Berkshire
DIVIDEND STRATEGY

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1st Quarter 2018 Commentary

A "WILD RIDE" - Q1 2018

If you decided to not read any financial news for the quarter (a client practice we usually recommend), you might conclude stocks really went nowhere – and you would be partly right. The S&P 500 indeed finished the first quarter about where it started, finishing with a small decline of about 1%.

But what a 90 days in between! After the S&P 500 increased over 21% in 2017 (thanks in part to a select group of highly valued large-growth stocks), markets vaulted another 7.5% in the first few weeks of the year. Many analysts marveled not just at the scale of this upward march but also at its consistency. Stocks went over 400 days without a 5% decline – a record. A steady dose of upbeat economic news, including positive earnings revisions and fiscal/tax reform, created a positive feedback loop. As we discuss later, those positive forces remain largely in place.

But just 26 days into this seemingly utopian environment, things changed. The first bout of downward volatility was sparked by problems in a group of products that specialize in, ironically, volatility itself. Wall Street has all sorts of statistical tools to measure how volatile stocks can be, and through investment products derived from this math, retail and institutional investors can speculate whether volatility will increase or decrease. And since these instruments are often thinly traded and employ leverage, when the strategies 'go bad' (as they did in January) reverberations can be felt through the entire market... It was enough to trigger the first of two 10% corrections. Berkshire felt this correction was likely transitory and would be short lived - Stocks indeed recovered quickly, rising 10% in just two short weeks.

But by mid-March, stocks again got into trouble on three additional threats. The first was fear that the Fed might be even more aggressive in raising rates than expected – potentially opting for 4 rate hikes instead of 3 in 2018. Even though rising rates are a strong indication the economy continues to expand, it left investors sensing the Fed was preparing to "take away the punchbowl".

Then growth stocks, which had been propping up many indices, declined sharply as the widely publicized Facebook privacy scandal developed. Anti-Amazon tweets from President Trump accelerated the slide. Growth stocks in general have since come down from very lofty levels, giving value-oriented stocks a chance to close the gap.

What really has the market reeling, however, is the threat of trade war with China. Markets have worked themselves into a dither over every tweet and headline hitting the tape. This trade war concern has sent stocks down nearly 10% yet again.

To summarize these major gyrations: stocks up 7.5%, down 11%, up 10%, down 8%, up 5%, and down 2% to end the quarter. The trade war-induced volatility remains a factor as we write to you here in early April.

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

SEEKING FUTURE WINNERS IN TODAY'S LOSERS

This volatility hurt Berkshire performance in the short term, which is never desirable. It's human nature to worry about the short term, to want to optimize the immediate. But the reality is, moments like these – when investor attention is distracted by daily headlines – provide investors with the most meaningful opportunities for long-term advantage.

(*Consumer*) The consumer sector provided several examples of dislocation this quarter. This dividend yield-rich sector felt pressure as interest rates rose. Normally, growth prospects would help them power through interest-rate sensitivity. However, near-term growth prospects appear tepid for some bellwether names.

For example, non-discretionary consumer stocks like Kraft and General Mills slumped along with other consumer names in "Big Food." Investors question whether new eating patterns, delivery systems, and consumer preferences have reduced the value of these companies' products and brands. But after evaluation, we do not. We believe these companies have withstood the test of time and evolved into marketing powerhouses that will adapt to this new environment.

Kraft is a behemoth with disciplined and focused cost management and operating margins well ahead of its competitors. We expect KRFT will continue to make accretive purchases of global food companies over the next few years, acquiring small, less-efficient companies and brands and applying their highly successful cost management and economies of scale to the acquired businesses. In the meantime, our investors will collect a 4.2% dividend yield, growing at a 7% rate.

Another example in this segment was GIS' purchase of Blue Buffalo, which was not viewed favorably by investors and pressured the stock. But we view GIS' purchase of Blue Buffalo as a long-term positive with high potential upside. The category is a growth market and this brand under GIS management and distribution can become very accretive. Financed primarily with low-cost debt, this acquisition could enhance GIS earnings per share for years to come.

We would also point to Qualcomm (QCOM) as a case where headlines were a distraction. QCOM slumped when it rebuffed a takeover offer by Broadcom based on its own concerns the deal would not clear anti-trust hurdles. These fears were validated when the Trump administration declared the deal would fail based on national security concerns (Broadcom is a Singapore based company). However, lost in the conversation was the premium offer QCOM received, which we believe validates our long-term investment thesis.

Walmart had a shaky quarter as its e-commerce platform (geared to compete with Amazon) did not demonstrate as much progress as the market had hoped. Investors also didn't like the news of a potential large acquisition of a health insurance company.

(*Financials*) On the plus side, our allocation and selection to financials performed well as interest rates rose across the board. A flatter yield curve may crimp the benefit of higher rates, but the sector has other tailwinds that may outweigh these forces. A lower corporate tax burden and regulatory relief are good examples. Many of our selections here have diverse streams of revenue which go beyond rate-sensitive business and are more related to growth sectors like investment management and capital markets.

(*Tech*) Finally, our tech holdings also performed well vs. their tech peers and the market in general.

OUTLOOK/BOTTOM LINE

With this near term volatility, should investors be concerned, or optimistic? Let's set aside the headlines and focus on the factors really driving valuations in the market today.

Fears of higher interest rates have the market on edge.
But the stock market is sorting out a return to a more 'normal' interest rate world, where policy decisions are not held hostage by a 'crisis mentality' – a crisis that happened nearly 10 years ago. In a big-picture context, higher rates and policy normalization is a sign the economy is healthy – good for stocks in the long term. But as the first quarter shows, the path may be lumpy as the market rationalizes these changes.

World economy/Corporate earnings are on a roll.
For the first time in many years, all major developed areas of the world economy are expanding at the same time – particularly Europe and Japan. As a result of this economic vitality, U.S. company earnings are expected to expand by nearly 18%, with broad-based gains across many key sectors.

The Growth/Value gap is closing.
Typically growth stocks perform well when growth is hard to come by – investors "pay up" for growth. And as recent price declines at high growth companies (like Facebook, Amazon) demonstrate, they can be even more volatile than the average stock. But as the economy broadens, value stocks –which often move with economic cycles should do better. This is the case right now, and we see increasing opportunity in sectors like financials, and energy.

Tax reform is adding value.
The U.S. government is like the market's largest shareholder: through regulation of the tax code, the government has a claim on profits before any other shareholders do. And that claim just went down a great deal, freeing up significant profits. We expect

to see those profits benefit shareholders through share buybacks and dividends.

- "The tax act is a huge factor in valuation. You had this major change in the silent stock holder in American business who has been content with 35 percent ... and now instead of getting 35 percent interest in the earnings they get a 21 percent and that makes the remaining stock more valuable." *-Warren Buffett CNBC squawk on the street January 10th 2018.*

Valuations are attractive.
One constant about volatility is it tends to make valuations better, which we find compelling at a time when fundamentals are arguably improving. Stocks now trade for around 16 times earnings – most attractive levels over the past few years. Dividend yields and earnings yields remain very favorable.

Here's our bottom line: We believe positive secular forces are creating meaningful long-term potential that will outweigh the short term factors creating volatility. After such a long period of steady gains, a bout of volatility is not surprising, and it may continue in coming months. But we believe investors who focus on long term fundamentals rather than these short term concerns will benefit in time.

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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.