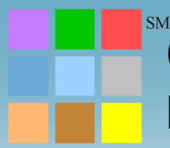

SM SPECTRUM

INVESTMENT ADVISORS

Woodstock of Capitalism

Berkshire Hathaway Annual Shareholders Meeting
Omaha, Nebraska - April, 2016

James F. Marshall
President

Jonathan Marshall
Chief Investment Officer

For the eleventh consecutive year, Jonathan, my brother Dave and I joined Gary Vanden Heuvel, President of the BLC Community Bank and his sons Sam and Casey along with Butch Pomeroy, President of the International Bank of Amherst, and Jeff Mueller, President of Collins State Bank, as well as Tom Medema and Kevin Eismann, for our annual pilgrimage to Omaha. This year's event marked the 51st Anniversary of Berkshire Hathaway (BH) with **Warren Buffett** (85), and **Charlie Munger** (92) on stage. Fifty-one years ago Warren started with $105,000 of family money, today Berkshire Hathaway is worth $552 billion, the fourth largest company in the United States. In 11 years, both Warren and Charlie are still witty and fun with very sharp minds. The only change was at 92, Charlie needed help getting into his chair.

The big news this year was that the meeting was being broadcast live on the Internet for the first time. That didn't stop the shareholders from attending, however, with just over 40,000 at the meeting, down from a record of 44,000 last year for the 50th Anniversary. Why do they (and we) keep attending? The answer is, for the experience and to listen to five hours of answers (with a one hour break) from Warren and Charlie, who often states, "I have nothing to add." This year's meeting started out with the song *New York* by Alicia Keys, with the words "Berkshire" used in place of New York. The Berkshire song was followed by a 45 minute video highlighting BH's 80 companies.

An interesting book available at the meeting was the Berkshire Hathaway 51st Anniversary Book, a timeline of when BH added each company. As successful as BH has been, it got off to a rocky start. In 1965, Warren, through his investment partnership, took over the management and control of Berkshire Hathaway, Inc., a then large but struggling New England textile maker. In 2001, he liquidated the company. In 1993, Warren bought Dexter Shoe Company and after eight years of trying to make his purchase work, he closed that company in 2001 as well. Part of what saved BH in the beginning was investing in See's Candies in 1972.

The following are answers to a few of our favorite questions asked by members of the media, analysts and the general audience, during the five hour session. Warren's introduction was simply, "I'm Warren, he's Charlie."

What is the ideal company to invest in and why?
WB: Our ideal investment is a company that takes very little capital reinvestment. An example of that is our See's Candies Company. We paid $25 million for See's Candies in 1972, and after 44 years, we have realized total earnings of over $2 billion. Today, because of our size, it's harder for us to buy low capital intensive companies because our minimum today is to invest in companies $2 billion and up.

CM: We love a great company that also has a great manager. You don't have to be smart to buy, just don't be stupid.

Tell us about your thoughts on Gen Re Insurance in Europe.
WB: We sold Gen Re in Europe, but not in the USA. Part of the success of an insurance company is to work the float. The bond yields in Europe have turned negative. We think low rates in Europe will be with us for a considerable period of time.

CM: The next 10 years in this business will not be as good as the last 10-20 years.

Do you think it is wise to continue to invest in Coca-Cola with the long-term impact of too much sugar in our diets?
WB: I happen to elect to consume about 700 calories per day from Coca-Cola. There are over 1.9 billion eight ounce servings of some Coca-Cola drink. That's almost 100 eight ounce servings per capita for 7 billion people in the world every year and that's been going on since 1886. If drinking Coke makes you happy every day, you will live longer because you are happy.

CM: The benefits to humanity and society is the measure of joy *(as Charlie is sipping a Diet Coke)*. People shouldn't point out the defects without mentioning the advantages. It's immature and stupid.

What are your thoughts on the upcoming Presidential election this fall?
WB: Business in this country has adapted extraordinarily well over 200 years and will continue to do so regardless of who is president. Gross Domestic Product (GDP) has gone up over six fold in my lifetime. America's population is growing about 0.8% per year *(0.5% from births minus deaths, and 0.3% from immigration)*. America's GDP per capita is now about $56,000, or six times the amount it was in 1930, the year I was born. Today, Americans don't work harder, but they work more efficiently and therefore produce far more. The GDP growth rate is 2% per year. That rate will deliver astounding gains. A 2% overall growth produces about 1.2% per capita growth. In a single generation, that leads to a 34.4% real GDP growth per capita. In turn, that 34.4% growth will lead to a staggering $19,000 increase in real GDP per capita for the next generation. For a family of four, that would be $76,000 annually for the next generation. All families in an upper middle class neighborhood enjoy a standard of living higher than John D. Rockefeller Sr. at the time of my birth in 1930.

For 240 years, it has been a terrible mistake to bet against America, and now is no time to start. America's kids today will likely do far better than their parents did. No presidential candidate will end progress in the U.S.

What do you see as the main problem for BH in the future?
WB: The main problem is our size. For example, we never like to hold less than $20 billion in cash. Today, we have $60 billion in cash as we look for the next opportunity. We purchased a capital intensive business, Burlington Northern Santa Fe Railway (BNSF) for $26 billion because it's so hard to find companies today that are at least $2 billion, that are not capital intensive. To maintain BNSF, last year we spent $4.6 billion in improvements.

CM: The danger of too much cash, or a full wallet, is that it's like a full bladder. You get the urge to pee it away.

What are your thoughts on incentives?
WB: You need to reward your employees on profit as well as growth, not just one or the other. When we buy a business, we ask the seller what his or her incentive plan should be. When you get a very greedy executive, he pays people below him too much to justify his compensation.

6329 W. Mequon Road ▪ Mequon, Wisconsin 53092 262.238.4010 ▪ 800.242.4735 ▪ 262.512.2704 Fax sia@spectruminvestor.com ▪ www.spectruminvestor.com
Investment advice offered through Spectrum Investment Advisors, a registered investment advisor. Registration with the SEC does not imply a certain level of skill or training.

CM: In the financial crisis in 2008, due to incentives, a lot of companies were reporting a lot of income they weren't making. We want compensation simple and right. If not, it's like rewarding your children for bad behavior.

What guidelines do you follow when buying a company?
WB: We still run our BH home office in Omaha with only 25 people. One thing we do not do is hire outside consultants to tell us what to do. In buying a business, we want to know if a manager will behave differently after he sells his business. Negotiations that drag out have a tendency to fall apart. Deals fall apart when egos get in the way. I'm willing to lose on small parts of the deal.

CM: How many people check their spouse's birth certificate before they get married?

Where does your sense of humor come from?
CM: If you see the world accurately, it's bound to be humorous because it's ridiculous.

The Warren Buffett Stock Portfolio by Mary Buffett

Part of the experience of attending the **"Woodstock of Capitalism"** is to visit the Bookworm book store both in downtown Omaha and also the exhibit hall in the CenturyLink Center. You can find over 70 books written about Warren and Charlie at the Bookworm. Each year we have added to our Spectrum library WB book collection, which now totals over 40 books. This year, in addition to the 51st BH anniversary book, one of our favorite books was, *The Warren Buffett Stock Portfolio: Warren Buffett Stock Picks: Why and When He Is Investing in Them*, by Mary Buffett, who was married to Warren's youngest son, Peter. The following gives an investor an understanding of how Warren thinks and acts on investing.

The first page of the book starts with Warren's statement, **"We welcome a stock market decline because it allows us to pick up many more shares at new panic prices."** Warren maintains that, **"The time to buy stocks is when nobody else wants them."** For example, in late fall, 2008, as the stock market was crashing, Warren was quoted in the *New York Times* as saying, "Buy American, I am."

Warren currently owns only 17 individual stock investments in the BH portfolio, not including his 80 companies he owns outright, or the stocks that portfolio managers **Todd Combs**, hired in 2010 or **Ted Weschler**, hired in 2012, own. Presently, there are only four people at BH who are selecting stocks for the BH portfolio. Warren, who makes 99% of the decisions and Charlie, who says he gets paid for telling Warren, "no", are two of them. The other two are Todd and Ted who both manage approximately $9 billion each. Todd has 7-8 positions and Ted has 13-14. According to Warren, both have done quite well. Todd and Ted focus on mid and large cap stocks and will not buy small cap stocks that are less than $500 million.

Warren's early strategy was to cash out of the market, which he did at the market top in 1969 and somewhat in the summer of 1987 (down to four stocks) before the October 19, 1987 correction. From late 1969, Warren waited three years to invest again in 1973. The book says it was the longest three years of his life. Today, rather than cash out, he builds cash waiting for the next opportunity to take advantage of; the inevitable correction in stock prices. Warren buys companies that have superior long-term economies in their favor, which can be defined as long-term, 20-40 year investments, similar to buying a home or a farm. **Warren's key to success begins by having cash when others don't. Then he waits.** Next, he buys, and/or holds, really great businesses as the market moves up, selling average businesses and letting cash pile up for the next opportunity; a cycle Warren has repeated over and over again and in the process, has become the third richest person in the world.

At the start of Warren's career, he was influenced by his economics professor at Columbia, **Ben Graham**. Ben identified companies (stocks) that were undervalued. However, in the crash of 1929 and 1932, Graham was nearly wiped out. From 1929-1932, the Dow Jones Industrial Average (DJIA) lost 88% of its value, falling from 380 to 43. It took the DJIA 24 years to 1956 to once again return to a new high of 380+. As the economy improved in the late 30s, the stronger, quality **brand** name companies improved a lot more than second and third tier companies, of which many did not have a **durable competitive advantage**. We consider second tier to be mid cap companies and third tier to be small cap companies. Historically, mid cap companies are less volatile than small cap companies and have a tendency to have more proven **brands**. Mid cap stocks (light blue) are a strong asset class as our 30-Year Spectrum Investor® Historical Analysis points out. Most Spectrum portfolios include mid cap stocks.

Warren got out of the market in 1969, but it's interesting to note that his friend and business associate, Charlie Munger, managing his own hedge fund, did not and made the same mistake Ben Graham did in the 1930s. Charlie lost 53% from 1973-1974.

In the fall of 1999, when the average investor was buying still more tech stocks, Warren gave his famous speech in Sun Valley Idaho and said that 10-year US Government T-Bills were very attractive with a 6% yield vs. the S&P 500 yield at only 1.1%. In 2007, with the market beginning to top and with 10-year T-Bill rates at 4.7% vs the S&P yield at 1.8%, Warren built $37 billion in cash by early 2008. With all that cash in late 2008/2009, who did companies like GE and Goldman Sachs turn to for help? Warren.

Warren states that predictable **brand** name products equal predictable profits and the constant predictability of a company's profits equates to a **durable competitive advantage**. For example, a company selling the same **brand** name product or service for more than 50 years has a **durable competitive advantage**, such as Coca-Cola, Procter & Gamble and Johnson & Johnson. Warren likes older companies with earnings consistency vs IPOs (new companies). If a company has an erratic earnings history, it is more likely the kind of company that produces a commodity type product without **brand** identification that competes on price. A good example is lumber or airline flights, that constantly experience a boom or bust cycle.

A company with a long-term **durable competitive advantage** will generally have a 10-year positive earnings history such as Coca-Cola, Procter & Gamble and Johnson & Johnson. The book states that all three of these companies had a positive earnings per share history for 10 consecutive years from 2001-2011. In comparison, Ford Motor Company's earnings per share were negative four out of the same 10 years. United Continental was negative eight out of the same 10 years. We are not necessarily advocating that you either buy or sell the above stocks, but only that in addition to other measurements, such as a stock's PE ratio, you may want to look at a stock's 10-year earnings per share history before investing in it.

When Warren was asked by a member of the audience what he wants to be remembered as, Warren said, "A teacher". And teach he does, at 85 years old, when he could be spending the same time on his favorite golf course (by the way, he's just an average golfer). As Warren said, to be a good investor, it's not the intelligence you have, it's the ability to control your emotions.

What investment icons like **Warren Buffett**, a value investor, **Peter Lynch**, a growth investor, or **Sir John Marks Templeton**, who pioneered global investing, all have in common is their unshakeable optimism about the future. It's what gives them the emotional strength to buy when everyone wants to sell.

In summary, to select individual stocks you need the time, energy and passion to do the research. Our investment philosophy at Spectrum is, if you are going to own individual stocks, own no more than 10-15 stocks, similar to **Warren, Todd and Ted**. Since most people don't have the time and energy to follow individual stocks, we suggest the core of the average investor's portfolio be invested in a combination of index and managed stock mutual funds and managed bond funds. We don't advocate market timing, but as the market climbs higher, our suggestion is to invest in a balanced portfolio of stocks, bonds and cash (rebalanced annually) so that the next time the market has a severe correction, you have cash to buy vs selling. At a minimum, a balanced portfolio will help keep your emotions in check, so you don't sell low. The investment community is so lucky to have someone like Warren and Charlie to teach us the business of investing and to have been blessed with good health, living long enough to share their stories.

We enjoyed the ride to Omaha as we do each year and wanted to share it with you. Can't wait until next year!