WOODSTOCK FOR CAPITALISTS

"Think of all the people you know who tried to take one last step and fell off a cliff."

-CHARLIE MUNGER ANSWERING THE LAST QUESTION OF THE DAY.

An estimated more than 42,000 shareholders, including Avalon's CIO Bill Stone, descended upon Omaha for the annual meeting on May 4, 2019, with a chance to listen to Warren Buffett and Charlie Munger answer questions for almost 6 hours. As usual, the meeting started with a movie which had a medley of past skits along with a new piece about Buffett's secret project with Apple (AAPL). He turned out to be developing a newspaper toss game app, which you can actually download in the iPhone app store, called Warren Buffett's Paper Wizard.

Buffett began the meeting discussing the first quarter earnings for Berkshire Hathaway (BRK/A, BRK/B). He again noted the relatively recent accounting change directing firms to mark publicly traded securities to market and show that gain or loss in the income statement. He continues to voice his opposition to the change and I must agree with Buffett and Munger that this makes little sense for a firm like Berkshire as it adds no clarity for owners. This first quarter earnings report was a great example of this issue with Berkshire posting a massive swing in earnings from a loss in 1Q 2018 to huge earnings of $21.7 billion in 2019 due to the stock rally when in reality the operating earnings were up about 5% year-over-year (Table 1). The change in market value of the securities was always reflected on the balance sheet, so this accounting change provides little in terms of additional information for shareholders.

TABLE 1

Earnings of Berkshire Hathaway Inc. and its consolidated subsidiaries for the first quarter of 2019 and 2018 are summarized below. Earnings are stated on an after-tax basis. (Dollar amounts are in millions, except for per share amounts).

	First Quarter 2019	First Quarter 2018
Net earnings (loss) attributable to Berkshire shareholders	$ 21,661	$ (1,138)
Net earnings (loss) includes:		
Investment and derivative gains/losses –		
Investments	15,498	(6,263)
Derivatives	608	(163)
	16,106	(6,426)
Operating earnings	5,555	5,288
Net earnings (loss) attributable to Berkshire shareholders	$ 21,661	$ (1,138)
Net earnings (loss) per average equivalent Class A Share	$ 13,209	$ (692)
Net earnings (loss) per average equivalent Class B Share	$ 8.81	$ (0.46)
Average equivalent Class A shares outstanding	1,639,821	1,644,958
Average equivalent Class B shares outstanding	2,459,731,886	2,467,436,888

Source: Berkshire Hathaway

Share repurchases were a significant topic during the meeting. Berkshire changed its policy regarding share repurchases and the company bought back $1.7 billion of shares in the first quarter. Buffett noted that they would be willing to buy back significant quantities of stock, perhaps as much as $100 billion. The pace of repurchases really depends on price and whether the purchase would add value for the remaining shareholders. Buffett added that if the stock gets cheap, he won't hesitate with repurchases. When Berkshire thinks about the publicly traded stocks that they own, stock buybacks are also generally viewed as a positive. Buffett noted that a major portion of Apple's earnings in the future will be spent via repurchases to increase Berkshire's ownership.

CHART 1

Source: Bloomberg as of 5/4/2019

Speaking of technology, Berkshire recently disclosed a purchase of Amazon (AMZN) shares. Berkshire's largest publicly traded stock holding is currently Apple (AAPL). While the AMZN shares were bought by one of his lieutenants and not Buffett himself, it does show the larger impact of technology even on Berkshire which has historically eschewed purchases of tech shares. Bloomberg recently noted that M-FAANG (Microsoft, Facebook, Amazon, Apple, Netflix and Google) now together account for almost one-fifth of the market capitalization of the S&P 500 (Chart 1). Buffett defended the AMZN purchase as still being consistent with their value philosophy. He went on to note that "all investing is value investing" and that the considerations are identical when you buy a technology stock or a bank stock. Munger added in strong language that he made a mistake in not purchasing Google (GOOG) despite being very familiar with their products. He noted that perhaps the Apple purchase was "atonement" for the Google miss.

With all the recent political talk about socialism, it wasn't a surprise that the subject came up during the Q&A. Buffett noted his past personal support for some Democratic presidential candidates but noted that he was a "card-carrying capitalist." He further stated that "I don't think the country will go into socialism in 2020 or 2040 or 2060." Munger touched on income inequality by positing that the response to the financial crisis caused policymakers to flood the world with liquidity with interest rates at zero which helped the rich more than others by inflating asset prices which were an accidental byproduct of the action. In his view, this is a temporary situation that will revert over time and that we "shouldn't worry so much that one class is ahead of another."

Surprisingly, it took until late in the meeting for Berkshire's recent transaction with Occidental Petroleum (OXY) to be mentioned. Berkshire agreed to invest $10 billion in Occidental as that company seeks to win the deal for Anadarko Petroleum. The funding arrangement consisted of preferred stock accruing eight percent dividends along with warrants. Buffett spoke about how Berkshire will be a resource for companies seeking financing. The speed at which Buffett can get deals done and that companies can trust that the money will be available can be a competitive advantage. Buffett said he was contacted last Friday afternoon and by Tuesday the companies had an official statement. This was at least another part answer as to how Buffett plans to deploy Berkshire's $112 billion cash hoard.

Another topic that came up frequently during the meeting was "circle of competence." Buffett used a quote by Tom J. Watson to illustrate the concept. Watson said, "I'm no genius, but I'm smart in spots, and I stay around those spots." This applies to technology stocks because Buffett and Munger had long stated that tech stocks were outside their expertise. But the addition of two investment managers, Todd Combs and Ted Weschler, has increased the circle of competence for the firm. Buffett discussed that investing is much harder now than when they started since it is much more competitive, so it is even more important to know where you have an edge. Expand your circle of competence if you can but discard areas where you learn that you are incompetent. Buffett suggested a "whole lot of reading" to improve knowledge and understanding. The Munger quote to start this update was an explanation about the dangers of going beyond the perimeter of your circle of competence.

There was also quite a bit of discussion about Kraft Heinz (KHC). Buffett pointed out that Kraft Heinz hasn't yet filed its 10-K, so they have not yet released first quarter earnings and Berkshire isn't including them in its results as it usually would. Buffett emphasized that the problems are primarily due to 3G and Berkshire overpaying for Kraft. He did note the competitive threat to brands now that Amazon itself has become a brand and Costco has Kirkland. Buffett gave two specific facts about the operational strength of the business: Kraft Heinz earning about $6 billion on $7 billion in tangible assets and it is earning more money than the two companies were earning separately years ago. In discussing Kraft Heinze Buffett provided two very important investment insights:

You can turn any investment into a bad deal by paying too much.

The business does not know how much you paid for it; it's going to earn based on its fundamental.

Buffett and Munger touched on some other important investment topics which I will summarize below:

When asked about "delayed gratification," Buffett used long-term bonds as an example where delayed gratification might not make sense because taxes and inflation will eat away at the returns. Clearly, Buffett still doesn't find long-term bonds an attractive investment, but this isn't a change, particularly from recent years.

BREXIT: Buffett also said, though he's not an Englishman, he thinks it was a mistake for the U.K. to vote to leave the European Union. Brexit doesn't destroy his appetite for a large deal in the U.K. or Europe and he would "get on a plane" tomorrow for the right opportunity, Buffett added. Munger said, "It strikes me as a horrible problem, and I'm glad it's theirs and not mine."

Buffett explained how the energy businesses have wind investments in response to a question about Environmental, Social and Governance (ESG) rankings. But he doesn't want their businesses spending time filling out reports about all those things to just score well for ESG. Buffett also pointed out that so-called independent directors aren't always the advocates for shareholders that one would hope.

RISK ANALYSIS: Buffett noted that Berkshire had no formula that calculates risk. Instead, they look at risk versus reward and how much of a loss they are willing to take. Buffett went on to say that they "will be wrong sometimes" but didn't think that having committees and spreadsheets would "favorably impact results."

Munger continued to be positive about China. At one point he alluded to a big China deal that almost got done. Munger said that "Dairy Queen is all over China, and it's working fine." He also noted that Berkshire has bought companies there and is likely to buy more. He stated that "generally the climate is getting better."

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