THE MEETING THAT WASN'T

2020 Berkshire Hathaway Annual Meeting

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Our Thoughts on the 2020 Berkshire Hathaway Annual Meeting

COMMENTARY

Provided by
Bridges Investment Management
Investment Committee

The definition of a meeting is an assembly of people in a common space. By that criteria, a digital meeting may seem like a contradiction in terms. This year's Berkshire annual meeting was held exclusively via live stream for the first time, without Charlie Munger and without the accompanying fanfare that has made it into an annual 'Woodstock for Capitalists.' But beyond these differences, many have observed that something else seemed unusual, something more substantive than the format.

As Berkshire's ownership has expanded, Warren Buffett has increasingly used his position as America's most famous (and not uncoincidentally, wealthiest) investor to educate the public in the basics of capital allocation. To think of stocks as ownership in a business rather than vehicles of speculation. To be greedy when others are fearful. He has often reassured us during turbulent times, counselling investors to look through panics, as he did in an October 16, 2008 op-ed in the New York Times, "Buy American. I Am."

Written in the throes of the Financial Crisis, he wrote "bad news is an investor's best friend. It lets you buy a slice of America's future at a marked-down price."

Two months into the current pandemic, after a quarter which included ample bad news, (including a 35% decline in common stocks and a 31% decline in Berkshire) the faithful could be forgiven for expecting a little handholding from the stock market's biggest cheerleader.

Unfortunately, he left his pom-poms at home.

Not only were Berkshire's buybacks paused, they were a net seller of stocks in the first quarter. With a cash position of over $133 billion and having long-lamented a dearth of attractive opportunities, one of history's greatest dip-buyers decided to sit this one out. Because this seems at odds with Buffett's past behavior, and because many are eager for him to deploy capital and improve returns, we'd like to share our thoughts.

BUYBACKS

Since Buffett took control of Berkshire in 1965, he went almost half a century without a buyback. In 2011, they announced they would be willing to buy shares at 110% of book value, later increased the hurdle to 120% and eventually made purchases north of 140%. He has often said that should Berkshire trade meaningfully below his estimate of intrinsic value, he would likely be aggressive. With the stock around 100% of book in mid-March, we thought this condition may have been satisfied.

Berkshire is one of the few public companies with a buyback authorization but no 10b5-1 plan in place (an SEC rule that allows companies to buy or sell securities on a set schedule). Given the market swoon came close to quarter-end, Berkshire may have been prohibited from buying without this protection. When asked about repurchases, Buffett said that Berkshire's intrinsic value had declined and that repurchases weren't more compelling at today's prices, especially relative to the option value of money (i.e. the returns he could theoretically earn on future deals).

Buffett has often compared shareholders to partners, spending years conditioning his readers to remain calm and not sell when panic overtakes them. A buyback during a crisis could be interpreted as facilitating this behavior, enabling shareholders to do the one thing he has cautioned them against. When first announcing the policy, he wrote "our bids will fade in particularly weak markets" and said he had no interest in 'propping up' the stock price. While it's true that repurchasing stock now may have this effect, it's certainly not the intent.

A buyback at depressed prices enriches the continuing shareholder at the expense of the seller. To our knowledge, Buffett is the lone CEO who expresses concern for the wellbeing of the soon-to-be former shareholder. While we admire his altruism and desire to not take advantage of the emotionally fickle, we admire returns slightly more. After all, if a person wants to throw in the towel, they'll likely find someone willing to oblige them. We'd prefer if it were Berkshire.

PUBLIC STOCKS

Buffett has long warned that size would restrict his ability to earn outsized returns, a fact which has become increasingly true over time. At year end, Berkshire's public equity portfolio was valued at $248 billion and is remarkably concentrated with just five positions accounting for two-thirds of the total. To initiate just a 3% position would require an outlay of $7.4 billion.

Because regulations require owners above a certain size to report every trade, Berkshire prefers to take a stake between 5 and 10% of the companies it invests in. This effectively limits them to companies with market capitalization in excess of $100 billion. There are just 56 stocks in the S&P 500 that meet this threshold. He owns sizeable positions in 10 of them, with smaller stakes in another two. Another 14 are technology companies, which he has long eschewed. Regulatory hurdles may prohibit buying competitors like Pepsi, Union Pacific and NextEra Energy. That leaves just 27 stocks that could absorb investments of $5 billion or more (a few of which he has owned in the past). The idea that he could pounce on a temporary price dislocation or quickly put a meaningful dent in the cash position isn't realistic. The S&P 500 spent just 14 trading days below 2,600 in the first quarter, far less time than it would take to build a position of sufficient size without moving the market.

PRIVATE INVESTMENTS

We've often said that sellers who want the highest price don't call Berkshire. Boards have a fiduciary duty to maximize shareholder value, meaning most public companies conduct a competitive process, providing directors cover from shareholder lawsuits. Berkshire has long avoided auctions, which may help explain why they've had more success with family-run companies. The downside of having a reputation for being an excellent buyer is that people assume (often wrongly) that if you sold to Buffett, you were taken.

Excellent businesses are almost never forced sellers meaning Berkshire is left waiting for the phone to ring. Because few are eager to sell stock at a discount, we've increasingly seen deals structured as debt with warrants or a conversion feature. These are typically only struck when capital markets are in disarray, which was only the case for a few days in the first quarter.

And that's the rub of being the buyer of last resort. It means having to wait your turn in line.

COVID-19

Regular readers know we've spilled sufficient ink on the pandemic. Rightly or wrongly, investors have looked to Buffett to provide reassurance when markets are wobbly, which this year, he declined to do. We found his allusions to 1930 telling. Many Americans thought it was a garden variety recession, rather than the beginning of the worst depression the country had ever seen. While he stated that the health outcomes have narrowed, he believes the economic possibilities are currently unknowable. Specifically, Buffett stated:

> *"The future is much less clear to me."*
>
> *"It's hard to think about things that haven't happened yet."*
>
> *"I don't know the consequences of shutting down the American economy."*

While the future is never knowable, a health crisis is different from the financial crises where Buffett has spoken up in the past (the Financial Crisis, Dot-Com Bubble or Savings and Loan debacle come to mind). We suspect that the earnings power of many businesses have changed materially, in some instances perhaps permanently. Said another way, just because a stock is down, doesn't mean it's a bargain.

When praising Dr. Anthony Fauci early in the meeting, Buffett said he "tells you when he knows something and when he doesn't know something." And in short, that's what we heard from Buffett. The economic consequences of the pandemic are currently unknowable and that while America will eventually find a way, blind optimism may be misplaced and caution is warranted. Buffett has felt he could calculate the odds in prior panics, but it appears he feels incapable of doing so now.

Of course, this isn't the message that many wanted to hear. But if it's hard to hear an unpalatable truth, it's usually even harder to speak it.

While we admire his transparency, we'd still prefer more share repurchases, which a 10b5-1 plan may help facilitate. As for private deals, Buffett can't make the phone ring, but at some point, he'll have to loosen his restriction around competitive processes (like the recent Tech Data transaction, where he was outbid). Regarding 10% ownership thresholds, we believe the benefit of capacity will eventually outweigh the cost of reporting requirements.

CONCLUSION

It seems odd to invest alongside one of the world's greatest allocators of capital then second guess his decisions or grumble when he calls it like he sees it. We would also highlight that Buffett has given the majority of his worth to the Bill and Melinda Gates Foundation, one of the world's largest funders of infectious disease research. Bill Gates serves on Berkshire's board and likely shared his insights on the pandemic. While you may or may not agree with Buffett's conclusions, you can't say he wasn't well-informed.

Should his caution prove unnecessary, shareholders will benefit from improvement at the operating companies and any upside from an extremely large equity portfolio. But in a worst-case scenario, $133 billion of cash (and rising) is likely to become more valuable, not less. Only time will tell if his decisions added value or subtracted it. While patience isn't an investment strategy, we feel that of anyone, Buffett and his track record deserve it. We will continue to monitor the situation and provide updates when warranted.

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