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Berkshire Hathaway Annual Letter: Cheap and Wonderful

March 1, 2016

At Smead Capital Management, we have great respect for the most successful long-duration investors. Warren Buffett is among those investors. He gives the public access to his thinking in his annual Berkshire Hathaway shareholder letter. In his recent 2015 letter, he reminded readers of a few of the things that should matter most to investors. We at Smead Capital Management like to buy wonderful companies at cheap prices. Buffett's letter dwells on the need for businesses to be cheap in a wise way. He also reviews what makes a company "wonderful."

Warren Buffett explains in emphatic terms how cheap Berkshire shares are on both a book value and intrinsic value basis. In the opinion of Smead Capital Management, if you read between the lines of his letter, he is screaming a buy recommendation on his own shares:

> *"Over time, this asymmetrical accounting treatment (with which we agree) necessarily widens the gap between intrinsic value and book value. Today, the large – and growing – unrecorded gains at our "winners" make it clear that Berkshire's intrinsic value far exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as 120% of book value. At that level, purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders."*[1]

Buffett goes on to describe how cheap his largest common stock holdings are and how much Berkshire has increased their holdings in each company. This is a strong endorsement of Wells Fargo and American Express, two stocks that we own in our portfolios whose prices have faltered in the last year:

> *"Berkshire increased its ownership interest last year in each of its "Big Four" investments – American Express, Coca-Cola, IBM and Wells Fargo. We purchased additional shares of IBM (increasing our ownership to 8.4% versus 7.8% at yearend 2014) and Wells Fargo (going to 9.8% from 9.4%). At the other two companies, Coca-Cola and American Express, stock repurchases raised our percentage ownership. Our equity in Coca-Cola grew from 9.2% to 9.3%, and our interest in American Express increased from 14.8% to 15.6%. In case you think these seemingly small changes aren't important, consider this math: For the four companies in aggregate, each increase of one percentage point in our ownership raises Berkshire's portion of their annual earnings by about $500 million.*

These four investees possess excellent businesses and are run by managers who are both talented and shareholder-oriented. Their returns on tangible equity range from excellent to staggering. At Berkshire, we much prefer owning a non-controlling but substantial portion of a wonderful company to owning 100% of a so-so business. It's better to have a partial interest in the Hope Diamond than to own all of a rhinestone."[2]

Warren describes his largest stock holdings as "wonderful" companies. This is different from most investors, who use stock price fluctuations to determine if a company is "wonderful." Most investors associate the recent poor performance in share prices of Berkshire Hathaway's holdings in Wells Fargo, Coca-Cola, American Express, Bank of America and IBM as conclusive evidence showing they are anything but "wonderful". Herein lies the advantage that we believe Buffett and the "Super Investors of Graham and Doddsville" have. At Smead Capital Management, our ideology seeks to capture this advantage as well.

The wonder of a business is found in what it does to meet a need and the moat built around its value proposition. We believe that exceptional corporate performance can be measured by high return on equity, high free cash flow, consistent profitability and strong balance sheets. Metrics such as these are inherently "weighing machine" concepts. Far from complaining about the short-term "voting machine" of the market, long-duration common stock investors can take advantage of the inefficiencies it offers. Short-run volatility does not bother Buffett and, in our opinion, should never bother long duration common stock investors.

Buffett loves operating managers and businesses who are "cheap" in a wise way. They watch every penny, while growing expenses only to become more productive. He points out how much more is produced by these stable businesses while using fewer humans than in decades past. He uses sweeping productivity gains in America to help us understand:

"In 1900, America's civilian work force numbered 28 million. Of these, 11 million, a staggering 40% of the total, worked in farming. The leading crop then, as now, was corn. About 90 million acres were devoted to its production and the yield per acre was 30 bushels, for a total output of 2.7 billion bushels annually.

Then came the tractor and one innovation after another that revolutionized such keys to farm productivity as planting, harvesting, irrigation, fertilization and seed quality. Today, we devote about 85 million acres to corn. Productivity, however, has improved yields to more than 150 bushels per acre, for an annual output of 13-14 billion bushels. Farmers have made similar gains with other products.

Increased yields, though, are only half the story: The huge increases in physical output have been accompanied by a dramatic reduction in the number of farm laborers ("human input"). Today about three million people work on farms, a tiny 2% of our 158-million-person work force. Thus, improved farming methods have allowed tens of millions of present-day workers to utilize their time and talents in other endeavors, a reallocation of human resources that enables Americans of today to enjoy huge quantities of non-farm goods and services they would otherwise lack."[3]

We at Smead Capital Management have grown tired of the naysayers who claim there is a limited opportunity to make money in companies tied to the US economy. We are glad to know that we are not alone. Buffett points out that the US economy is still "wonderful" and should create ever higher standards of living in the next 30 years:

> *"It's an election year, and candidates can't stop speaking about our country's problems (which, of course, only they can solve). As a result of this negative drumbeat, many Americans now believe that their children will not live as well as they themselves do.*
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> *That view is dead wrong: The babies being born in America today are the luckiest crop in history.*
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> *American GDP per capita is now about $56,000. As I mentioned last year that – in real terms – is a staggering six times the amount in 1930, the year I was born, a leap far beyond the wildest dreams of my parents or their contemporaries. U.S. citizens are not intrinsically more intelligent today, nor do they work harder than did Americans in 1930. Rather, they work far more efficiently and thereby produce far more. This all-powerful trend is certain to continue: America's economic magic remains alive and well.*
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> *Some commentators bemoan our current 2% per year growth in real GDP – and, yes, we would all like to see a higher rate. But let's do some simple math using the much-lamented 2% figure. That rate, we will see, delivers astounding gains."*[4]

The Berkshire Hathaway annual shareholder letter once again gives us continued confidence as long-duration common stock holders. We believe our portfolio is made up of "wonderful" companies like Berkshire Hathaway, Wells Fargo and American Express. We continue to look for cheap use of capital by wise business managers. We are also committed to seek out quality companies via our eight criteria for common stock selection in our portfolio and our future investment opportunities.

Warm Regards,

William Smead

[1]Source: *2015 Berkshire Hathaway Annual Letter (http://www.berkshirehathaway.com/letters/2015ltr.pdf), p. 2.*
[2]Source: *Ibid, p.6*
[3]Source: *Ibid, p.20*
[4]Source: *Ibid, p.6*

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