Woodstock For Capitalists | May 3, 2020

Report from the Berkshire Hathaway Annual Meeting - 2020

"Fear is the most contagious disease you can imagine. It makes the virus look like a piker."
- Warren Buffett

Unfortunately, due to the pandemic my long-standing annual pilgrimage to Omaha for the Berkshire Hathaway Annual Meeting on May 2, 2020 was cancelled. It was replaced with a Warren Buffett and Greg Abel question and answer livestream lasting almost five hours. Sadly, Charlie Munger was absent but said to be in good health and utilizing Zoom extensively for meetings. Full disclosure: I am a long-time shareholder of Berkshire Hathaway and worked for Salomon Brothers when Warren Buffett became Chairman and CEO.

Table 1
An analysis of Berkshire's operating earnings follows (dollar amounts are in millions):

	First Quarter	
	2020	2019
Insurance-underwriting	$ 363	$ 389
Insurance-investment income	1,386	1,237
Railroad, utilities and energy	1,751	1,858
Other businesses	2,038	2,200
Other	333	(129)
Operating earnings	$5,871	$5,555

Source: Berkshire Hathaway

First quarter earnings for Berkshire Hathaway (BRK/A, BRK/B) were released the morning of the meeting with many headlines noting the loss of almost $50 billion for the quarter. This loss was caused by a relatively recent accounting change directing firms to mark publicly traded securities to market and show that gain or loss in the income statement. This first quarter report posted a massive swing in reported earnings due to the stock market plunge when operating earnings were up over 5% year-over-year at almost $5.9 billion (Table 1). Buffett did note that the operating earnings were "considerably worse" than they would have been without the virus.

According to first quarter filings, Berkshire had about $137 billion in cash and U.S. Treasury Bills at the end of March versus $128 billion at the end of December 2019. Buffett quoted some slightly different numbers during the livestream, since he adjusted for cash held in the railroad and energy segments. During 1Q, Berkshire bought about $4 billion in stocks and repurchased $1.7 billion of its own stock while liquidating $2.1 billion in holdings, so the net equity purchases were a relatively small $3.6 billion. Regarding repurchases of Berkshire stock, Buffett noted that there was a very short window of time when the stock was significantly lower. Interestingly, he said that Berkshire was not at a much larger discount to fair value than previously. In other words, he has lowered his fair value estimate of Berkshire due to the impact of the coronavirus outbreak.

In a rare occurrence, Buffett disclosed specifics about Berkshire's equity activities in April. Berkshire bought only $426 million in stocks while selling $6.5 billion and making no stock repurchases, so net stock sales were over $6 billion. Buffett further disclosed that the sales were primarily the divestment of his entire airline positions in American Airlines (AAL), Delta Air Lines (DAL), Southwest Airlines (LUV) and United Airlines (UAL). After long eschewing airlines, Buffett began buying airlines in 2016 and amassed about 10% ownership of each. According to Buffett, he invested between $7-$8 billion in the group and "didn't get that much out" with Bloomberg estimating the value of the holdings at about $10 billion at the end of 2019 (Chart 1). He stated that these were specific sales and not a market call and his view was that the airline business has "changed in a very major way" and the "future is much less clear to me." Though not mentioned during the discussion, Berkshire retains significant exposure to aerospace through wholly owned entities like Precision Castparts, FlightSafety and NetJets.

Chart 1

Source: Stone Investment Partners, Bloomberg as of 4/30/2020

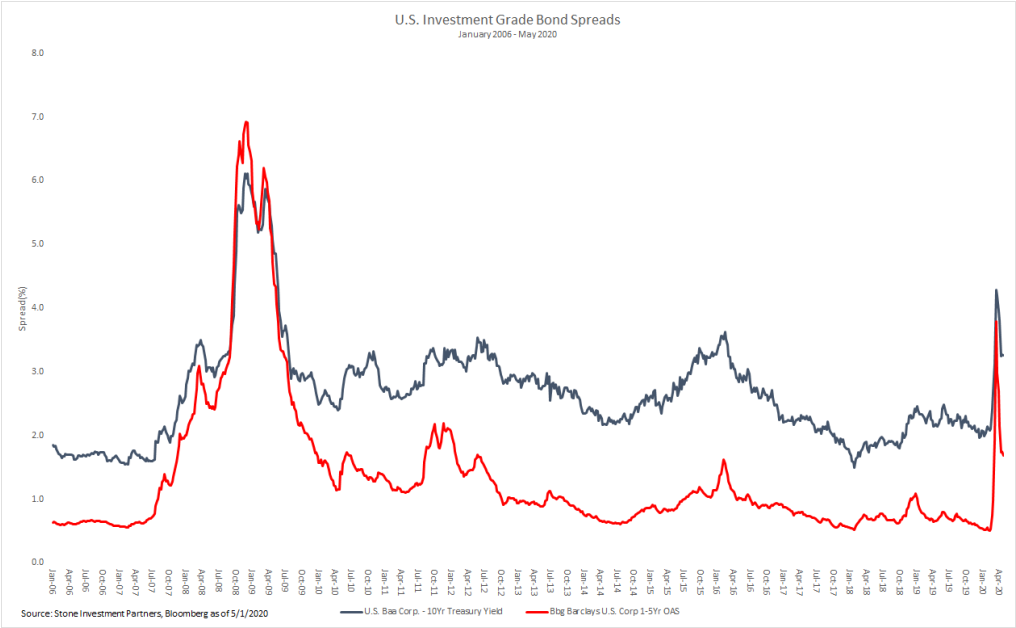
Looking at these sales can also provide insights into the mind of one of the greatest investors of all time. Buffett was willing to take a loss when the facts changed. As chart 1 shows, the stocks are down between about 30% to 70% since the end of 2015. While he praised the respective managements for their handling of the crisis and noted that the airlines have aggressively raised liquidity, there are "too many planes if the business only comes seventy to eighty percent back." Second, the investing process is about probabilities and he observed that a "low probability risk ended up happening." Third, he eliminated the entire position when he became "uncertain about the future" of industry profitability rather than just trimming the positions.

Buffett began the meeting with the longest monologue that I can recall in all my years of attending the annual meeting. While the conclusion of the teaching session was "never bet against America," Buffett was clearly warning that downside risk remained in the short and intermediate term even with the long-term outcome of prosperity unchanged. Here are my main takeaways from Buffett's lecture:

- There is positive news that the range of outcomes in terms of the health impact from the virus has narrowed. It is neither the worst case nor the best case in terms of health risk. The range of outcomes on the economic side remains extremely wide and unknown. He noted the amazing growth of the United States did not come without some very serious "bumps in the road" and that we have faced worse circumstances in the past like World War Two. He spent considerable time discussing the Great Depression and how long it took for stocks to regain their highs and how this impacted investor psychology.
- Buffett warned that despite his long-term optimism, "markets can do anything." His advice continued in terms of being "careful how you bet" on America and never to use borrowed money or margin to buy investments. He recommended owning a cross-section of American businesses which for most people should be through an index fund. He is clearly worried about the downside risks because he noted that Berkshire's cash hoard was "not that large when we consider the risks."
- While seemingly being less effusive than in past years, Buffett said that stocks will produce a "fine result" if owned over the long-term. He went on to discuss that equities will outperform the 30-year U.S. Treasury over the long-run especially with yields around 1.3% and the Federal Reserve targeting 2% inflation. Buffett noted that stocks will outperform T-bills as well, but "no one knows what the market will do tomorrow, next week or next year."

Buffett spent a fair bit of time praising the U.S. policy actions during the crisis while remarking that the future consequences of those actions are unclear. He spoke about the capacity of Wall Street to provide liquidity being severely strained during late March and even the U.S. Treasury market was "somewhat disorganized." The stress in the investment grade debt market can be observed in yields over Treasuries reaching levels not seen since the global financial crisis (Chart 2). Buffett mentioned that there has been large debt issuance since and the markets are unfrozen due to the "speed and determination" of Federal Reserve action. Even Berkshire took advantage of the opportunity to issue bonds. Buffett noted that if the FDIC had been around during the Great Depression, the economic downturn may not have lasted as long because bank failures were a big issue. As a side note, and not mentioned at the meeting, bank failures were also a major reason for municipal defaults during the Great Depression.

Chart 2



While the rapid action of policymakers avoided the worse economic and financial market outcomes, it likely caused Berkshire to miss out on any significant deals. Buffett said there is no shortage of funds now available for companies at rates that are not attractive for Berkshire to provide capital to these companies. Buffett continued that it is a "very good time to borrow money" which is good for the country, but it may not be such a great time to lend money.

Buffett was clear in his praise of the policy actions and said he would not criticize them because they are "trying to do the right thing" and large programs like these are "hell to administer." In his view these decisive actions avoided a much worse outcome, but the implementation will certainly be imperfect and the consequence of the massive increase in the Federal Reserve balance sheet is unclear. Buffett dismissed worries about U.S. government default risk despite the large increase in borrowing. If the U.S. government issues debt only in its own currency, there is no risk of default. While default is not an issue, the value of the currency is the real concern if borrowing is taken too far.

Buffett and Abel touched on some other important investment topics summarized below:

- Buffett said that it is now politically correct to be against stock buybacks, but they are just another way to distribute cash to shareholders like dividends. Abel added that sometimes the financial engineering was too extreme. Repurchases should be price sensitive and companies should retain enough cash to fund growth and a strong balance sheet.
- Succession at Berkshire, once Buffett and Munger are no longer involved, was further clarified with the discussion that Abel, Todd Combs and Ted Weschler would share the capital and asset allocation duties while Ajit Jain would continue to focus on evaluating and pricing insurance risk.
- When asked about the energy sector, Buffett said that there is a chance of permanent loss of capital in the energy industry at these oil prices. He added that how it works out is largely dependent on the price of oil and "who knows where they go in the future." Buffett noted that his investment in Occidental Petroleum (OXY) was a "mistake so far in terms of where prices went."
- Buffett stated that the banking system is "in far better shape" than during the global financial crisis and is not the problem this time. While he can "dream of scenarios that put lots of stress on banks," they are "not a primary worry."
- Buffett opined that it is "better to own equities or something else if interest rates stay negative." He admitted to being wrong so far about inflation rising with negative rates but does not think negative rates can co-exist with more debt relative to productive capacity. He does not know the outcome but there will be consequences.

In summary, Buffett remains optimistic about the American economy and stocks outperforming over the next twenty to thirty years. He noted that the range of economic outcomes in reopening the economy remain wide and markets can react in unknowable ways in the short-term. He recommended that investors in stocks need to be psychologically and financially prepared for further declines. This is consistent with my long-held view that despite my long-term optimism, investors should "know what they own" and be prepared for further volatility. It is essential that investors' investments and asset allocation provides the financial means to make it through an economic valley of unknown depth and duration.

Bill Stone, CFA, CMT
Chief Investment Officer

Disclosures

SUBSCRIBE | CONTACT