is quite obvious that the investment community did not approve of this action in the 1973-1975 time period. If Berkshire Hathaway had been a mutual fund during this time period, it probably would have lost many of its customers. As a company, its shares merely declined to a 60% discount-to-book value. If this result is what presumptively rational investors can do with Berkshire Hathaway, one can only imagine what might be accomplished with a lesser enterprise.

In summary, the following observations might be legitimately made about Berkshire Hathaway during the 1972-1975 period:

1. Paradoxically, the shares performed as poorly during the period in question as the typical high P/E shares of the era.
2. This proved to be a blessing for Warren Buffett, as he was able to substantially increase his ownership in the enterprise at an enormous discount to liquidation value. If the shares had exhibited better performance, it is arguable that he would ultimately have become far less wealthy.
3. Buffett was able to increase his ownership of Berkshire at a time when the company was able to deploy its capital in a variety of superlative investments only available because the investment community appears to have focused its attention upon the price of an asset, rather than the value of an asset. The two concepts are hardly synonymous.

HORIZON
© Horizon Asset Management, Inc. 2010