MORE MORTGAGE MELTDOWN

6 Ways to Profit in These Bad Times

WHITNEY TILSON

T2 PARTNERS LLC

GLENN TONGUE

Praise for

MORE MORTGAGE MELTDOWN

"You couldn't ask for better guides than Whitney and Glenn to take you through the tough times. They saw the mortgage meltdown coming and their new book can help get you through it with timely, useful, and sage advice."

—Joel Greenblatt, Managing Partner, Gotham Capital; author of *The Little Book That Beats the Market* and *You Can Be a Stock Market Genius*

"Two great students of investing explain the great economic debacle and teach us what to do about it."

—David Einhorn, founder, Greenlight Capital; author of *Fooling Some of the People All of the Time*

"A cogent guide to current financial events and sourcebook with investment case studies for value investing practitioners and aspirants. I strongly recommend that you give it a thorough and careful read."

—William Ackman, founder, Pershing Square Capital Management, LP

"With clarity and their typical attention to detail, Whitney and Glenn deftly illustrate key plot lines for our economic horror show. They thankfully offer some hope that all won't be lost when the house lights go up."

—Steven Romick, Partner, First Pacific Advisors, LLC

"Whitney and Glenn have done an extraordinary job alerting all who would listen of deep, and in many instances irreversible, perils confronting financial industry investors with exposure to U.S. mortgage industry securities. While most bank analysts busied themselves rearranging deck chairs on our financial *Titanic*, Whitney and Glenn fixed their vision on mortgage industry icebergs. While there is surely enough blame to be spread around as a result of the financial industry's shameful conduct, they deserve credit for speaking out with their early and accurate warnings."

—Thomas A. Russo, Partner, Gardner Russo & Gardner

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Front Flap

The housing market has imploded and the stock market has followed suit, with stock portfolios, retirement accounts, and pension funds cut in half. The U.S. economy is reeling from the real estate meltdown and credit crunch. Not stopping at the border, the storm has broadened to Europe, Asia, and beyond throughout 2008 and into 2009. Is there anyone on the planet who has not been touched by this disaster?

Even though we've all been affected by the calamity and have heard no shortage of news about it, it still seems unfathomable and utterly incomprehensible to most people that the actions of certain banks, mortgage companies, and Wall Street firms could bring the economic engine of the world to a grinding halt. Now, for the first time, and in terms everyone can grasp, noted analyst and value investing expert Whitney Tilson, along with his partner Glenn Tongue, explains not only how it happened, but shows that the tsunami of credit problems isn't over. Another even larger wave is yet to come. If you know catastrophe is looming, you can sidestep the train wreck, and even profit, but you need to understand how bad times present opportunity and where to look.

Tilson, a columnist for *Kiplinger's Personal Finance*, featured on *60 Minutes*, and a regular on CNBC, started presenting his findings to everyday people and found them clamoring for more. Now in *More Mortgage Meltdown*, Tilson explains in a clear and understandable way how misguided assumptions, insatiable greed, reckless risk taking, and government inaction led to the creation of the greatest asset bubble in history, the aftermath of which is the perfect economic storm. Then, he shows you why there's still much more pain to come and what we can expect from the ongoing crisis over the next few years.

Finally, *More Mortgage Meltdown* teaches you how to find investment opportunities within the rubble and position your portfolio to take advantage of the crisis. The book uses in-depth case studies of individual companies and stocks to show how to evaluate investments in these uncertain times. You will learn how to spot warning flags in the financial statements of companies that can help you avoid losing your hard-earned money. And you will learn how to spot undervalued businesses with competitive advantages or hidden assets that will likely emerge stronger from the crisis. It is important for all of us to understand how the credit and mortgage crisis happened. Equally important is the chance to potentially profit in its aftermath.

Back Flap

WHITNEY TILSON and **GLENN TONGUE** are the Managing Partners of T2 Partners LLC and the Tilson Mutual Funds. The former firm manages three value-oriented hedge funds while the latter is comprised of two mutual funds, Tilson Focus Fund and Tilson Dividend Fund.

MR. TILSON is the cofounder and Chairman of the Value Investing Congress, a biannual investment conference in New York City and Los Angeles, as well as the investment newsletters *Value Investor Insight* and *SuperInvestor Insight*. He writes a regular column on value investing for *Kiplinger's Personal Finance*, has written for the *Financial Times* and TheStreet.com, and was one of the authors of *Poor Charlie's Almanack*, the definitive book on Berkshire Hathaway Vice Chairman Charlie Munger. He was featured on *60 Minutes* in December 2008, was one of five investors included in *SmartMoney*'s 2006 Power 30, was named by *Institutional Investor* in 2007 as one of twenty Rising Stars, and appears regularly on CNBC and Bloomberg TV. He received an MBA with high distinction from the Harvard Business School, where he was elected a Baker Scholar, and graduated magna cum laude from Harvard College with a bachelor's degree in government.

MR. TONGUE spent seventeen years on Wall Street prior to joining T2 Partners, most recently as an investment banker at UBS, where he was a managing director specializing in acquisitions and leveraged finance. Before UBS, Mr. Tongue was at Donaldson, Lufkin & Jenrette for thirteen years, the last three of which he served as the president of NYSE-listed DLJdirect, the consistently top-rated online brokerage firm. Prior to DLJdirect, Mr. Tongue was a managing director in the investment bank at DLJ, where he worked on over 100 transactions, aggregating more than $40 billion. He received an MBA with distinction from the Wharton School of Business and received a Bachelor of Science in electrical engineering and computer science from Princeton University.

Visit **www.moremortgagemeltdown.com** to ask Whitney and Glenn questions, read their latest thoughts on the companies they analyze in the book, see updated color versions of the book's charts, and much more.

Chapter 7

A False Alarm on Derivatives

Case Study: Berkshire Hathaway

Before we share our analysis of the six stocks we either own or are short, we want to repeat that our goal in writing about these companies is not to give hot stock tips.* By the time you read this book, these stocks might have moved dramatically and we might not have positions in any of them anymore—or we might even have switched positions. In fact, as we discuss in the Wells Fargo chapter, in the weeks

*This book is not a solicitation to invest in any investment product, nor is it intended to provide investment advice. It is intended for information purposes only and should be used by sophisticated investors who are knowledgeable of the risks involved. All data and comments herein are believed to be correct, but there are no guarantees and readers should do their own work. Please refer to the relevant Confidential Private Placement Memorandum for full details on the investment products and strategies of T2 Partners LLC.

before we submitted the manuscript for this book to our publisher, we covered our Wells Fargo short and went long the stock. Our goal in sharing our work on these six stocks is to help you become a better analyst, and we hope these case studies will be valuable even to people reading them many years later.

With that, let's turn to Berkshire Hathaway (BRK), currently our largest long position and the only stock we've owned continuously since we started our original hedge fund on January 1, 1999.

We've seen a lot of crazy things in our investment careers, but struggle to think of anything that tops this: Berkshire Hathaway's five-year credit default swap (CDS) spreads went up *10 times* from June 2008 through March 4, 2009 to stand at an all-time high of 514 basis points above the risk-free rate, as shown in Figure 7.1.

To get some perspective on what this means, the median CDS spread for companies with the lowest investment-grade bond rating (BBB–) is around 350 basis points, so the CDS market is indicating that Berkshire's bonds are junk, 11 notches lower than its actual AAA rating! Or consider Figure 7.2, which shows that Berkshire's CDSs are higher

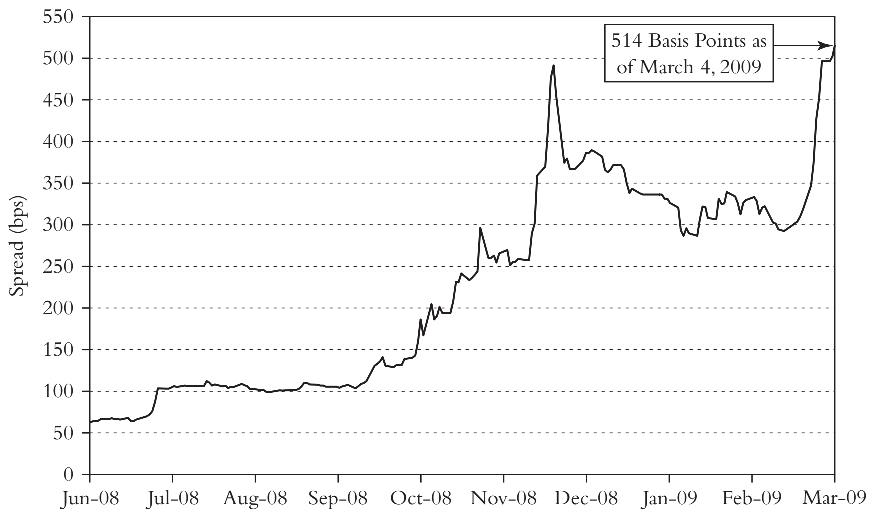

Figure 7.1 Berkshire Hathaway Five-Year Credit Default Swap Prices, March 4, 2009
SOURCE: Bloomberg Finance, L.P.

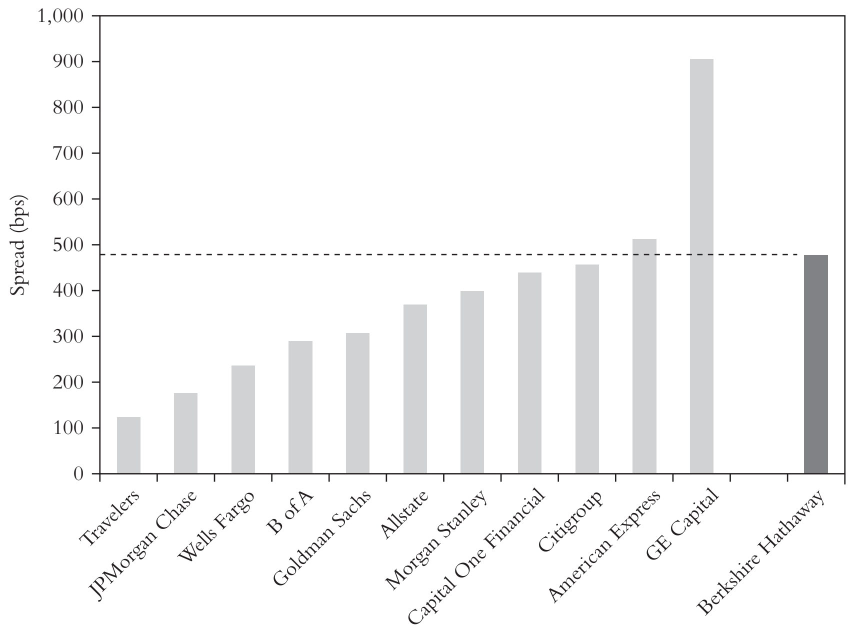

Figure 7.2 Credit Default Swap Prices for Various Financial Companies, March 4, 2009
SOURCE: Bloomberg Finance, L.P.

than a wide range of other financial companies, not one of which is even close to Berkshire's financial strength.

We struggle to think why anyone would pay such an absurd price for protection against Berkshire defaulting on its debt, given that Berkshire has $100 billion of equity, more than any other company in the United States except Exxon Mobil (excluding the doubtful equity numbers of Citigroup and Bank of America). We can think of two reasons:

1. *American International Group (AIG) flashbacks.* Superficially, there are some parallels between Berkshire today and AIG when it was collapsing in 2008: a massive, complex, global insurance company built over decades by a revered and legendary man, with a rapidly falling stock price, rapidly rising CDS spreads, and exposure to derivatives. But as we discuss later, these similarities mean nothing once one does a bit of homework—though we question how many people are in fact doing much homework in this sell-first/ask-questions-later environment.

2. *Hedging.* Berkshire sold 15- and 20-year index put options to certain companies (most likely life insurers that have sold annuities that guarantee the principal in 15 or 20 years) that are now sitting on paper gains of more than $10 billion. However, these companies can't collect for more than a decade, so nervous risk managers may be forcing them to buy CDSs as protection against Berkshire not being able to pay when the puts expire. This raises two questions, however: (1) What good is a five-year CDS against the possibility that Berkshire doesn't pay in 10 to 20 years? and (2) If the world has collapsed to such a degree in 10 to 20 years that Berkshire can't pay, exactly which counterparty is going to be able to pay off on the CDSs?

There is no rational explanation for Berkshire's CDSs trading where they are—they are certain to expire worthless—but during market panics lots of crazy things happen. We wish we were set up to sell CDSs, but it's not easy and we're content to own the stock.

Why Are Investors Panicked about Berkshire Hathaway?

Perhaps in part due to investors getting spooked by the widening CDS spreads, Berkshire's stock tumbled to a six-year low of $70,050 in early March 2009 before rebounding to $84,844 on March 10. Berkshire is our largest position, so the decline has been painful, but we're delighted to have the opportunity to add to our largest investment at such attractive prices, and have been doing so aggressively.

Beyond the dreadful economy, the market's recent concerns appear to revolve around four things: the pounding Berkshire's stock portfolio has taken, earnings, the exposure to derivatives, and Buffett's age, all of which are raising questions as to whether Buffett has lost his touch. Before we address each of these, let's step back and provide some background.

Background

Berkshire Hathaway is an unusual company and possibly the most talked-about yet least understood business in the world. It is a diversified conglomerate whose chairman is the world's most famous and successful investor. The company employs more than 246,000 people worldwide (only 19 of whom are at the headquarters) and is ranked second, fourth, and eleventh in equity, market capitalization, and sales, respectively, among U.S. companies. Finally, it is one of only seven AAA-rated corporations in the United States and, according to *Fortune* magazine, was the second most admired company in the world in 2008.

Berkshire Hathaway has been one of the most extraordinary investments of all time. Buffett took control what was then a New England textile company on May 10, 1965, when it had a market cap of $18 million and equity (book value) of $22 million, equal to $19.46 per share (he bought his first shares at $7.50).[1] It was a classic Ben Graham cigar-butt stock, trading below its liquidation value. The stock closed that year at $19.02 and now sits at nearly $85,000, approximately *4,500 times higher.* As late as 1983, both the Dow Jones Industrial Average and Berkshire Hathaway were trading at 1,000. The Dow on March 10, 2009, closed at 6,926 and Berkshire closed at $84,844.

The company's performance has been extremely consistent: In the 44 years under Buffett, it has grown its book value per share, a good proxy for the growth in intrinsic value per share, in all but two years (its worst year was –9.6 percent in 2008). In addition, book value has grown each year by more than the S&P 500 index in all but six years (the last time Berkshire trailed was in 2003).

Market Inefficiencies

In spite of this extraordinary track record and Buffett's fame, Berkshire Hathaway is not well understood for a number of reasons:

- It is a very complex company, operating in a wide range of businesses with many sources of value.
- Earnings can be volatile. Buffett doesn't try to manage them so that they increase smoothly and steadily. In fact, he highlights the fact that one of the company's competitive advantages as an insurer is Berkshire's willingness to accept the risk of periodic large claims in exchange for a higher level of overall profitability over a long period of time.[2]

- Berkshire Hathaway's shares trade at high prices, which intimidates many buyers and makes it impossible for small investors to purchase the stock.
- There is very little coverage of the stock by Wall Street firms because Buffett does not try to promote it, refuses to play the quarterly earnings game, and has little need for investment banking services. Also, the stock's high price and low turnover discourage brokers from promoting the stock since their commissions are based on the number of shares traded. In fact, Berkshire, which has the eighth largest market capitalization of any U.S. company, isn't even a part of the S&P 500 index.

These factors (and others) lead to severe mispricing at times, including the current one, from which savvy investors can profit.

Overview of Berkshire's Businesses: Insurance

Berkshire's single most important business is insurance, consisting of Government Employees Insurance Company (GEICO), General Re, Berkshire Hathaway Reinsurance Group, and Berkshire Hathaway Primary Group. These four generated $58.5 billion in float as of year-end 2008 and during the year earned $25.5 billion in premiums and $2.8 billion in pretax profits.

In general, insurance companies make money in two ways. First, like any other business, they can make an operating profit by charging more than they pay out in expenses (in this case, claims plus overhead). Over time, the best insurance companies are lucky to break even on their operations. Second, and this is where insurance companies can become fabulous businesses (and investments), they can invest the float—the premiums charged to customers, but which have not yet been paid out in claims—and pocket the returns as profit.

Berkshire Hathaway's returns over time have been driven by extraordinary success in both areas. First, Berkshire's insurance operations, over time, have been consistently profitable, meaning the cost of float has been *negative*. In other words, Berkshire has effectively been able to borrow money at a cost significantly *below* that of the U.S. government. That's quite remarkable.

At year-end 2008, Berkshire had $58.5 billion in float, up from $22.8 billion 10 years earlier, after the acquisition of General Re (that's 9.9 percent compound annual growth). The growth and negative cost of float—coupled with Buffett's superior investment talent—have had the effect of turbo charging Berkshire's results over time.

GEICO sells auto insurance directly to consumers, cutting out the brokers and other intermediaries used by almost all of its competitors, and thus it can offer lower prices while making higher profits. It was founded in 1936 and was one of Warren Buffett's first major stock purchases in 1951. It is the third largest auto insurer in the United States, having grown its market share from 2.0 percent in 1993 to 7.7 percent in 2008, and is poised to continue this growth. In his 2008 annual letter to Berkshire Hathaway shareholders, Buffett wrote: "As we view GEICO's current opportunities, Tony and I feel like two hungry mosquitoes in a nudist camp. Juicy targets are everywhere."[3] (Tony Nicely has been at GEICO for 48 years and has been CEO since 1993.)

Berkshire Hathaway's reinsurance business includes both General Re and Berkshire Hathaway Reinsurance Group, which specializes in "super cat" policies ("cat" stands for catastrophe). A typical super cat policy might be written when, say, Allstate insures homes on the Florida coast against hurricane damage. Allstate's total exposure could be billions of dollars, so it will sell some of its exposure to reinsurance companies like Berkshire's.

The economics of the reinsurance business are volatile: A reinsurer might pocket hefty profits in years with few claims, but will have to pay out very large claims in some years, such as 2005 when hurricanes Katrina and Rita hit. The competitive advantages of Berkshire Hathaway's reinsurance businesses are its willingness to write very large policies, unsurpassed capitalization to back up them up, long-standing presence and unsurpassed reputation in the market, global reach, and the ability to make quick underwriting decisions. It also has the singular ability to withstand long periods of declining business activity if pricing isn't commensurate with the risks taken. Buffett doesn't care about market share or business volume; he cares about being properly compensated for the risks taken. Very few reinsurers have this type of discipline.

Given Berkshire's success, why don't other insurers use their float to buy companies and stocks rather than mostly bonds? The reason is that the float is needed to pay claims, so insurance regulators, rating agencies, and investors will not allow most insurance companies to invest more of their float in equities, which can be quite volatile (as we've certainly seen recently!). But Berkshire Hathaway is an exception, for reasons explained by then-PaineWebber analysts Alice Schroeder and Gregory Lapin in a January 1999 research report:[4]

> Berkshire is the only insurer with an unlimited investment universe and maximum flexibility to allocate capital. Thanks to its track record of superb investing and superior capitalization, the Nebraska insurance department, the rating agencies and investors give Berkshire Hathaway investing latitude not granted to any other insurer. This enables Berkshire to invest for an equity return any capital that it is not using in the insurance business, eliminating the "burden" of subpar returns on excess capital. Because no competitor has, or could develop in a reasonable time horizon, an investment record similar to Berkshire's, we believe that this is an overwhelming and practically permanent competitive advantage.

Overview of Berkshire's Businesses: Utilities and Other

Berkshire's second most important business is utilities, which includes a wide variety of operations, which Buffett described as follows in his 2008 annual letter to shareholders:

> The largest of these are (1) Yorkshire Electricity and Northern Electric, whose 3.8 million end users make it the U.K.'s third largest distributor of electricity; (2) MidAmerican Energy, which serves 723,000 electric customers, primarily in Iowa; (3) Pacific Power and Rocky Mountain Power, serving about 1.7 million electric customers in six western states; and (4) Kern River and Northern Natural pipelines, which carry about 9% of the natural gas consumed in the U.S.
>
> Somewhat incongruously, MidAmerican also owns the second largest real estate brokerage firm in the U.S., HomeServices

of America. This company operates through 21 locally-branded firms that have 16,000 agents.

Collectively, these businesses had $14.0 billion of revenues and $2.2 billion of pretax operating earnings in 2008.

Beyond insurance and utilities, Berkshire Hathaway owns a wide range of more than 60 manufacturing, service, and retailing businesses, including NetJets, FlightSafety, Iscar, Shaw carpets, Marmon, McLane, Dairy Queen, Borsheim's jewelry, Clayton Homes, See's Candies, Benjamin Moore paints, and a number of furniture stores. In 2008, these businesses had $66.1 billion in revenues and $4.0 billion in pretax profits.

As a group, Berkshire's businesses have shown very healthy long-term growth, generate high returns on capital, and produce prodigious amounts of free cash flow, which Buffett and longtime investing partner and Berkshire Vice Chairman Charlie Munger invest wherever it will generate the highest returns. Figure 7.3 shows the billions of dollars they've put to work over the past 13 years acquiring businesses outright and purchasing stocks.

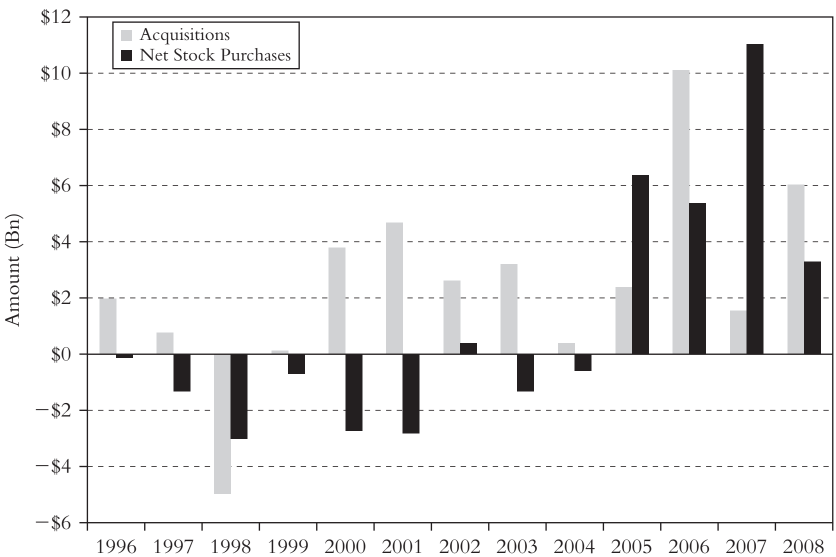

Figure 7.3 Berkshire Hathaway: Net Acquisitions and Stock Purchases and Sales
Source: Berkshire Hathaway annual reports.
Note: Acquisitions were negative in 1998 due the purchase of General Re and the liquidation of its investment portfolio.

Table 7.1 Berkshire Hathaway: Investments and Commitments in 2008

Investment/Commitment	Amount (Bn)	Comment
Mars/Wrigley	$6.5	
Auction rate securities	$6.5	Q2 event; sold much in Q3
Goldman Sachs (GS)	$5.0	Plus $5Bn to exercise warrants
Constellation Energy stock and preferred	$5.7	Sold for a $1.1Bn gain including breakup fee
Marmon	$4.5	The remaining 34.6% not owned by BRK will be purchased from 2011 to 2014
General stock purchases	$3.3	Full year; net of sales
Dow/Rohm & Haas	$3.0	
General Electric (GE)	$3.0	Plus $3Bn to exercise warrants
Federal Home Loan Discount Notes	$2.4	Q2 event; sold much in Q3
Tungaloy	$1.0	Iscar acquisition
Swiss Re unit	$0.8	Plus sharing agreement
ING reinsurance unit	$0.4	
Other businesses purchased	$3.9	
Total	**$46.0**	Plus $8Bn to exercise GS and GE warrants

SOURCE: Berkshire Hathaway press releases, T2 Partners estimates.

As shown in Table 7.1, Berkshire also put approximately $46 billion to work in 2008 as prices tumbled—in some cases too early, but we think it's likely that these purchases will work out well over time.

Investments

Buffett and Munger have invested very successfully over time both the float from the insurance operations and the high levels of excess cash generated by Berkshire's many businesses (approximately $10 billion in 2008), buying all of the companies that make up Berkshire and also accumulating large holdings in such blue-chip companies as Coca-Cola, Procter & Gamble, Kraft Foods, American Express, Washington Post Company, and Wells Fargo. Though these stock holdings are substantial, they represent only 31 percent of Berkshire Hathaway's market capitalization, so

Berkshire Hathaway is not, as many people think, similar to a closed-end mutual fund.

Table 7.2 shows Berkshire's 11 U.S. stock positions that are larger than $800 million, based on values as of March 10, 2009.

One of the major drivers of Berkshire's recent stock price decline is the massive decline in the company's U.S. stock portfolio from roughly $70 billion at the end of Q3 2008 to $34 billion as of March 6, 2009. This $36 billion drop, after adjusting for taxes, is equal to $15,000 per share, which sounds like a lot until you consider that the stock has fallen $58,200 per share.

Does this decline indicate that Buffett is starting to lose it and/or is out of touch with the realities of the postbubble world? One critic even went so far as to say that while Buffett is the Willie Mays of investing, over the past three years he's been the aging, over-the-hill Willie Mays who hit .250, .250, and .211 in his last three seasons. We remember well similar nonsense at the peak of the Internet bubble, when critics said Buffett just didn't get it and that his investing principles no longer worked.

It's absurd and unfair Monday morning quarterbacking, in the midst of the most severe market downturn since the Great Depression, to compare Buffett to an aging athlete in the twilight of his career. On the

Table 7.2 Eleven Largest U.S. Stock Positions of Berkshire Hathaway as of March 10, 2009

Company	Shares	Price	Value ($Bn)
Coca-Cola	200.0	$39.16	$7.8
Procter & Gamble	91.9	$45.17	$4.2
Burlington Northern Santa Fe	70.1	$54.87	$3.8
Wells Fargo	304.4	$11.81	$3.6
ConocoPhillips	84.9	$38.00	$3.2
Kraft Foods	130.3	$21.80	$2.8
American Express	151.6	$12.17	$1.8
Johnson & Johnson	30.0	$47.78	$1.4
Wal-Mart	19.9	$48.67	$1.0
Moody's Investors Service	48.0	$18.04	$0.9
U.S. Bancorp	75.1	$11.40	$0.9

Source: Berkshire Hathaway 10-K, 2008.

contrary, we think Buffett is still at the peak of his game, though by his own admission he has made some mistakes—nobody claims he's perfect.

Regarding the recent losses in Berkshire's stock portfolio, some of the things that look like mistakes might end up turning out okay. We recall that earlier in this decade he bought USG Corporation in the high teens and it soon plunged to around $3—yet by 2006, the stock was above $120. We think most of the stocks in Berkshire's portfolio are likely to eventually return to their former highs.

The financial stocks Berkshire has large positions in—Wells Fargo, American Express, and U.S. Bancorp—have declined significantly during the crisis, but long-term the jury is still out. As we discuss later, we recently covered our short position in Wells Fargo because if it survives without a bailout or a highly dilutive equity raise, the stock could skyrocket once things improve. Ditto for U.S. Bancorp. And as we discuss in the next chapter, we're long American Express because we think it's likely to recover in a huge way.

Even if some of these stocks end up being permanent losses, this has been a brutal, once-or-twice-in-a-century bear market that has clobbered just about everybody, making it really easy for critics to throw stones.

Financial Performance

If the decline in Berkshire's equity portfolio doesn't explain the stock's decline, what about its financial performance? When the company released its annual report on February 28, 2009, the headlines in the newspapers highlighted that Q4 2008 net income was down 96 percent year over year and that it was Berkshire's worst year ever in terms of book value, which declined 9.6 percent (since 1965, it has declined only once before, by 6.2 percent in 2001). But we view 27.4 percentage points of outperformance relative to the S&P 500, which declined 37.0 percent, as remarkably strong. In fact, it was the third-best outperformance in the past three decades.

Berkshire's operating profits also are remarkably strong in light of the weak economy, setting a new record in 2008. Table 7.3 shows Berkshire's annual operating profit over the past five years. Note the losses for the reinsurers in 2005 due to hurricanes Katrina and Rita and the skyrocketing profits of MidAmerican.

Table 7.3 Berkshire Hathaway's Annual Operating Profits, 2004–2008

	2004	2005	2006	2007	2008
Insurance Group					
GEICO	$ 970	$1,221	$ 1,314	$ 1,113	$ 916
General Re	$ 3	–$ 334	$ 523	$ 555	$ 342
Berkshire Reinsurance Group	$ 417	–$1,069	$ 1,658	$ 1,427	$ 1,324
Berkshire H. Primary Group	$ 161	$ 235	$ 340	$ 279	$ 210
Investment income	$2,824	$3,480	$ 4,316	$ 4,758	$ 4,722
Total Insurance Operating Income	**$4,375**	**$3,533**	**$ 8,151**	**$ 8,132**	**$ 7,514**
Non-Insurance Businesses					
Finance and financial products	$ 584	$ 822	$ 1,157	$ 1,006	$ 787
Marmon					$ 733
McLane Company	$ 228	$ 217	$ 229	$ 232	$ 276
MidAmerican/Utilities/Energy	$ 237	$ 523	$ 1,476	$ 1,774	$ 2,963
Shaw Industries	$ 466	$ 485	$ 594	$ 436	$ 205
Other businesses	$ 1,787	$1,921	$ 2,703	$ 3,279	$ 2,809
Total Non-Insurance Operating Income	**$3,302**	**$3,968**	**$ 6,159**	**$ 6,727**	**$ 7,773**
Total Operating Income	**$7,677**	**$7,501**	**$14,310**	**$14,859**	**$15,287**

SOURCE: Berkshire Hathaway annual reports.

Table 7.4 shows Berkshire's quarter-by-quarter performance in 2008. Note that the weak economy hit Shaw Industries and "other businesses" hard in Q4, but that was also Berkshire's best quarter ever for income from both insurance underwriting as well as investments (MidAmerican also reported its best quarter ever, but that was driven by a one-time gain in Constellation Energy).

Most important, Berkshire's main businesses, insurance and utilities, are performing exceptionally well, have bright future prospects, and are not correlated to the general economy, as Buffett writes in his annual letter to shareholders:

> . . . [W]e are fortunate that Berkshire's two most important businesses—our insurance and utility groups—produce earnings that are not correlated to those of the general economy.

Table 7.4 Berkshire Hathaway's Quarterly Operating Profits in 2008

	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Insurance Group				
GEICO	$ 186	$ 298	$ 246	$ 186
General Re	$ 42	$ 102	$ 54	$ 144
Berkshire Reinsurance Group	$ 29	$ 79	–$ 166	$1,382
Berkshire H. Primary Group	$ 25	$ 81	–$ 8	$ 112
Investment income	$1,089	$1,204	$1,074	$1,355
Total Insurance Operating Income	**$1,371**	**$1,764**	**$1,200**	**$3,179**
Non-Insurance Businesses				
Finance and financial products	$ 241	$ 254	$ 163	$ 129
Marmon	$ 28	$ 261	$ 247	$ 197
McLane Company	$ 73	$ 68	$ 68	$ 67
MidAmerican/Utilities/Energy	$ 516	$ 329	$ 526	$1,592
Shaw Industries	$ 51	$ 82	$ 49	$ 23
Other businesses	$ 721	$ 874	$ 749	$ 465
Total Non-Insurance Operating Income	**$1,630**	**$1,868**	**$1,802**	**$2,473**
Total Operating Income	**$3,001**	**$3,632**	**$3,002**	**$5,652**

SOURCE: Berkshire Hathaway quarterly and annual reports.

Both businesses delivered outstanding results in 2008 and have excellent prospects.

As predicted in last year's report, the exceptional underwriting profits that our insurance businesses realized in 2007 were not repeated in 2008. Nevertheless, the insurance group delivered an underwriting gain for the sixth consecutive year. This means that our $58.5 billion of insurance "float"—money that doesn't belong to us but that we hold and invest for our own benefit—cost us less than zero. In fact, we were *paid* $2.8 billion to hold our float during 2008. Charlie and I find this enjoyable.

Over time, most insurers experience a substantial underwriting loss, which makes their economics far different from ours.

Of course, we too will experience underwriting losses in some years. But we have the best group of managers in the insurance business, and in most cases they oversee entrenched and valuable franchises. Considering these strengths, I believe that we will earn an underwriting profit over the years and that our float will therefore cost us nothing. Our insurance operation, the core business of Berkshire, is an economic powerhouse.

Charlie and I are equally enthusiastic about our utility business, which had record earnings last year and is poised for future gains. Dave Sokol and Greg Abel, the managers of this operation, have achieved results unmatched elsewhere in the utility industry. I love it when they come up with new projects because in this capital-intensive business these ventures are often large. Such projects offer Berkshire the opportunity to put out substantial sums at decent returns.

Derivatives Exposure

The single biggest area that appears to be causing investors to panic and dump Berkshire's stock is concern over the company's derivatives exposure.

Buffett provided many details in his 2008 annual letter about this exposure, which should put to rest the silly rumors that we heard about possible liquidity risk. Here are the highlights:

- "Berkshire is a party to 251 derivatives contracts."
- There is no counterparty risk. ("Our derivatives dealings require our counterparties to make payments to us when contracts are initiated. Berkshire therefore always holds the money, which leaves us assuming no meaningful counterparty risk.")
- Berkshire's derivatives provided $8.1 billion of float ("the payments made to us less losses we have paid") as of year-end 2008.
- There is no liquidity risk. ("Only a small percentage of our contracts call for any posting of collateral when the market moves against us. Even under the chaotic conditions existing in last year's fourth quarter, we had to post less than 1% of our securities portfolio." Later, when commenting on why he was not writing more

credit default swaps, Buffett added: "We are unlikely to expand this business to any extent because most buyers of this protection now insist that the seller post collateral, and we will not enter into such an arrangement.")

Buffett then went into even more detail about the four types of derivatives he has written. The equity puts have gotten the most attention because of the large potential exposure ($37.1 billion), so let's review what Buffett had to say about them (emphasis added):

> We have added modestly to the "equity put" portfolio I described in last year's report. Some of our contracts come due in 15 years, others in 20. We must make a payment to our counterparty at maturity if the reference index to which the put is tied is then below what it was at the inception of the contract. *Neither party can elect to settle early; it's only the price on the final day that counts.*
>
> To illustrate, we might sell a $1 billion 15-year put contract on the S&P 500 when that index is at, say, 1300. If the index is at 1170—down 10%—on the day of maturity, we would pay $100 million. If it is above 1300, we owe nothing. For us to lose $1 billion, the index would have to go to zero. In the meantime, the sale of the put would have delivered us a premium—perhaps $100 million to $150 million—that we would be free to invest as we wish.
>
> Our put contracts total $37.1 billion (at current exchange rates) and are spread among four major indices: the S&P 500 in the U.S., the FTSE 100 in the U.K., the Euro Stoxx 50 in Europe, and the Nikkei 225 in Japan. Our first contract comes due on September 9, 2019 and our last on January 24, 2028. We have received premiums of $4.9 billion, money we have invested. We, meanwhile, have paid nothing, since all expiration dates are far in the future. Nonetheless, we have used Black-Scholes valuation methods to record a year-end liability of $10 billion, an amount that will change on every reporting date. The two financial items—this estimated loss of $10 billion minus the $4.9 billion in premiums we have received—means

> that we have so far reported a mark-to-market loss of $5.1 billion from these contracts.
>
> We endorse mark-to-market accounting. I will explain later, however, why I believe the Black-Scholes formula, even though it is the standard for establishing the dollar liability for options, produces strange results when the long-term variety are being valued.
>
> *One point about our contracts that is sometimes not understood: For us to lose the full $37.1 billion we have at risk, all stocks in all four indices would have to go to zero on their various termination dates. If, however—as an example—all indices fell 25% from their value at the inception of each contract, and foreign-exchange rates remained as they are today, we would owe about $9 billion, payable between 2019 and 2028. Between the inception of the contract and those dates, we would have held the $4.9 billion premium and earned investment income on it.*

Berkshire has reported a loss of $5.1 billion on these equity puts, which has likely risen to between $8 billion and $9 billion in light of what markets have done through early March 2009. So was this a mistake? We think not, for two reasons. First, even if Berkshire ends up losing money on these puts, it doesn't mean Buffett made a mistake. This is an important concept to understand: Sometimes you make money on bad bets and lose money on good bets, so it's critically important to learn the right lessons.

For example, if you gave us a 2:1 payoff if we threw anything but a pair of ones on one throw of two six-sided dice, we'd bet a lot of money (not more than we could safely afford to lose, however, because no matter what the odds might be, we'd never risk losing what we have). Why? Because the expected value is very favorable: there's a 35 in 36 chance of doubling our money and only a 1 in 36 chance of losing all of our money. But if by chance snake eyes came up and we lost our money, would you say we'd made a bad bet? Of course not.

Buffett's index put bet is similar. When he wrote the contracts, the odds were extraordinarily favorable. Consider that March 2009 was only the third time *ever* that the Dow was flat compared to 12 years earlier, so a 17-year period where any of the major indexes have been even flat, much less down, is an extremely rare event (the only exception has been the Nikkei over the past 20 years, but that peak in 1989 was a far bigger bubble by any measure than our market when it peaked in October 2007).

The second reason we don't think Buffett made a mistake is that Berkshire's actual losses will likely be much lower than currently reported or may even end up being none at all—in stark contrast to most mark-to-market losses, which turn out to be very real. Why?

First, Berkshire's losses are calculated by the Black-Scholes formula, which has major flaws when valuing long-dated options. In fact, in his 2008 letter Buffett gave a detailed example to prove this, showing that the Black-Scholes model would allow you to borrow money at 0.7 percent for 100 years on an equity index put on the S&P 500 index. Note that this is *exactly* what Buffett has been doing in his insurance businesses: generating float at very low, or negative, cost. He then concluded:

> Though historical volatility is a useful—but far from foolproof—concept in valuing short-term options, its utility diminishes rapidly as the duration of the option lengthens. In my opinion, the valuations that the Black-Scholes formula now places on our long-term put options overstate our liability, though the overstatement will diminish as the contracts approach maturity.
>
> Even so, we will continue to use Black-Scholes when we are estimating our financial-statement liability for long-term equity puts. The formula represents conventional wisdom and any substitute that I might offer would engender extreme skepticism. That would be perfectly understandable: CEOs who have concocted their own valuations for esoteric financial instruments have seldom erred on the side of conservatism. That club of optimists is one that Charlie and I have no desire to join.

In addition, there is a very strong likelihood that the indexes Buffett sold puts on will rebound before the expiration of the puts, such that Berkshire will have to pay out little or nothing on them. The average strike price of the puts has not been disclosed, but let's assume the worst case that these indexes are down by 40 percent on average from their strike prices (the major indexes are down more than 50 percent from their peaks, but Buffett wrote the puts over the past few years). If the indexes rebound by 67 percent over the next 13.5 years (the average remaining duration of the puts), a mere 3.9 percent annually, then the puts will expire worthless and Buffett can pocket the entire $4.9 billion.

Berkshire's maximum exposure is $37.1 billion if all four indexes go to zero, but this isn't going to happen, so let's look at more likely scenarios. Imagine that the indexes are down 50 percent from the puts' average strike price 13.5 years from now, an additional 17 percent below today's levels. This would require Berkshire to pay out $18.5 billion (half of the $37 billion maximum). This would be a painful loss, to be sure, but one that Berkshire could easily afford: The company's earning power today exceeds $10 billion per year and, even factoring in Berkshire's losses this year, its net worth is approximately $100 billion—and both figures will be *much* higher more than a decade from now.

It's also important to understand that the loss in this doomsday scenario would not be $18.5 billion minus $4.9 billion, because Buffett can invest the $4.9 billion for the entire period. If he earns a mere 7 percent return for 13.5 years, $4.9 billion becomes $12.2 billion, making Berkshire's break-even point on this investment a 34 percent decline in the indexes from the point at which the puts were written. This, in turn, means the indexes would only have to increase less than 1 percent annually over the next 13.5 years to reach this from today's level (down 40 percent).

We believe it's very likely that the indexes will compound in excess of 4 percent annually from today's depressed levels, if only simply from inflation (consider all the money governments around the world are currently printing), retained earnings, and survivorship bias (the indexes remove failing/failed companies every year and replace them with thriving companies). Thus, we think it's unlikely that Berkshire will have to pay out a single dollar on these contracts. And given how much Buffett was paid to write them and his ability to invest the premium he was paid in any way he chooses, it's even more unlikely that this will be a losing investment.

In conclusion, even knowing what we know today, we think Buffett was wise to have sold these index puts—and we very much hope he's writing more of them today, because the odds are even more favorable now that the markets have fallen so much.

Hypocrisy or Style Drift?

Some critics have accused Buffett of hypocrisy or style drift because he exposed Berkshire to derivatives after repeatedly warning about their dangers, famously calling them "financial weapons of mass destruction" in his 2002 annual letter to shareholders:[5]

> The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. . . . Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts. . . . In our view . . . derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

These critics have little understanding of Buffett, what he's said about derivatives, or the natures of the derivatives he's written. If one takes the time to read all three pages he wrote on derivatives in his 2002 annual letter, for example, it's clear that he doesn't think all derivatives are inherently evil or dangerous and even notes that he sometimes engages in "large-scale derivatives transactions":

> Many people argue that derivatives reduce systemic problems, in that participants who can't bear certain risks are able to transfer them to stronger hands. These people believe that derivatives act to stabilize the economy, facilitate trade, and eliminate bumps for individual participants. And, on a micro level, what they say is often true. Indeed, at Berkshire, I sometimes engage in large-scale derivatives transactions in order to facilitate certain investment strategies.

In fact, Buffett's remarkably prescient point was that derivatives, as they were being used by a wide range of companies, especially financial institutions, were subject to all sorts of problems like accounting issues and counterparty risk, and were morphing into a monster that created systemic risk:

> Charlie and I believe, however, that the macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one other. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties. Some of these counterparties, as I've mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems.

Buffett elaborated during an interview with CNBC on March 9, 2009:[6]

> We've used derivatives for many, many years. I don't think derivatives are evil, per se. I think they are dangerous. I've always said they're dangerous. I said they were financial weapons of mass destruction. But uranium is dangerous, and I just went through a nuclear electric plant about two weeks ago. Cars are dangerous.
>
> A lot of things can be dangerous, but generally we regulate how they're used. I mean, there was a guard up there with a machine gun on me, you know, when I was at the nuclear plant the other day. So we use lots of things daily that are dangerous, but we generally pay some attention to how they're used. We tell the cars how fast they can go.

The derivatives Buffett has written are far different from the ones he warns about, because he has no counterparty or liquidity risk. Buffett acknowledges and addresses his apparent inconsistency in his 2008 annual letter to shareholders:

> Considering the ruin I've pictured, you may wonder why Berkshire is a party to 251 derivatives contracts (other than

> those used for operational purposes at MidAmerican and the few left over at Gen Re). The answer is simple: I believe each contract we own was mispriced at inception, sometimes dramatically so. I both initiated these positions and monitor them, a set of responsibilities consistent with my belief that the CEO of any large financial organization *must* be the Chief Risk Officer as well. If we lose money on our derivatives, it will be my fault.

As for accusations of style drift, this is nonsense. Buffett has been in the insurance business for more than 40 years, and all he's doing with the derivatives is selling insurance. The fact that the insurance is structured in the form of a derivative is irrelevant. He is simply making a probabilistic bet, like the countless others he makes every day—and has made so successfully over the years. He has written insurance on all sorts of things, including a major California earthquake and a terrorist attack that results in the cancellation of the National Collegiate Athletic Association (NCAA) Final Four basketball tournament. In fact, the index puts he's sold are among the simpler types of insurance he has written.

Buffett himself makes no apologies for his derivatives bets. He concluded the discussion of derivatives contracts in his 2008 annual letter by writing:

> We have told you before that our derivative contracts, subject as they are to mark-to-market accounting, will produce wild swings in the earnings we report. The ups and downs neither cheer nor bother Charlie and me. Indeed, the "downs" can be helpful in that they give us an opportunity to expand a position on favorable terms. I hope this explanation of our dealings will lead you to think similarly.

When pressed on CNBC on March 9, 2009, about whether this was one "of the investments maybe you regret," he replied:[7]

> Well, the S&P has to end up 15 or 20 years from the time we did the deals at the price at which we did them. Although, if the S&P actually ends up, you know, 15 percent below or so, we still break even and we've had the use of the money for 15 or 20 years. So we're holding about $4.8 billion. The first one

comes due in the latter part of 2019. And obviously I would rather put those positions on now than having put them on a few years ago. But if you—if you gave me the choice of not having the positions at all, and not being able to put them on or sticking with the positions we have, I would stick with the positions we have. I think—I think we will—the odds are good we will make money. And the thing I know for sure is we'll hold almost $5 billion for between 15 and 20 years in conjunction with it.

Succession

The most common question we get these days is: "What happens when Buffett is gone?" Let's start with the facts: Buffett turned 78 on August 30, 2008, and is in excellent health. We expect that he'll be running Berkshire for at least another decade. We watch closely for any signs that his age is catching up with him—we're not oblivious to his age and obviously nobody can go on forever—but so far his mind actually seems to be getting even sharper with age. It's really quite remarkable.

The answer to what will happen when he is gone depends on where the stock price is and how unexpected his departure is. If he died suddenly today, that would be an unexpected, negative surprise to the market (not to mention Buffett!), so the stock would go down, but probably not by very much since it's currently trading right around cash and investments and therefore it's hard to argue there's much of a Buffett premium in the stock. (Heck, if you read some of the articles being written, some might say there's a Buffett discount!) But most people don't die suddenly. They get older, their minds and bodies start to fade, they retire, and eventually they pass away—hopefully with many loved ones around them. Why should it be any different for Buffett?

In fact, it's very likely that there will be a smooth transition as Buffett passes the reins to his successors, so his age and the succession plan are not things we spend much time worrying about. (Buffett's job will be split into two roles: a CEO to run the businesses and a chief investment officer to handle investing. The CEO has been identified, but his name hasn't been revealed because it would create unwanted pressure and publicity and the choice might change, in part depending on how long Buffett remains CEO. As for the CIO, Buffett and Munger are currently evaluating four people—again, unidentified—by giving them a bit of Berkshire's money to manage.)

Valuation

We value Berkshire the same way Buffett has indicated he does: value the investments (cash, bonds, and stocks) at market prices and then add the value of the operating businesses by putting a conservative multiple on their earnings.

How do we know this is how Buffett values Berkshire? He's never come out and said it explicitly, but he's given clues in some of his annual letters to shareholders:

> Over the years we've . . . attempt[ed] to increase our marketable investments in wonderful businesses, while simultaneously trying to buy similar businesses in their entirety.
>
> **—1995 Annual Letter**

> In our last two annual reports, we furnished you a table that Charlie and I believe is central to estimating Berkshire's intrinsic value. In the updated version of that table, which follows, we trace our two key components of value. The first column lists our per-share ownership of investments (including cash and equivalents) and the second column shows our per-share earnings from Berkshire's operating businesses before taxes and purchase-accounting adjustments, but after all interest and corporate expenses. The second column excludes all dividends, interest and capital gains that we realized from the investments presented in the first column.
>
> **—1997 Annual Letter**

> In effect, the columns show what Berkshire would look like were it split into two parts, with one entity holding our investments

> and the other operating all of our businesses and bearing all corporate costs.
>
> **—1997 Annual Letter**

The cash and investments are easy to value, but what multiple should one use to value the operating businesses? Again, Buffett has provided clues over the years that lead us to believe he uses a 12 multiple of pretax earnings, equal to about an 18 P/E multiple, which until the recent market meltdown was roughly the market multiple. But it's no longer 18. With the cyclical P/E around 12, that translates into an 8 pretax multiple for the average large U.S. company. While we think Berkshire's collection of businesses is *far* above average, let's be conservative and use this.

One final (and somewhat controversial) adjustment: In his 2008 annual letter, Buffett said that Berkshire's pretax earnings for the year were $3,921 per share (after minority interest). It is important to note that Buffett *excludes* the earnings of Berkshire's insurance businesses, which earned an additional $1,807 per share. Given the unparalleled quality of these businesses, their consistent profitability, and Buffett's prediction that they will continue to be profitable, we think these earnings should be included, which brings the total to $5,728 in pretax earnings per share last year. In light of the worsening recession in 2009 and a relatively benign year for super-cat insurance claims in 2008, to be conservative we estimate Berkshire's pretax earnings at $5,000 per share in 2009.

Some would argue that we are double counting because we're including the float from Berkshire's insurance operations in investments, plus we're putting a multiple on the insurance earnings in valuing the operating businesses. Perhaps this is a little aggressive, but to exclude the earnings of Berkshire's superior insurance operations and simply value them at book value is ridiculously conservative. In addition, we don't factor in any value for the fact that Berkshire's float isn't static, but instead has grown at a healthy rate over time and is likely to continue to do so. Finally, the 8 multiple we use is an estimate based on a blend of various businesses, some of which would have a higher multiple and some lower. Given that insurance companies traditionally trade at low multiples of earnings, if we removed Berkshire's insurers from the calculation, one could argue that a 10 multiple would be more appropriate for the remaining businesses, which gets us to the same place (i.e., \$5,000 per share times 8 is roughly equal to \$3,921 times 10).

Regarding Berkshire's investments, they were valued at \$77,793 per share as of year-end 2008, but in the annual report Berkshire disclosed that book value had fallen "approximately \$8 billion since the end of 2008." Let's assume this figure was through the third week of February and Berkshire's stocks have fallen since then, so let's say investments are down by \$12 billion after tax or \$7,700 per share, which would bring the total to approximately \$70,000 per share.

Now the math is easy: \$70,000 + (\$5,000 × 8) = \$110,000. With the stock closing at \$84,844 on March 10, 2009, Berkshire is trading at a 23 percent discount to its intrinsic value.

Look-Through Earnings

Another way to value Berkshire is to simply put a multiple on its after-tax earnings—the P/E ratio—just as one might do for any company. It's a little complex for two reasons, however: First, Berkshire's earnings need to be adjusted for "investment and derivative gains/losses," which (from the 2008 annual report) have "no predictive value, and variations in amount from period to period have no practical analytical value." For example, in 2008 there were big mark-to-market losses on derivatives, and in 2005 there was a huge gain when Gillette was acquired by Procter & Gamble. So, net earnings for Berkshire in 2008 were \$5.0 billion, to which one would add back \$7.5 billion in investment and derivative losses, which equals \$12.5 billion. However, it was a benign year for super-cat losses and the odds that Berkshire might have to pay out real cash on its derivatives contracts went up, so we haircut the \$12.5 billion to \$10 billion.

The second adjustment is that Berkshire owns large stakes in many publicly traded companies, but the pro-rata shares of those companies' retained earnings don't appear on Berkshire's income statement, so we need to estimate what Berkshire's shares would be. Our estimate is \$2.4 billion of 2008 look-through earnings. Again, now the math is easy: \$10 billion of Berkshire's earnings plus \$2.4 billion of look-through earnings equals \$12.4 billion, or \$8,000 per share. With the stock at \$84,844,

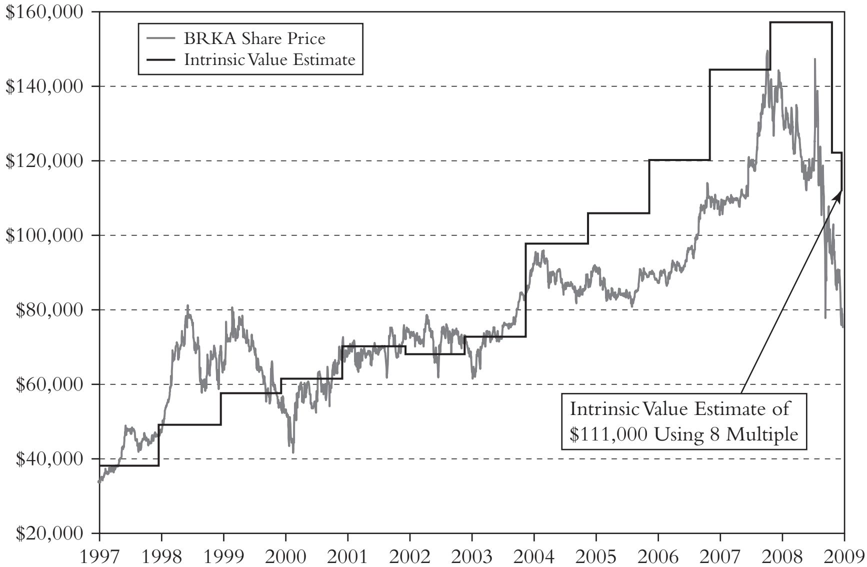

Figure 7.4 Berkshire Hathaway's Share Price vs. Estimated Intrinsic Value
SOURCE: Yahoo! Finance (http://finance.yahoo.com), T2 Partners estimates.

that means Berkshire is trading at only 10.5 times earnings, a very low multiple for such a great business. We think Berkshire warrants a higher-than-market multiple; if we use 14, it translates into $112,000 per share.

Using either valuation method, we come to roughly the same intrinsic value. Figure 7.4 shows Berkshire's stock price from 1997 through early March 2009, along with the intrinsic value each year using the first method: cash and investments plus 12 times pretax earnings until 2008, when 8 times earnings was used. Note that in most years, Berkshire's stock at some point during the year reaches intrinsic value. If Berkshire were to do so this year, it would jump more than 30 percent.

What Could Go Wrong?

It's always a good idea to ask about any investment: What could go wrong? In Berkshire's case, there are a number of possibilities:

- The current recession turns into a depression and impacts Berkshire's earnings materially.

- Berkshire's stock portfolio collapses even further (for example, Wells Fargo, U.S. Bancorp, and American Express all go under, wiping out a portion of Berkshire's investments).
- The recent investments in General Electric, Goldman Sachs, and others turn out badly.
- Losses in shorter-duration derivatives such as credit default swaps are larger than expected and/or mark-to-market losses mount among the equity index puts.
- A major super-catastrophe event occurs that costs Berkshire many billions.
- No catalyst occurs, so the stock sits there and doesn't go up.
- Something happens to Buffett.

We don't think any of these things are likely to happen, but there are indeed many things to worry about in these bad times. If you think the U.S. economy is headed toward something resembling the Great Depression, with unemployment and gross domestic product (GDP) declines exceeding 25 percent, then you probably don't want to own Berkshire—or any other stock, for that matter!

Conclusion

In every investment, we look for securities that we believe are safe, rapidly growing, and cheap—and Berkshire has all three in spades. It has one of the few AAA credit ratings in the world, maintains a Gibraltar-like financial position, and has huge excess liquidity—critical in these troubled times—that increases every day thanks to the enormous profits earned by Berkshire's operating businesses; in addition, the stock trades at more than a 20 percent discount from intrinsic value. In addition, it has exemplary corporate governance and is overseen by Warren Buffett, perhaps the world's greatest capital allocator.

It is only fitting to conclude with a final quote from Buffett's 1998 shareholders meeting:

> You just have to make a few good investment decisions in a lifetime. But the important thing is that when you do find one where you really do know what you are doing, you must buy

> in quantity. . . . Charlie and I have made a dozen or so very big decisions relative to our net worth, although not as big as they should have been. And in each of those, we've known that we were almost certain to be right going in. They just weren't that complicated. . . . That's what we look for—a fat pitch.

We believe that we have found a fat pitch in Buffett's own company, and are aggressively taking advantage of the opportunity.