Berkshire DIVIDEND STRATEGY

Second Quarter 2016 Commentary

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"THE PRODUCERS"

In the famous Mel Brooks musical The Producers, the central character Max Bialystock needs to lose money. So he produces a musical he thinks will generate such negative reviews it'll undoubtedly flop. Ironically, the show ends up being seen as hysterical satire and becomes a huge hit. The more distasteful the bumbling Max makes the play, the more popular it becomes.

World economies are having a Producers-like moment of unintended consequences. Central bankers need banks to lend more, so central banks are utilizing negative interest rates as a policy tool. Under this arrangement, central banks charge interest (rather than pay interest) on the excess reserves banks hold.

Surely, the thinking goes, the distaste for negative rates will spur banks to lend money out, and expand credit. Businesses that borrow at low rates will in turn expand productive capacity, hire more workers and raise wages. Higher wages will spur consumer spending and a virtuous cycle of prosperity will get underway. But as in The Producers, using a negative incentive to try to push money out the door isn't working.

Since negative central bank interest rates mean very low profit margins on loans, bankers feel little incentive to take risks by lending out reserves. Why lend when they can just buy securities? Corporations are similarly defying expectations: why go through the exercise of hiring people, investing in new equipment, and expanding in the face of increasing regulation when they can just borrow (at super low rates!) and buy back their own stock?

And negative interest rates have spread beyond the banking sector to government bond markets. Liquidity is creating demand for income-producing assets, but it is now estimated that over $10 trillion in bonds – roughly a third of the bonds in the world – now carry a negative yield. That's right: buy a 10 year Japanese bond at today's prices, hold it to maturity and your return will be a negative -0.29% annually. Regulatory bodies like the SEC hate when advisors make guarantees, but we're pretty sure that transaction guarantees a loss.

In this world of low and negative rates, generating adequate investment income is difficult. The result? People like retirees, whose income relies on their assets rather than their labor are tending to save money rather than spend it – which slows the economy rather than stimulating it.

We think there is another reason super low interest rates are bad: they signal that central bankers have little confidence in their economies. Tighter policies or rate increases might build confidence.

In our view, negative rates are not the solution to sluggish economies but instead may be part of the problem.

Near the end of The Producers, Max laments: "How could this happen? I was so careful. I picked the wrong play, the wrong director, the wrong cast. Where did I go right?" Given how negative rates seem to have backfired, perhaps central bankers across the globe are wondering the same thing.

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

RECENT PERFORMANCE

As investors contemplate weak national economies and the added problem of the Brexit threat, interest rates have once again plunged to record lows. Markets both at home and abroad are volatile and choppy. Broad U.S. equities produced modest returns between 2 and 4%: respectable if not remarkable. Berkshire's Dividend Strategy rose well in excess of most U.S. large cap indexes.

At Berkshire, we attribute our strong relative performance partially to the decline in rates, which pushed U.S. large cap dividend-oriented equities higher relative to the rest of the world.

In addition, some of our larger holdings in the industrial and consumer space had very solid quarters. Finance-related companies have suffered from low interest rates, as it is difficult to generate attractive net interest margins.

Unlike many competing strategies, we did not own a lot of the top performing sectors like utilities or telecom companies – sectors that because of strong recent performance appear very expensive and offer low prospects for future dividend growth.

INVESTING IN A LOW RETURN WORLD

Given low rates, a sluggish economy, and choppy markets, can companies and investors still generate attractive returns? And if so, how? We believe they can and our results so far this this year bears us out – but good results in tricky circumstances require sharp focus.

Value Creating Money Managers:

In what is likely to become a more discriminating market, we feel offering a forward-looking, more nimble approach focused on "tangible" investing – solidly grounded in fundamentals, dividends, and buy backs – has the best opportunity to create value. This approach has helped us slowly but steadily muster attractive excess returns over recent periods.

Value Creating Corporations:

When top-line growth is flat and GDP is tepid, great companies can still build value by focusing on superior execution. Cutting costs, refining operations, and enhancing the brand optimize the current business while building leverage for when growth returns. Capable corporate managers create value for shareholders with stock buybacks or by growing their dividend. They can sell non-strategic assets and re-deploy cash. They can make acquisitions if prices are attractive.

Here are a few examples in Berkshire's portfolio:

- **GE (GE)** is reshaping the company by shedding GE Capital. It is winding down the portfolio, selling assets, and re-deploying the resulting funds to higher-margin businesses. Their SIFI designation (Systematically Important Financial Institution) has been dropped, which should provide considerable benefits by lowering their regulatory burden.
- **M & T Bank (MTB)** has completed some remarkably cheap shareholder acquisitions that will create significant shareholder value over time. Its latest capital plan was approved by regulators, which granted them permission to raise the dividend up to 8%.
- **Proctor and Gamble (PG)** is making great progress in sharpening its portfolio of products to enhance margins, a move likely to save the company $2.0-2.5 billion annually.
- **Nucor (NUE)** continually re-assesses operations to maintain its status as a low-cost producer in the steel industry. It makes strategic acquisitions when prices are low, grows the dividend commensurate with earnings, and repurchases shares opportunistically. As a consequence, they remained strongly profitable through the most recent commodity downturn, while most of their competitors' debt was downgraded to junk status.

On the flip side, we are disappointed in Microsoft's (MSFT) acquisition of LinkedIn, since we believe higher dividends would have made better use of their cash.

The current economic situation has investors cautious, especially overseas. With so many intangibles, we think our focus on tangible investing – solid evidence in support of our hand-picked cast of companies – offers the kind of carefully considered investment strategy our clients are looking for.

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