Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: "Priced To Perfection" + Zone Stealing? – *March 23rd, 2018*

This week was highlighted by meaningful change in market tone and some notable rotations occurred. The decline in the growth/tech sectors, seemed to be ignited by the Facebook/Cambridge Analytica scandal and to a lesser degree Uber's self-driving pedestrian fatality. The public reaction to Facebook is somewhat interesting as data collection really is their business. One analyst reminded us: "Remember, if you are on social media and the product is free, then *you are the product*." Fears of higher regulation and reminders of what can go wrong with emerging technologies took some shine off the booming tech sector.

Selling seemed to spread after the Fed's announcement late Wednesday. Some pundits called the remarks "hawkish" some called it more "dovish." Markets, the ultimate arbiter, sent mixed signals - Gold was higher (dovish reaction), the dollar was lower (dovish reaction). The curve initially flattened then steepened. Ironically, stocks were mostly lower and if the market really believed Powell was more dovish they should have probably rallied.

Our bottom line? This market is sorting out a return to a more normal world, where policy decisions are not held hostage or dictated by a crisis that happened nearly 10 years ago. And that, over the longer horizon should be good for stocks. The path from here is likely to be lumpy as the market fully rationalizes these changes.

Trade war escalation also acted as an additional negative catalyst Thursday.

Maybe it's the Facebook story, maybe its valuation, but value is having a pretty darn good week relative to growth indexes and the S&P 500. We know many advisors have been working hard to defend value positions. So, last week we shared some new macro charts on the issue:
Berkshire – Growth Value and Volatility

Growth Stocks "Priced to Perfection"?:

The market has been enamored with growth stocks lately as they have outperformed value stocks by a wide margin. But Investors should keep in mind valuations matter and many of the FAANG stocks are "priced for perfection". Amazon is a 'prime' example. Most would agree Amazon is one of the best companies in the world with a long runway of growth and a dynamic business model.

However, what price is too high for Amazon?

AMZN currently trades at 182 times 2018 estimated earnings. Simple P/E analysis may not be appropriate given AMZN is still in high growth phase and margins are low. Many believe Bezos could raise margins easily but he would rather spend heavily on SG&A and R&D to continue AMZN's dominance and expansion into new markets.

So let's assume AMZN can achieve a 6% net margin by 2023. That's a pretty aggressive assumption considering peak margins for Walmart are roughly 3.5%. Walmart has more than twice the sales of AMZN and better pricing power when it comes to negotiating with vendors. AMZN bulls would argue an internet based retailer without the expense of brick and mortar locations could be much more profitable. But that's not entirely true since internet retailers have higher R&D expenses related to technology which can offset some of the advantage. Plus real estate is not pure expense, real estate has intrinsic value for a company's balance sheet.

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.

Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

Next, let's assume AMZN can grow sales over the next 5 years at a blistering 22% per year. That would put sales at roughly $630 billion. Using a 6% net margin, AMZN would generate $38 billion in earnings. We estimate shares outstanding in 2023 will be about 530 million which drives eps of $71. If you own the stock today and require an annual 10% return, Amazon stock would need to be trading at $2486 which would equate to a P/E 35x – and that's IF it delivers on the assumption stated above.

Said differently, *if you pay today's price and "perfection" happens, the investor earns 10% annually* - Right in line with average equity returns.

Our point is Amazon needs to execute flawlessly and continue to grow at a blazing pace which becomes much harder as numbers get significantly larger. As we saw with Facebook earlier this week, things can go wrong. What if the Whole Foods acquisition doesn't pan out as expected? What if other retailers catch up? Or, what if Amazon shifts gears and decides to buy Toys R Us stores out of bankruptcy to open Amazon retail locations?

With respect to our growth manager friends, it's important to remember valuations can't grow to the sky and the price you pay for a stock determines your unique rate of return. Plus, when corrections occur the aftermath is usually very unpleasant. Given how popular these stocks are, we feel it's important to equip our advisors with ideas and concepts which can help keep their clients from simply chasing returns.

Defend Your Defense:
Tonight the March Madness continues as Syracuse faces off against Duke.
Did Duke steal key elements of Syracuse's famously effective 2-3 zone? What do you think?
http://www.newsobserver.com/sports/college/acc/duke/duke-now/article205985439.html

Give us a call with thoughts/questions!
Regards,
- Gerry

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