Berkshire
DIVIDEND STRATEGY

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Second Quarter 2017 Commentary

Not So Happy Anniversary Financial Crisis!

It's hard to believe the financial crisis started 10 years ago: on June 22, 2007, Bear Stearns announced it needed more than $3.2 billion to bail out two struggling hedge funds based on subprime real estate loans, the first major domino to fall as the financial crisis got underway. Over the next months the crisis spread: losses accelerated, paper-thin capital ratios shredded, and investor confidence imploded. By March 2008 Bear collapsed, followed by Fannie Mae, Freddie Mac, and Lehman. The ensuing panic and shock to the economic system is painfully well documented. Despite ten long years, it is still fresh in the minds of many investors.

Markets have recovered since the financial crisis – but is the system fundamentally stronger? How different is the landscape now, especially for financial institutions?

Bank underwriting has changed drastically. In 2006, the year before the tumble started, banks issued over $400 billion in new subprime mortgage loans, in an environment where home prices were badly outstripping wages. Today that number is *under* $100 billion – a much smaller portion of bank balance sheets. So called NINJA home loans ("no income, no job, no assets") a common practice of 2006 are largely gone.

Home prices are moving in line with incomes and other measures of economic health. Loan underwriting standards are much more stringent, with banks demanding higher down payments, which means even if a loan goes bad, banks now have a cushion. And loans are less likely to go bad: in 2010, almost 30% of mortgages were underwater. Today, that number is 3.6%.

Loan losses today are nearly non-existent. Credit metrics are healthy, bank balance sheets are far more heavily weighted towards liquid securities than illiquid mortgages, and mortgages are stronger. Banks are much better capitalized, and regulators keep close (perhaps too close!) eyes on bank operations.

One bank in our investment universe shared these facts on today's regulatory context:

- The cost of compliance has gone up: $90mn in 2010 vs. $440mn today – that's 15% of total operating expenses
- Regulators are on site 50 of 52 weeks of the year
- The bank has undergone 27 different exams from 6 different regulatory agencies
- It's provided 225,000 pages of documents to answer 1,200 requests for information

What matters to investors is whether today's banks pass the "stress tests" that the Federal Reserve implemented after the crisis. The last round of tests was just completed in June, measuring whether banks could withstand:

- An economic contraction of over -6.5%
- Unemployment at 10%
- Commercial real estate losses over 35%
- Synchronized contraction throughout much of the developed world

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.

IN THIS REPORT

All tested banks passed this crisis scenario demonstrating how the system is much stronger now than it was in 2007–2008.

In fact, the nation's 34 largest banks now have a $1.2 trillion *excess* capital cushion. That's $750 billion more than in 2009. Banks are now actively returning *excess* capital back to shareholders as stock buy backs and dividends – one of the main reasons we believe the banking sector will grow dividends faster than any other sector in the S&P 500. They are a major area of emphasis in our strategy.

Q2 2017 Markets

For most of the quarter the market received good earnings support, propelling key U.S. stock indexes to all-time highs. But nearly 30% of the S&P's yearly gain of over 9% came from a few key tech stocks like Facebook, Amazon, Apple, Netflix, and Google – the "FAANGs".

Bond yields headed lower for most of the quarter, signaling quiet yet growing skepticism in the economy and Trump agenda that pushed stocks higher. We think this lack of confidence also supported much of the upward move in the FAANG stocks: investors may look to tech companies as likeliest to grow in a slow environment. Utilities, a classic defensive sector, rose along with other bond proxies.

Oil stocks were once again weak: large inventories from U.S. producers failed to offset production cuts abroad. The dollar had a huge 4th quarter rally but then continued to weaken, contributing to rising international stocks.

Late in the quarter, market sentiment changed dramatically. Central bankers from around the world announced that growth has become robust enough to warrant removing the massive monetary stimulus heaped on markets since the 2008 crisis. Bond yields shot higher and many value indexes also rose, as if to signal investors' faith in the ongoing recovery. As the rally broadened, "the FAANGs" corrected. In this environment, financials also performed well.

So what do we make of these cross currents? We're optimistic and our portfolio is positioned for offense, focusing on banks, tech, and cyclicals vs. more defensive sectors. Our evidence:

- Strong corporate earnings last quarter – the average revenue increase was nearly 8% and average quarterly earnings rose by nearly 16%
- Many of the gains were led by key industrial and financial sectors – a healthy sign of recovery
- Europe appears to be waking up, with growth percolating for the first time in many years

Yes, markets have reached all-time highs, but valuations remain attractive. A correction of 10–15% is possible – corrections are always possible – but we don't see the credit excess that could lead to much more than that. Banks appear rock solid, well shielded against losses.

Acquisition Highlight: General Electric

Late in the quarter we made a meaningful purchase/addition to General Electric (GE).

We believe the purchase is timely and opportunistic. Given the swarm of negative sentiment surrounding the stock, it's even a bit controversial.

We understand why the company has naysayers. GE has had 15 years of languishing returns and under-performance during CEO Jeff Immelt's regime.

Our strategy is to capitalize on Wall Street short-sightedness, and in many ways this purchase fits our criteria perfectly. Wall Street is looking back, not ahead: underestimating the potential turnaround and the underlying attractiveness of the business. What's more, we believe headline financial numbers are being misinterpreted.

GE's underlying businesses are very attractive:

- The company makes highly engineered and technologically advanced products, validated by high margins
- It operates in growth markets: aerospace, energy, global infrastructure build, health care
- It offers growth geographies in emerging markets
- It has a global footprint and distribution systems

Cash flow issues are misunderstood, temporary, or fixable:

- The market is confused about the timing and recognition of service contracts. Some divisions book revenue first then collect cash later (turbines). Others collect cash first then book revenue later (aerospace). This creates some "lumpiness," disconnects between earnings per share (EPS) and cash flow, especially when booking many new contracts, like now. Investors are punishing the company

– but the underlying economics of these multi-year service contracts carry 25%-30% margins.

- The company is introducing a number of new product launches. New turbines and engines require extra inventory build, negatively affecting working capital. Product cycles like these often come once in a decade and GE is investing heavily on execution. This pressures near-term inventory turns and drains cash – until the new products are sold.

- Investors are overly pessimistic about GE Capital dividends. GE sold much of the low-margin commodity consumer finance division that impacted dividends during the financial crisis. What's left now is specialty finance with juicy margins. Today's GE Capital division helps GE sell more big-ticket items, like aircraft and power plants. The market doesn't seem to appreciate the profitability of this revamped division, or the competitive advantage it brings to bidding on multi-billion dollar contracts.

- Other concerns – pension liabilities, gain-on-sale accounting – aren't material drivers of long-term business value, in our view. The factors above are.

Yes, there are legitimate issues and lack of execution. We think they're fixable.

GE could better execute on what they own vs. chasing acquisitions. For example, Alstom, a ten billion dollar acquisition, has not fared well. However, power markets, oil, and gas are bouncing back for GE – and for Alstom.

- Some argue GE is too big to manage and their execution is sloppy. In our view, this presents a significant opportunity to cut costs and increase working capital turns, the way Honeywell did years ago – and activist investor Nelson Pelz is pressuring management for greater efficiency.

- Management credibility is certainly weak. That is why we were pleased to see the announcement that Jeff Immelt announced his retirement. Pressure will be high for the new CEO John Flannery to reshape the company and boost value. Change can't come fast enough – so we're buying in while valuations are still attractive.

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.