Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: The "Vol Of Vol" + Olympian, Advisor Evolution – *February 9th, 2018*

Correction Territory: Technical or Fundamental?

Heading in to last weekend, the rise in interest rates spooked the market and triggered significant volatility, reflected in the VIX spike. After months of steady increases, it's as if the collective investment community finally remembered "oh yeah stocks actually can go down!" and then went looking for reasons to support a decline.

We just don't ascribe to the view higher rates will set off a major correction. Why?:

- Rates are rising because the economy is steadily improving
- We are still far from 'normal monetary policy' - even after recent hikes, rates are very low and accommodative
- "Yeah, but what if the ten year goes to 4%?" Well…show me the corresponding S&P 500 earnings. They would probably be quite robust.

Ultimately, price/earnings ratios are a *dynamic interrelationship of 3 variables*:

- interest rates (a risk free rate + a premium for risk)
- current earnings
- earnings growth

This relationship is simply a law of finance. As long as earnings and earnings growth are strong, the foundations are there for investment gain, even as rates rise.

So what to root for…higher rates or lower rates? When rates go down a lot (like we saw earlier this week), it's usually a sign of panic. As an investor, I'd much rather see the "higher rate/better economy" narrative keep going, and take my chances it's a sign earnings are going to stay on their current roll.

Dissecting VIX Problems:

You never know exactly how the dominoes fall. But it appears Friday's rate action sparked an increase in "volatility" which set off problems in the world of…volatility/VIX related products and strategies. It's kind of ironic but as you think about it, "volatility" itself is quite volatile! It moves from quiet to violent in no time.

An (Oversimplified) Formula for Trouble in VIX ETNs

- Short VIX futures contracts at a premium
- Let contracts roll down the abnormally steep futures curve, creating natural price decline
- Cover trade at lower price in with cheaper near-term contract…the fund benefits

Two problems arose Monday…

- **Absolute rise in VIX:** because these strategies were shorting VIX futures at such low levels, when volatility spiked they suffered big losses on the absolute short position.
- **Inverted VIX futures curve:** instead of shorting and gaining from the price decay created by the future rolling down a steep curve, the VIX curve inverted. Now the short position rolls UP an inverted curve, forcing the strategy to cover at higher levels, creating losses.

Futures are inherently leveraged instruments. This accelerated the mad scramble to unwind these trades. There are also strategies which use VIX levels to create asset allocations and risk exposures. They add money to stocks when VIX is low and sell stocks when the VIX spikes.

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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.

We believe the unwinding of these trades is behind much of the turmoil. Throw in: a market near all-time highs, possibly overdue for a correction, and we were ripe for selling pressure to spread. Sometimes selling creates selling, so it's always hard to call a bottom. But we believe the ultimate arbiter for the market's fate will be earnings, which still appear to have considerable momentum.

So while this event is not "nothing", in general we think this market pullback tilts toward short term/technical in nature, and a possible opportunity for advisors to deploy some cash. With volatility high, our earnings-focused strategy is a great option for those who have been waiting for a correction.

Update on Portfolio/Stocks of Interest

An important question from one of our Advisor partners – how is the portfolio holding up?

We track our model portfolio in real time and as the market sells off it appears to be acting as we hope – capturing less downside than broader markets. But the turmoil gives us opportunity to evaluate some of our holdings with a more critical eye.

General Electric (GE)

As upset as we were when GE first cut the dividend, we viewed it as a severe yet manageable earnings downturn. We even could foresee reasonable paths to re-raising it over 12-24 months. At that time, we felt owning a contrarian name, beaten down as it was, had a place in a portfolio filled with quality.

Now, after the latest series of bombshells (health care contracts, SEC investigation) the balance sheet problems are larger and a path to renewed dividend growth is far more difficult. As we emphasize growing cash flow in our strategy, we are contemplating exiting the position - regardless of current yield, or how cheap it may appear on a P/E or sum-of-the-parts basis. It's a strategy-specific evaluation – our decision could be vastly different in a strategy with a different objective. Stay tuned - all views subject to change.

Qualcomm (QCOM)

Talk about a head scratcher…This week Broadcom (AVGO) offered a 40% plus premium to acquire Qualcomm (QCOM) and Qualcomm goes…DOWN?

We are quite pleased that a rational, industry-oriented acquirer validates the value we see. Management at QCOM has had years to translate its attractive assets into a much higher share price--and has failed to do so. Therefore, we lean to giving new management a chance and receiving $82 share would give us a big vault toward that goal.

Winter Olympics start tonight!

Today's Olympic athletes look and perform nothing like they did 20-100 years ago.
Their methods have changed, evolved and the results have been dramatic!

Here is an awesome two minute video of athletes in action – then and now - and how they evolved…
https://qz.com/757648/it-isnt-olympians-who-have-evolved-its-sports/

Similarly, today's advisory business looks nothing like it did 10, 20 or 30 years ago. More change is coming!

- What will your business look like 3, 5, 10 years from now?
- How will your business methods evolve?
- Will your business evolution and results be as dramatic as the athletes in the video?

Best Regards,
Gerry

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