Berkshire
DIVIDEND STRATEGY

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First Quarter 2016 Commentary

OVERVIEW

Like last August, January's market crash proved a false alarm and once again showed the difficulty of trading on macro events. Despite widespread fears, China's currency stabilized; world central bankers from Europe to Japan continued their accommodative monetary policies. Junk spreads tightened. Oil prices steadied, which eased concerns soured energy loans would pressure banks. Although, in our view that was never much of a concern anyway. We believe the banks we own have been careful in their underwriting, have limited exposure (under 2% of loans) and are adequately reserved.

These forces set the stage for the dramatic reversal in equities in mid-February. Many 2015 laggards bounced and helped value-oriented indices close the gap with their growth counterparts. Last year, many managers with a value bias saw their performance suffer as a select group of internet and social media stocks zoomed higher in the fourth quarter. This year a broad rally in some low-priced industrial stocks with exposure either to China or energy rebounded nicely. While some were tempted, we think the value/growth reversal is a good reminder why simply chasing an index based on a rear-view mirror approach is usually an ineffective strategy.

To start 2016, the weaker dollar has buoyed emerging markets and has helped many U.S. multi-nationals, an area of emphasis in our portfolio. As we pointed out earlier, had the dollar not appreciated so dramatically, S&P 500 earnings would have actually increased 4% instead of 0% in 2015--a more respectable performance. And while currency movements do not impact how we ultimately value a company, we thought that headwind could become a tailwind in 2016. So far, this has been the case.

Utilities & Telecom (an underweight for us) ripped higher as rates dropped, but banks (an overweight for us) slumped as they struggled to boost margins in a near-zero rate environment. Our financials outperformed the rest of the sector, however. With rates so low, are banks due for a rebound? We think so. First, we think a large valuation gap exists between banks and other sectors. Our analysis shows over the last few years when this gap opens to this level, banks perform well in the coming year. Most of these patterns have shown up when interest rates are very low, like they are now.

Plus, to the surprise of many, fundamentals in the banking sector ARE improving. The U.S. banking industry actually achieved record profits in 2015 with net income growing 9% at FDIC insured banks. How did they accomplish this in a near-zero rate environment? Loans grew, credit losses were low and expenses declined. If rates rise even marginally from here, banks could enjoy very positive operating leverage. We also think banks could be a stand out sector dividend-growth wise.

We saw good reversals in many individual stocks that held back our performance in 2015. A preliminary estimate for our portfolio shows an increase of 3.20%* for the quarter vs. the S&P's total return of 1.34%*.

BERKSHIRE is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 20 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

DO MASTER LIMITED PARTNERSHIPS (MLPS) PRESENT OPPORTUNITY?

Part of our investment discipline is to comb through hard-hit sectors that have experienced mass investor outflows. It's the "look to buy when there is blood in the streets" mentality. Opportunistic managers looking to capture a full investment opportunity set need to incorporate major price events in their idea list.

MLPs are fitting of this description today. Many investors were enticed by high relative yields and the perception of reliable cash flows from a "toll-road" type business. During the good times, the sector attracted large amounts of capital and the MLP sector expanded by 3-5 times.

But as we reevaluate these companies (one at a time), we are reminded of what kept us out of the sector in the first place:

- High leverage
- Difficulty generating consistent free cash flow (by our definition)
- Dividend payout ratios often run well over 100% (meaning they usually need to borrow to pay the dividend)
- The fact that MLPs are largely operating non-differentiated commodity businesses.

However, the implosion of the oil and gas industry has caused the high-yield bond market to reprice yields dramatically higher, causing a seismic shift to the MLP business model. Also, many indebted oil and gas producers may not be able to make good on their distribution contracts, which may threaten current and future cash flows.

Looking forward, we see a more difficult environment as more pipeline capacity comes online. For example, in the Northeast Marcellus Shale region, it is estimated pipeline capacity will quadruple from 2 bcf/d (billion cubic feet/day) to 8 bcf/d by 2019. As pipeline contracts renew, the MLPs will have much less pricing power.

A company like Microsoft is much closer to what we feel is an outstanding business. Today's Microsoft:

- $70 billion in (net) cash on the balance sheet
- On track to generate about $30 billion plus in cash this year (a nearly 28% free cash flow margin)
- An entrenched, growing and differentiated product offering.

But is Microsoft 'too big to grow?' The most critical part of Microsoft's business at the enterprise level is the center of the information technology "plumbing" as it were. Despite its revenue in the $50 billion dollar range, this business is still growing in the mid- single digits, with very good margins. Plus as more business moves to the cloud, Microsoft looks positioned to continue its dominance. In short, we believe Microsoft is a very special "one of a kind asset" uniquely poised to provide enduring cash flow for many years to come.

Another company we feel is a very unique asset is M&T Bank. Over the last eight years, M&T Bank has navigated a financial crisis and a series of capital intensive but successful acquisitions. With these acquisitions now in the rear view, a solid balance sheet and a healthy diversified revenue stream, M&T Bank has emerged stronger than ever. After an 8 year hiatus, Berkshire feels M&T is now positioned to return to its history of attractive dividend increases. M&T is a mid-Atlantic banking franchise with an excellent track record of credit discipline and capital allocation. It consistently generates higher than average net interest income margins relative to the risk it takes. This means customers are extremely loyal to the bank and don't just shop for the loan with the lowest rate.

M&T has a history of making vulture like acquisitions—striking when prices are attractive. It purchased Provident Bancorp in 2008 at the height of the financial crisis and Wilmington Trust in 2010 below market prices. Additionally, from 1983-2008 its dividend had grown at an average annual rate of 18.8%. However, the company has not raised its dividend since 2008 and for good reason. M&T was the only top 20 bank not to cut its dividend in 2008.

In fact, during the 2008 financial crisis, regulators allowed M&T to maintain its $2.80 annual dividend because of its excellent credit quality. So, while all of its competitors slashed dividends and are now only returning to their pre-crisis levels, M&T shareholders have enjoyed a $2.80 dividend annually. In addition, M&T's acquisition of Hudson City Bancorp which was originally announced in 2012 was only recently completed due to regulatory issues. Now that the Hudson City merger has been completed, we think M&T can grow earnings at 12% to 14% over the next 2 years which should pave the way for dividend increases.

We believe M&T is one of the top banking franchises in the country and remains a model for excellent management.

Unlike Microsoft and M&T, most MLP's usually lack any true secular advantages. Success tends to be more dependent on unpredictable commodity prices and the whims of the capital markets.

We do not wish to be critical of investors who may participate in MLPs, but want to point out why MLPs do not fit well with our traditional investment criteria. That said, we continue to evaluate individual names and may find a standout that does fit our discipline. In general however, we will likely avoid meaningful capital commitments at this time.

OUTLOOK

Looking forward, the hunt to find companies with growing earnings, cash flow and dividends to help our investors meet their liabilities continues. Ten-year U.S. Treasuries remain below 2% and $7 trillion in worldwide debt now carries a negative yield. Central bankers are nothing if not fully committed to maximum monetary easing. But perhaps monetary policies ARE the problem. A "liquidity trap" is caused when people hoard cash because they expect an adverse event such as deflation, insufficient aggregate demand, or war. So, the more bankers talk about the need for intervention, the more it becomes a self-fulfilling-prophecy!

We would like to counter these fears by pointing out the following positives for the U.S. economy:

• Lower energy and fuel costs are likely to act like a major tax cut for consumers and for business. The consumer makes up 70% of the U.S. economy.

• Employment is growing and so are average hourly wages.

• America is on pace to build over 1.1 million new homes vs about 600,000 in 2012.

• New vehicle sales are very brisk.

• With emerging markets hitting major speed bumps, America has maintained and increased its lead in key sectors and important technologies like aerospace, technology and health care.

• Corporate balance sheets are strong, and banks are very well capitalized.

Dividend-growth strategies had the winds at their back the last few years. Rates continued to fall, the economy improved, balance sheets were rebuilt and earnings bounced off depressed levels post crisis. 2015 saw a record number of dividends paid out. S&P 500 dividends grew 18.24%, 11.97%, 9.77%, and 9.19% the last few calendar years. Last year's 9.19% increase came with 0% earnings growth. Earnings are only expected to grow 4% this year. So we do not expect an indiscriminate advance for dividend growth.

So perhaps tailwinds turn into headwinds for dividend strategies, making dividend growth a scarce commodity in the years ahead. Simply running screens based on past dividend growth is unlikely to be able to exploit the full dividend growth opportunity set. Managers will need to be nimble, creative, and forward looking as the environment continues to get more discriminating. We feel confident in this environment, as thoughtful analysis and an ability to see past conventional wisdom has helped us navigate challenges in the past.