Berkshire
DIVIDEND STRATEGY

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AN EDGE WITHIN OUR REACH - Q2 2018

So far this year, the market has been challenging and volatile. While a select group of stocks had strong results, the average stock has not; including many of the type of stocks our strategy favors. Is this a sign the game has changed? Or does today's market environment spell opportunity?

We've been reading "Black Edge," by Sheelah Kolhatkar which details the rise of SAC Capital and the attempts by regulatory agencies to bring it down. The book alleges Stevie Cohen and his firm were consistently right on so many trades because they used corporate espionage to obtain and trade on illegal inside information. Having access to critical information before others is indeed an investment "edge"…obtaining it illegally is what makes it "black". *- (Cohen's former hedge fund, SAC Capital, pled guilty to insider trading charges in 2013 and paid $1.8bn in penalties. Cohen escaped criminal indictment himself despite being the living, breathing heart of SAC Capital, and now runs a private fund with $11bn in assets. [1])*

It's a fascinating book but it begs the question – how do investors gain an edge legally? Some investors will utilize their trading prowess, or the ability to react and trade on information more quickly than everyone else. This can require a lot of computing power, complex algorithms and rapid fire trading (sometimes measured in nano seconds!). Surely this is not a strategy we or most of our clients identify with.

Berkshire attempts to gain part of its edge by analyzing public information (10-k's, 10-q's, company events etc.) and organizing it in an exacting manner to glean unique market insight. Our process attempts to reveal clues about a company's true and meaningful fundamentals and to help us understand what is discounted into its current price versus vs. its true long term value.

But there's another source of investment edge, and while it isn't very exciting, it's potentially more powerful: having a longer time horizon and more patience than the average investor. Professional and retail investors alike are often over-reacting to near term earnings estimates and fixated on current price performance. These forces can create a great deal of temporary selling pressure in the near term.

We are more interested in what will happen to a company many quarters or even years out. We feel that's our biggest edge and its one our investors can emulate and embrace.

Sometimes, this patience and discipline means we need to stay focused during periods where our typical holding may not be in favor. Throughout our careers, we've seen many investors abandon what is not performing at the time and chase investments that are. Yet this type of performance chasing behavior by both professional and individual investors (selling at the bottom and buying at the top) acts like a "silent killer", devastating the potential for long term compounded returns which could result by staying the course.

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 30 years, we have successfully implemented highly focused equity, fixed income and balanced portfolios. Our guiding principle is a belief that success is achieved by combining rigorous, well crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference... Diligence, Integrity and Focus.

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THE TRIALS OF "AVERAGE" AND THE RISKS OF INDEXING

Which leads us to the current environment. Despite terrific fundamentals, and what we think are attractive valuations, the average stock in the market is not performing particularly well. Most large-cap indexes are reaching nominal new highs, yet the gains are not broad-based across a wide list of stocks.

For example, the S&P 500, a standard benchmark for U.S. stocks, advanced 2.65% for the quarter. Yet look closer and you will see nearly 100% of the return came from the returns of just 7 stocks – most notably a few growth stocks, which we think are very pricy. Approximately half the stocks in the S&P 500 find themselves in negative territory year-to-date.

This kind of narrow, growth-driven market has happened before, but we see the pattern becoming even more extreme with the rise of index funds. The math is painfully clear. When index performance is driven by relatively few, highly concentrated positions, it's tough for other types of portfolios to outperform. More money flows to indexes, which drives up the performance and the concentration of those few stocks feedback loop is created, which creates its own kind of investment bubble – an exponential rise in stock price not supported by meaningful changes in company fundamentals.

Take Netflix (NFLX) for example. It now composes .57% of the S&P 500 index and it has increased 103% contributing 14% of the total return of the S&P 500.* But look deeper at its fundamentals. NFLX cash flow is still negative and its debt is reaching record levels. Yet its stock continues to skyrocket. (*Bloomberg Professional)

As investors with an eye toward the long term, we see serious potential risk in this trend. Here's a simple way to view it: If I told you to buy the stock of a highly expensive, debt-ridden company, you might find that crazy. And would it make sense if I said buy more simply because the price is up? But people are doing just that when they buy an index portfolio, because more and more of the performance of that index is being driven by the results in that one stock.

Losses can accelerate when the air comes out of these overinflated stocks. This is why many active managers may not do as well in bull markets, but can and should earn their keep during market declines.

PORTFOLIO DETAIL

Our underperformance so far this year isn't all chalked up to not owning growth stocks. We've had a few companies with what we view as temporary issues having a disproportionate effect on recent results. Here are a few notes about portfolio performance:

Packaged food stocks have struggled over the past 18 months. Investors have questioned whether new eating patterns, delivery systems, and consumer preferences have reduced the value of products and brands. Although we are fully in tune with these concerns, we feel our selections **Kraft (KHC)** and **General Mills (GIS)** are set up for future success. Both companies possess attractive dividend characteristics and the ability to cut costs, and importantly the ability to acquire other companies. Their playbook has been pretty straightforward. Acquire a large company, broaden distribution, and slash costs. They can do this while they develop new products of their own.

Walmart is in a lull. **Walmart (WMT)** is a company with a solid history of growth that investors think is being outmaneuvered by online retailers. But Walmart has a playbook of its own: online retailer Jet.com, on-site pick up, and of course copious cash flow. It also has a strong presence internationally with assets like Flip-Kart, a leading online retailer in India. We don't doubt Walmart's staying power or its ability to reinvent itself.

Financial companies have received little fanfare this year despite favorable developments. A number of our holdings have had their capital plans approved by regulators this year. This has paved the way for them to greatly increase payouts to shareholders in the form of stock buybacks and increased dividends. Regulatory relief, higher rates, and a healthy economy should also keep margins and loan volumes on the rise, even as the yield curve flattens.

Energy-related companies aren't attracting attention. The energy sector is generally up year-to-date, but it has a long way to go to catch up with the broader market. Despite strong global growth and rising commodity prices, the stocks still appear undervalued. Some are still recovering from 2015-2016 slumps, but it's clear to us that the market is underestimating the earnings leverage at these companies.

LOOKING FORWARD

Why aren't investors more excited about the average stock? Why do they only seem focused on a narrow group of expensive growth stocks? Perhaps it's because some investors believe we are late in the economic cycle and the good times simply won't last. So, they appear to be willing to overpay for select growth stocks they feel are so unique they are immune to the economic cycle. These investors cite a long list of worries…

- Higher interest rates; generally…
- A flatter yield curve, which historically signals a coming recession…
- Sudden potential for inflation…
- And of course, the looming trade war.

These fears have pushed the average value stock down to approximately *13.5 times earnings. (*Bloomberg Professional) By any historical measure, that's highly attractive given the fundamentals. The overall global economy is still expanding at an attractive pace, corporate earnings continue to sizzle and the financial system appears very healthy.

If you are inclined to agree with the worriers, then an equity strategy built around reasonable valuations, supported by strong fundamentals, and producing regular returns in the form of dividends is a prudent option. Our approach to long-term wealth creation emphasizes all these factors, and we feel comfortable our portfolio is loaded with companies which will survive and thrive in the years to come.

But the truth is, we're not sold on all the worry. This list doesn't seem all that different from what we've heard the past few years (The fiscal cliff! European debt crisis! The election!). We see these kind of headlines on our news feed every day, but they seem out of step with the real world we see, where there are many companies performing extremely well, in a favorable economic climate, and carrying relatively low valuations.

Investors may not always be looking at fundamentals closely, but over the longer haul, fundamentals don't lie. Fundamentals are the signal in the noise. Our focus on sifting through the day-to-day anxiety to find out what's really happening within these companies and their markets is a real edge – and one we come by honestly, through hard work and disciplined focus.

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[1] How Steven Cohen Survived an Insider Trading Scandal, Book review, by John Gapper. Financial Times, February Times, 2017

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Definitions: The S & P 500 Index is a market capitalization weighted index of the largest 500 U.S. stocks. It is a market-value weighted index (stock price times # of shares outstanding), with each stock's weight in the index proportionate to its market value. The index is designed to measure changes in the economy and is representative of most major industries. You cannot invest directly in an index. Beta is a measure of volatility vs. an index. Current yield is the mean estimated annual dividend amount based on current calendar year, divided by the current stock price. Dividend Payout ratio is the fraction of net income a firm pays to its shareholders in dividends, in percentage. Forward Price Earnings Ratio (P/E) is the ratio of the price of a stock and the company's projected earnings per share.