Berkshire Hathaway 2017 Shareholder Letter – Highlights, Notes, and Comments

February 28, 2018

Berkshire Hathaway Class A $314,345

Berkshire Hathaway Class B $210

Summary

1. 2017 was a very good year for Berkshire: Book value grew $65.3 billion, or 23%, and BRK's stock price increased 21.62%, essentially in line with the 21.88% total return for the S&P 500.

2. BRK's gain in book value was significantly enhanced by the cut in the corporate tax rate enacted in December of 2017, which resulted in a gain of $29 billion ($36 billion of the gain in book value was attributable to operations). Buffett noted that other changes to the tax code will result in BRK's earnings including changes in unrealized gains and losses in BRK's large portfolio of public companies. Buffett emphasized that the tax reporting change should not distract investors from focusing on changes in Berkshire's underlying earning power: the company's ability to grow its earnings and free cash flow over time.

3. Business value growth at Berkshire happens in four primary ways: 1) large private company purchases, 2) bolt-on acquisitions that enhance existing BRK businesses, 3) organic sales growth and operational efficiencies achieved by BRK's existing businesses, and 4) earnings from BRK's large portfolio of publicly-traded securities. Buffett noted that BRK was unable to find any large acquisitions in 2017, because of elevated private company valuations, but BRK's large and growing cash position will allow it to capitalize on opportunities as they arise in the future when lower valuations occur.

4. Buffett reviewed BRK's insurance operations in terms of its balance sheet strength, growth over time in premium "float," the inherent unpredictability of the timing and magnitude of mega-catastrophes (there were three major hurricanes in 2017), and BRK's underwriting performance (BRK lost $3.2 billion in 2017, its first underwriting loss is 15 years). Buffett remains confident in BRK's insurance businesses' ability to generate significant profits over the long-term, based on its two primary competitive advantages: the significant intelligence of its people, and BRK's immense balance sheet strength and capital.

5. Berkshire's other operating businesses performed well in 2017, generating pre-tax income of $20 billion, an increase of $950 million over 2016. The operating businesses

had $9 billion of depreciation and amortization, and made capital investments of $11.5 billion. Buffett noted that if/when BRK can make acquisitions of large operating businesses, the company's profitability will improve significantly, as BRK's cash increased from $86 billion to $116 billion year-over-year, but the opportunity cost of the cash remains high as interest rates remain low.

6. Buffett briefly reviewed BRK's portfolio of common stocks, but his comments focused on BRK's investment philosophy, which views investment holdings in public companies as pieces of ownership of good businesses that are held for the long-run. Notably, BRK materially increased its position in Apple during 2017; Apple is now the second largest BRK holding at $28 billion, just behind Wells Fargo at $29 billion. Buffett also touched on market volatility, noting that stock prices in the short run often move independently of company fundamentals and valuations, but reiterated his often-cited quote of Ben Graham: the stock market is a voting machine in the short term, but it is a weighing machine longer-term. The implication is that Buffett and his team will remain focused on identifying and owning positions in public companies where they have a very high degree of confidence in the growth of intrinsic value and free cash flow over the long run.

7. "The Bet": Buffett returned to a discussion of "the bet" that he outlined in the 2016 annual report, where Buffett wagered that the S&P 500 would outperform a hedge fund "fund of funds" over the decade ending December 31, 2017. Buffett used this year's discussion of "the bet" to highlight several familiar investment themes: 1) the very high fees embedded in hedge funds, and other investment products, significantly reduce returns to investors: investment "cost" really matters; over the decade, the S&P 500 earned 8.5% annually, versus a 3% average annual return for the five fund-of-funds in the bet. Buffett noted: "performance comes, performance goes, fees never falter." 2) The current low interest rate environment materially favors stocks over bonds, assuming a reasonably long time horizon. Buffett allows that in the short run, stocks are much "riskier" than bonds, but for investors that have time horizons that are measured in years, stocks purchased at reasonable valuation levels relative to interest rates offer considerably better returns, and during periods of very low interest rates, bonds are actually riskier than stocks. 3) Investors should focus on making a few common sense, intelligent, long-term investing decisions, and not obsess over a myriad of details that can obscure longer-term investment objectives.

Implications for BRK shareholders

1. As he was in early 2017, Buffett remains positive on the long-term outlook for both the U.S. economy, and Berkshire's ability to generate good returns for its shareholders. Buffett (again this year) did not signal any immediate concern regarding current capital markets valuations, other than to express some frustration with his ability to find large acquisition opportunities that fit BRK's valuation criteria. Buffett reiterated that 1) periodic sharp declines in stock prices are inherently unpredictable, 2) but highly valuable for long-term investors, because they allow investors to acquire attractive assets at favorable valuations, and 3) Berkshire remains focused on

capitalizing on opportunities created by periodic asset price declines if/when they occur.

2. The 2017 shareholder letter was roughly half the usual length; Buffett referred shareholders to the footnotes in the annual report, rather than writing extensively about the details of BRK's various businesses. On one hand, the shorter letter might be viewed as an indication that Buffett's age is showing – he may have less appetite for details. On the other hand, the advantage of the letter's brevity (and this may be very intentional on Buffett's part) is that its key points and insights are not buried in as much verbiage. And Buffett's key points of emphasis remain both consistent, and very important: 1) the long-term outlook for U.S. businesses and returns for shareholders remains positive; 2) it is critical for investors to have a long-term time horizon, a simple common sense investment approach, and a general understanding of the returns that are implied by asset class and individual security valuations; 3) BRK has a consistent, rational, and disciplined long-term approach to capital allocation across its businesses; and 4) "costs" really matter in the process of investing.

3. Berkshire's stock price in 2017 increased in line with the growth of its book value. While BRK is not as cheap as it was two years ago, we believe that it currently trades at a valuation that is reasonably close to our estimate of "fair value," such that future increases in the stock price should track growth in underlying business value over time. We believe that BRK would repurchase shares if/when the stock trades at 1.2x book value (or less), which provide some measure of downside support for the shares. Further, BRK's large and growing cash position both 1) cushions the stock during periods of stock market weakness, and 2) provides management will significant resources to find accretive acquisitions over time. We believe BRK's current valuation implies high-single to low-double digit annual returns over the long run (BRK's share price will continue to benefit from the impact of BRK's insurance float). We believe that BRK is a significant beneficiary of the changes in tax laws, and would also be a net beneficiary of higher interest rates.

4. Risks- The primary risks around BRK include: 1) uncertainty around the stock's reaction to Buffett's eventual exit from the company; 2) insurance exposure to large-scale catastrophes; and 3) recession risk: BRK's mix of operating companies has skewed more toward companies with economic exposure in recent years. We believe all three risks are manageable, well-known, and would be transitory in nature. Shareholders would likely benefit from the next economic and market downturn, because it would provide management with a much better opportunity to invest accumulated cash at more favorable valuations than have existed for some time.

Summary

We continue to believe that Berkshire Hathaway remains an attractive long-term investment because of its ability to grow cash flow consistently over the long run, and because of the quality and diversification of its various lines of business.