Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: Correction Commonalities? + 5 Chart Friday – *March 6, 2020*

Good morning...
Markets again are feeling downward pressure as of 10am 3.6.2020. Instead of making a market call, we want to share important perspectives for advisors and clients...Lets keep in mind what most corrections seem to have in common:

1. The swiftness of the sell-off takes most by surprise. Often, it's an escalator up and an elevator shaft down.
2. The catalyst is usually from something UNKNOWN - KNOWN threats are likely reflected in current prices
3. **Importantly, each correction appears to have a unique problem associated with it, to which collective wisdom thinks there's no solution. In this case it's a run-away virus, destined to cause a recession. And to the extent the market "speaks its mind" (and to the extent you can interpret it) Tuesday's action says The Fed has totally lost its way, and can do little to alter the path of a potentially ailing economy. So down and down it goes…**
4. Most financially driven corrections have financial media amplifications that potentially sensationalize the magnitude of the event (CNBC, Bloomberg). This story has virtually all media providing round the clock coverage
5. Recently, machine driven/program trading seem to accelerate the swings in both directions (think December 2018), making it very difficult to call tops and bottoms

We've often said: "Everyone wants to buy stocks at lower prices…until they see the news, fear and uncertainty creating those lower prices." This goes for indexes, sectors and companies. Many investors want to wait in cash because "there's no catalyst." If the catalyst were visible, stocks would be already be higher – negating the opportunity to buy low. We suspect this correction's path will be like many others...where investors will (someday) look back in hind sight and be happy they resisted the urge to hit the panic button. Because time and time again, high quality U.S. companies have proven quite resilient in our estimation.

We were also reminded by an advisor friend: "These are the times when advisors earn a premium fee. Advisors need to work hard to keep clients from 'the big mistake' like *emotionally* selling at a potential bottom that destroys their balance sheet." While no one knows near term, we couldn't agree more with this philosophy

We fielded a number of questions this week...

"Do you have a near term outlook for the direction of the market."

No. BUT--we *don't* believe COVID-19 is an event that will permanently affect the long term cash generating ability of most companies. Of course, business will be lost short term, but unlike other financial panics which reshaped entire industries, when the virus is either contained or eradicated, it will almost certainly be business as usual. Demand could return very quickly. In short, we believe this is is an earnings event, not a valuation event!

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Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

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Exceptions? Its possible marginal/low quality companies get hit so hard near term, they could go bankrupt. Or if this event sparks some sort of credit crisis. We think the first is possible, but probably not the second (we are monitoring credit spreads). But of all the panics this market has endured over the last decade, this one appears, in our opinion, to be the least scary for financial markets.

"You bought an airline in this environment? Southwest Airlines (LUV) purchase"

One of the fastest growing airliners – EPS growing at 20%+ YOY
Rapidly growing dividend – current payout ratio < 15% of free cash flow
We believe one of the best managed airliners in industry
Strong balance sheet and healthy ROE components (low 20% range)
Our purchase came after Coronavirus outbreak which sent stock down over 20%.
Are we "early"? It's possible, but this is a name we've been wanting to own for some time

Source: Bloomberg

"How the heck are banks going to make money with the ten year below 1%?"

A banks' income statement has many levers.

The first and most important is net interest income. A low-interest rate environment, while not ideal for the financials, **is not a death knell**. Currently, loan spreads are still positive, loan growth appears strong and most important, the loan quality is very high. In the coming months, we expect a refi wave to be a significant source of high-quality, portfolio growth.

The second lever is fee income. Banks have considerably diversified with alternative streams of income. Loan and mortgage origination fees, swap income and brokerage/wealth management products will continue to bolster income for years ahead.

The third lever is the balance sheet. Banks are entering this period with overcapitalized balance sheets which provide a cushion against downturns like this, and allow for significant share repurchases and dividend increases. Capital levels, liquidity and credit quality has not been this high in a very long time.

so there are some positive fundamentals. But the final consideration is valuation. Banks are trading at just 1.4 times tangible book currently. Return on shareholder equity is running mid teens, dividends are often over 3% (approx 3 times the ten year treasury) and share repurchases greater than 5% of outstanding shares in some cases.

What would change our minds? An eventful downturn in the credit cycle. We don't see anything yet on the horizon likely to cause systemic and liquidity issues.

Source: Bloomberg

Some quick charts detailing the current market environment:
[Five Charts For Your Friday 3.6.2020]

Give me a call today - I'd enjoy hearing client thoughts, strategies through this market and overall tone in the field. Thanks.

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