



Berkshire

DIVIDEND STRATEGY

Gerard Mihalick, CFA
gmihalick@berkshiream.com

46 Public Square
Wilkes-Barre, PA 18701
570.825.2600

3rd Quarter 2018 Commentary

THIRD QUARTER 2018

U.S. large cap equities continued to defy many nay-sayers, with most indices rising at a rate squarely in the mid-single digits for the quarter. We are pleased to report clients invested in our equity strategies largely kept pace with those broad averages.

These positive results were once again driven by a strong U.S. and, to a lesser extent, strong global economy. U.S. GDP is growing at an annualized rate just over 4%. Most other economic regions of the world are also expanding as well, some faster some slower, but for the first time in a while, there is a bona fide synchronized global expansion going on.

Corporate earnings, especially in the United States, continue to impress. Earnings estimates are now on pace to grow 32% for all of 2018. This comes after they grew over 12% in 2017.

In past quarters, we have noted that much of the gains of the equity market have been concentrated in a few growth stocks. This quarter we've seen that start to turn, as investors are realizing attractive growth and solid business results can be found throughout a broad range of U.S. companies – not just in technology. Energy, health care, financial and industrial-related industries, large areas of focus for our strategy, are delivering double-digit earnings increases and raising their dividends, yet their stock prices don't seem to fully reflect the good news.

As usual there are macro threats and opportunities, but on balance we don't see anything on the horizon that would prohibit our clients from participating from the attractive long-term returns (5 years and beyond) that equities generally afford. Yes, it has been a long time since there has been a meaningful correction, and those are to be expected, but are very difficult to time. They just come with the territory of investing in equities.

Speaking of corrections, this fall marks the 10-year anniversary of the financial crisis of 2008. It is not lost on us how far the financial system has come since those dark days. The one lesson? As dark as those times were and as serious as it was, the U.S. financial system is nothing if not resilient, dynamic and enduring. We hope you will find that reassuring during any inevitable bout of volatility to come.

FINANCIAL CRISIS REWIND ROOT CAUSES AND LESSONS LEARNED

To mark the 10-year anniversary, we felt we would review those fateful events with an eye towards lessons that can be applied today. Many articles we read *summarize* the crisis. But what good is history if you can't use some of its lessons to be a better investor?

In 2008 the highly charged worlds of media, politics and finance collided and culminated into a financial cataclysm for the world's largest economy. It was difficult watching many of the holdings we had such faith in decline in value and hurt client portfolios – and confidence. Berkshire is truly a believer in the power of equities over time, so it was very disheartening to watch the

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 30 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

- Bull market run continues, supported by strong GDP, earnings growth
- The market begins to broaden beyond technology
- Value stocks turning?
- Financial Crisis Rewind: Seeds of crisis and lessons for today

confidence and faith just drain out of the U.S. financial system from October of 2008 to March of 2009 and beyond. But Berkshire had a couple advantages. The first is that we and importantly our clients, are focused on the long-term – we knew a good strategy could overcome short-term losses with long-term gains. The second is we understand fundamental value and company quality. We knew that some companies would survive the mayhem and grow once more.

Of course the natural reaction is to find a villain and to sensationalize:

- “How could this happen?”
- “Who is responsible for this?”
- “How can we prevent this from happening again?”

Politicians wanted to blame the banks, banks wanted to blame the speculators, and of course each political party wants to blame the other. Given the magnitude of the crisis, the words “finger pointing” don’t seem to do it justice.

So how did it all start? How far back does one have to go? Should we go back to the very first quasi government sponsored entity that attempted to influence home buying or the real estate market? After all, many investment models behind the crash had nearly 100 years of real estate data that said “home prices only go up.” Perhaps by artificially lowering the cost of capital through government intervention home prices were artificially propped up. Wikipedia defines the first Gov. Sponsored Enterprise as the Federal Farm Credit System, 1916, and The Federal Home Loan Bank in 1932. *“Their intended function is to enhance the flow of credit’ to targeted sectors of the economy and to make those segments of the capital market more efficient and transparent, and to reduce the risk to investors and other suppliers of capital.”*

Or should we blame the 9/11 attacks which caused a painful recession, lowered rates and pushed investors away from stocks and into a real estate bubble? As we see it, the story is very entangled. It’s hard to synthesize an event 100 years in the making.

But the modern day part of the story probably starts with Fannie Mae. If 2007 - 2008 was the giant oak crashing down, the early and mid 90s created the massive root system.

Lending standards began to change drastically in 90s. Fannie Mae ramped up easy lending standards and the banks followed. Many third parties (Boston Fed included) fueled the flame by publishing research on the issue showing discriminatory lending practices across the industry. Congress pushed Fannie Mae and Freddie Mac to deviate from their traditional 20% down mortgages to accept smaller down payments and sub-prime mortgages in order to put lower income citizens on the path to homeownership. It may have been a noble pursuit but it had the effect of creating excess demand for real estate and pushed housing prices higher. Banks

assumed real estate prices across a diverse geography never go down. Virtually no bank or rating agency even had a model incorporating a scenario of falling home prices.

The mid 1990s also saw a proliferation of derivative mortgage instruments such as collateralized mortgage obligations (CMOs) and later collateralized debt obligations (CDOs). Fannie basically set the guidelines to relax lending standards and sell the loans into the market – with the promise of a government guarantee. These relaxed lending standards came with additional risk to the underlying mortgages. But through the wizardry of finance Wall Street felt these risks could be mitigated.

In time the system grew. Non-traditional mortgage and credit providers emerged. New technology created sophisticated quant systems to model and “mitigate risk.” And of course a new breed of real estate mortgage investors emerged – those who wanted to own real estate directly or those who sought higher incomes from securities derived from real estate. This made asset managers and hedge funds all too happy to create and market new structures. And since everyone believed real estate “never goes down” what could possibly go wrong?

For a while this system was a finely tuned mortgage creation machine which could efficiently generate massive volume. Everyone (politicians, investors, Wall Street) was all too happy. That was, until cracks started to emerge in late 2006.

So, how did it start? What was the true catalyst? Who was to blame? In the final analysis we think the best answer is...no one really knows for sure.

APPLICATION FOR TODAY’S INVESTOR?

Why go through the exercise of laying out the seeds of this crisis?

To reinforce our belief that “intelligent investing” (of any kind) or true understanding of finance does not lend itself to mechanized thinking, rules, and oversimplifications.

As we described above, financial systems or the forces that move a market or a stock involve an intricate web of diverse players, with complicated and constantly changing connections.

If the events of the financial crisis taught us anything, it’s:

1. Realize the limitations of backward looking data. (even if it’s a 100 year data series!)
2. Invest with an eye to the future, incorporating as many variables as possible vs. a narrow set of static criteria.

3. Don't try to sidestep corrections, but expect them, and allocate a portion of your assets to preservation strategies with money you don't want to see decline in value by a bear market.
4. Selling into a panic is rarely a good idea. A few smart (or maybe lucky souls) got out of the market in the middle of the crisis, sparing a large draw down. But many of those same investors failed to get reinvested and missed a record bull run. Cash may be comforting in the short term, but usually loses out to inflation.
5. Keep focused on your overall plan for the long term, not what the market is doing on any one given quarter or series of quarters. Investing for cash flow plays a powerful role in this. As long as dividends and interest are flowing and covering a good part of your annual cash needs, there will be little need to panic during the next downturn.
6. Investors rarely catch market bottoms or tops as they attempt to capture opportunity. The Nasdaq looked expensive through the third quarter of 1999...then went up nearly 50% in the fourth before it began its famous crash. For those brave souls who allocated more money to equities in October or November of 2008 – and stuck with it! – they were rewarded handsomely over the years but first endured a gut wrenching drop. Even Warren Buffett, who likely made a killing through the crash, wrote his famous editorial “Buy American. I am.”... in October 2008.
7. The media is a powerful amplification mechanism. They get paid to sell ratings, so its usually never as good or as bad as it seems on financial news.
8. Transparency and simplicity matters. Many investors have lost fortunes panic selling. We believe the more complex the strategy is, the more likely it will be sold during times of distress. So we suggest a “keep it simple” approach: buy good businesses you know and understand and own them for long periods of time.
9. The U.S. financial system is extremely resilient. The system took on one of the greatest shocks ever, yet failed to be permanently impaired. In many ways, it has emerged stronger, eventually providing investors with handsome gains. Never count out the U.S. financial system.
10. An investment firm is really only as good as the quality of its client base. And on that score, Berkshire is most grateful to work for a great group of clients who know and trust us, and have stuck with our strategies in good times and bad. We hope by sticking with us and your stocks you have been rewarded.

Contact Berkshire:

Gerard Mihalick, CFA, Portfolio Manager,
gmihalick@berkshiream.com or (570) 825-2600

Jason Reilly, CFP®, VP Distribution,
jason@berkshiream.com or (570) 825-2600

1Lemke, Lins and Picard, Mortgage-Backed Securities, Chapters 1 and 2 (Thomson West, 2013 ed.).

Berkshire Asset Management is a fee-based, SEC registered advisory firm serving the portfolio management needs of institutional and high-net worth clients. Registration with the SEC or any state securities authority does not imply a certain level of skill or training. The views expressed reflect those of Berkshire Asset Management, LLC (Berkshire) as of the date of the commentary. Any views are subject to change at any time based on market or other conditions, and Berkshire disclaims any responsibility to update such views if you are not a client. This presentation is not intended to be a forecast of future events, a guarantee of future results or investment advice. Because investment decisions are based on numerous factors, these views may not be relied upon as an indication of trading intent on behalf of any portfolio. The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by Berkshire as to its accuracy or completeness. Risks: Past performance does not guarantee future results. All investing carries risk including risk of principal or income loss. Dividends are subject to change, are not guaranteed, and may be cut. Investing based on dividends alone may not be favorable as it does not include all material risks. There is no guarantee any stated (or implied) portfolio or performance objective mentioned by Berkshire can be met. Berkshire's equity style may focus its investments in certain sectors or industries, thereby increasing potential volatility relative to other strategies or indices.

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.