Berkshire DIVIDEND STRATEGY

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Third Quarter 2016 Commentary

EQUITY MARKETS YEAR TO DATE

Despite yet another serious worry at the macro level, stocks posted modest gains for the third quarter 2016. The quarter started with plenty of angst about Britain's surprise vote to leave the European Union. After a brief bout of volatility to the downside, stocks rallied back to new highs and then stayed locked in a tight trading range – the market went 44 days without more than a 1% daily move in either direction. As summer ended volatility started back up again. This time the US Federal Reserve was the culprit, as various Fed governors articulated tones ranging from hawkish (we should raise rates) to dovish (we should keep them low). The end decision was a little bit of both – the Fed kept rates the same yet strongly assured investors rate hikes were likely coming. Day-to-day, it is seemingly a desperately Fed-dependent market.

The net of all this gyration is US equity markets have posted mid to high single digits returns through the third quarter. The market's advance is somewhat broader this year than in 2015, when a few high-P/E stocks in the growth indices masked poorer results for the average stock in the S&P 500.

BERKSHIRE PORTFOLIOS

Berkshire portfolios have enjoyed broad participation in market gains year-to-date. True to form, our success reflects solid returns from individual stock picks. Big-cap technology stocks contributed nicely to our absolute return this year. Notably, Microsoft did well as it continued to thrive in emerging technologies like cloud computing.

Cisco has also captured new growth markets by leveraging its massive customer base. They provide leading solutions in wireless, data centers, cloud and importantly, security. All of these areas are growing smartly and Cisco has executed well. Among other contributors, our allocation to health care stocks also helped, with Merck and Johnson and Johnson making new highs.

Financials have been a mixed bag. On the one hand, earnings have been hampered by low interest rates, which are blinding investors to inexpensive sector valuations. On the other, regulators have given the green light for major players to raise dividends, which is very attractive to our strategy. A great example is M&T Bancorp. This well run bank did not have to cut its dividend in 2008, and focused on making strategic acquisitions during the aftermath of the financial crisis. With these acquisitions now fully integrated, the bank has greatly expanded earnings potential. Also, in disclosing their capital plans, M&T announced intentions to raise its dividend for the first time in over 8 years.

It's always important to talk about what we consciously avoided and for the most part that has been meaningful allocations to utility and telecommunication stocks. While they are top-performing sectors this year, many investors have stretched for yield and bid up valuations to what we think are unsustainable levels. More recently, rates have ticked slightly higher, and we've seen meaningful price declines in those sectors.

BERKSHIRE is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 29 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

- Stocks shake off macro worries; rally to new highs.
- Valuations remain in line with historical averages.
- A quiet summer ends with the threat of higher rates.
- Stock picking proves effective for Berkshire portfolios.
- Addressing investor concerns: time is on your side.

'THE MARKET IS UP BUT…'

Despite the advance, we sense investor unease persists. For example, we cite a quote from a client who runs a small industrial company: "The market is at all-time highs, yet things are terrible! We need to wait until these things get sorted out." He then rattled off issues that concern him: slow demand in his business, slow US demand, European bank troubles and of course the Presidential election in the US – just to name a few.

It's a common and understandable assessment of how investors process the current environment. Yes, the market is near all-time highs, but valuations are not. They are not "give away values," just low enough to offer modest appreciation – given an intermediate to long-term time horizon.

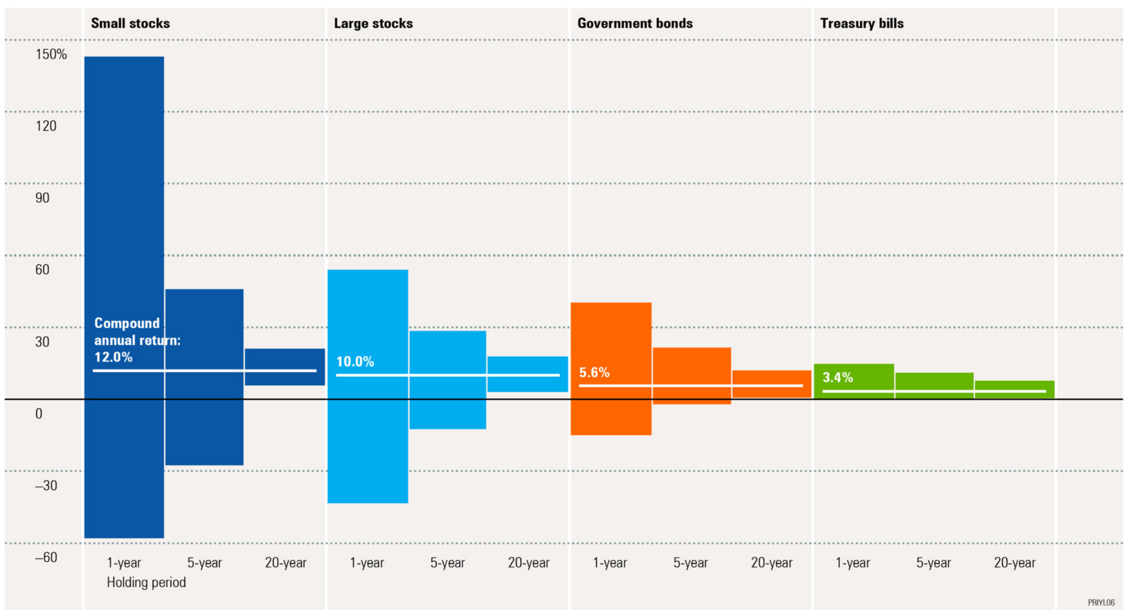
When there are no visible worries, prices can get bid up to dangerously high levels. We don't feel prices are at euphoric and unjustified levels where they threaten to impair client's long term investment objectives (although, some utility or telecom stock valuations look very stretched).

It's usually unwise to try to guess where the market is going over the next 90 days but we feel confident the next 3-5 years will bring mid to high single-digit returns for stocks. While near term challenges exist, there are many secular positives. American companies are leaders in many emerging industries with strong platforms for growth: the internet of everything, robotics, 3-d printing, technology advances, advances in health care, the sharing economy, and rising incomes in the emerging markets.

The events of the Great Recession exposed some unattractive corners of the financial markets which still weigh on investor psychology. But from a longer-term perspective, the market is behaving now much as it has done historically and the long-term odds of asset growth are very much in investors' favor.

Consider:

- Annual returns in the stock market have been positive 27 of 36 calendar years.
- Large-cap stocks have trounced the returns of many other asset classes by an overwhelming margin. Since 1926 these stocks have compounded at 10%, while government bonds and inflation have averaged only 5.6% and 2.6% respectively.
- On a year to year basis, stocks are more volatile and corrections in any one year average about -14%. This volatility is just the price of striving for higher returns. There have been only two periods in the last 80 years when 10-year rolling returns were negative for the S&P 500 – we just completed one of them during the 10-year rolling period ending 2008.
- From the Morning Star chart below, you can see that time greatly reduces the variability of returns. As time horizon increases your range of probable returns significantly decreases.



We don't want to dismiss the fear investors may feel on a daily basis. It is clearly understandable given the swings in the market and the sensationalized nature of a lot of news media. But clearly time is on investors' side. In our view, all that is required to capitalize on those good long term odds is a consistent stock picking strategy with a strong, long-term record of success. Berkshire's approach of picking recognizable, high-quality companies with enduring cash flow is such a strategy, and we think it's a recipe for long-term growth and a good night's sleep.