Dear Partners,

Close your eyes. Now imagine the stock market didn't exist. What would you think about?

My guess is you wouldn't think about how many hundreds of billions of dollars of valuation your neighbor—let's call him Bob—would be willing to pay for a brand new, barely-profitable business. Pinch yourselves but we're still here.

The opening exercise wasn't really a joke. That's the perfect-form exercise I attempt to do every time I look at a business. I say perfect form because it's only an ideal. The stock market is there, waiting. If not actively in session trading pre-hours, during hours, or extended-hours, the chatter about what's come or gone is ever-present. Social media has only made the problem worse.

The only way to evaluate a business for purchase is through a careful examination of its fundamentals. Only after that exercise is done should you look at the price. In reality the search process is often backward—"what's gone down recently that I can assess and sift out a price/value discrepancy?" We take the opposite approach and ask, "what are the best businesses *regardless of valuation"* and then follow them until a price valuation discrepancy emerges.

The distinction is important. For me, searching the new lows list is akin to arriving at the scene of your neighbor's house on fire and quickly trying to assess whether to accept his offer to sell it to you. Will it burn all the way down? Is the fire department right around the corner? How much would it cost to rebuild? Looking for the good businesses first and then waiting for an opportunity to buy is analogous to already understanding your neighbor's house has sprinklers, is next to a fire hydrant, and a block from the fire department. Oh, and it's made of solid stone. All that's necessary to know is whether Bob's panicked offer is worth taking given all other opportunities available to you at the time (sorry Bob).

This is all to say that my style of value investing is to study good companies and managements first, and then wait for short-term renters of stocks to panic. We arrive on the scene fully aware of the key variables and risks associated with the business (if I've done my job appropriately). Married to a Justice of the Peace (79 weddings last year!), I've come to enjoy a good love story. There's a positive correlation between length of courtship and duration of a marriage—I'm thinking of both soulmates *and* stocks. Long-term partnerships really are much more enjoyable.

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I led with the above example because of the market we find ourselves navigating. It's unlike anything I've seen in my investing lifetime. There are many factors at play which raise more questions than answers.

1. **Interest rates:** Will they stay historically low forever? For a long time? What are the long-term effects of a multi-decade low interest rate policy? What happens if inflation unexpectedly returns? Who has become complacent because we've operated in a low rate environment for so long? What would happen to the huge number of companies on the verge of junk-bond status if rates go up?
2. **Tech companies:** How many of today's money-losing tech companies will survive? Which ones are truly game-changers, and which ones are pretenders? How can I understand these shifts – which are accelerating because of the pandemic – while staying true to a fundamental value-based approach to buying companies? What are the implications of low-to-no capital requirements on an ever-larger segment of the economy? Where will that cash/capital go? What won't change because of these dramatic shifts?
3. **Economy/pandemic:** What are the long-term implications for shutting down large swaths of our economy? What are the second- third- and fourth-order consequences of today's actions? What happens if the growing pile of cash building up on the sidelines is suddenly released? What happens to those permanently displaced because of the pandemic, and how will that affect other areas of the economy? What happens if an even deadlier pandemic emerges?
4. **Day traders:** When will the current generation learn that businesses ultimately must generate cash to have value? How long can the "casino" go on? Where might our investments get hurt because of the irrational actions of others? Could those burned by this generation's major market crash (which seems just around the corner) create the conditions for good value picks in the not-to-distant future? What other spillover effects might occur between the financial and real economy?
5. **Cryptocurrencies:** Can humans manufacture scarcity? To borrow a thought from Charlie Munger, will the huge implied market capitalizations of Bitcoin and other cryptocurrencies create incentives to find a way to make more or otherwise alter an "unalterable" system? What are the beneficial aspects of these inventions? Can blockchain technology be used for societal good elsewhere? If these currencies do stabilize and are adopted, how will humans adapt to a "rational" currency? (Many people would rather get a nominal raise lower than inflation than face a nominal decrease in pay with a real increase in living standards.) Does a slowly depreciating currency matter to systems of wealth creation (businesses) and individuals with the ability to generate "claim checks" on society?

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Keeping my hair (or, why we don't short stocks)

Today's "frothy" market, including several cases of obvious disconnects between price and value, provides a good opportunity to expand upon why we don't engage in short selling. For those who aren't familiar with shorting stocks it amounts to borrowing shares from someone who owns them and selling them in anticipation of buying them back at a lower price later. In brief, short sellers make money when the price of a stock goes down.

All markets, shorting included, are like the pari-mutuel system of betting on horses. You can know for sure who the winner or loser is likely to be, but the odds often reflect the probabilities and even the scales.

Take GameStop. The company's shares went on a tear in January for various interesting but irrelevant reasons, trading at over $400 per share after languishing at under $20 for years, and often below $5. Nothing fundamentally changed with the company. It is in a struggling industry and has lost money over the last few years. And they didn't discover they'd been sitting on a pile of platinum or something. At some much lower price the company had cash in excess of its market cap. But at even $300 per share the valuation was north of $20 billion. In short, the price/value discrepancy appeared huge.

The problems with short selling are numerous:

1. **The basic math is against you.** The most you can make is double your money if the price goes to zero. The most you can lose is infinite. While an infinite price is unlikely, the GameStop saga illustrates that in the short-term it can go up many multiples of your initial price. Remember, the short seller eventually has to purchase the shares in the market to deliver them to the original owner. Which leads to the next problem…

2. **Supply/demand creates risks.** A short seller must continually borrow the shares. The true owner of the shares has the right to sell at any time. To maintain the open short position the broker must have a supply of shares available. If they do not, they have every right to force you to close the position – at any price. Which leads to the next problem…

3. **Holding the short position can be costly.** The supply/demand of shares of a company works just like other things in economics. In addition to any dividends the original owner is entitled to (which the short seller must pay), s/he also must pay a fee to borrow the shares. In normal times this fee might be less than 1% for an average stock to a few percentage points for a more heavily shorted stock. The borrowing fee to obtain GameStop shares to sell short rose as high as 30% to 50%—*per annum*. Which leads to the next problem…

4. **Time is against you.** With an effective interest cost in the double digits a short seller must not only be right on the *what*, they must be right on the *when.* It's difficult enough to get the "what" right on the long side. Trying to time the "when" adds a whole other element. Short sellers get on a backward-moving treadmill and must make up the lost ground if they are to come into the black at the end of the day. Which leads to the next problem…

5. **Distraction.** The half-joke about buying a good business and then leaving for a yearlong vacation is exactly 180-degrees from the imagery short selling evokes. The life of the short seller is restless. Think constant checking of prices. Whether or not actual short sellers are sitting in front of a multi-monitor computer continually hitting refresh isn't important. I'm sure some do, but for me I don't think I could have the equivalent of a financial Sword of Damocles above my head without continually checking to see if the string were ready to break. Which leads to the next problem…

… I don't think I could have the equivalent of a financial Sword of Damocles above my head without continually checking to see if the string were ready to break.

Okay, I won't list another, but you get the idea. The problems and risks with short selling accumulate and compound. It's far better (and more enjoyable at that) to spend time thinking about good businesses to buy and *own*. The world of short selling isn't wrong or immoral. Some do it well (many do it poorly). But the basic idea of short-sellers acting as a police force of the market rooting out fraud is a useful one for society so long as it comes without manipulation. All markets, shorting included, are like the pari-mutuel system of betting on horses. You can know for sure who the winner or loser is likely to be, but the odds often reflect the probabilities and even the scales.

One last observation before moving on. There exists a paradox of sorts where a company's irrational stock price leads to its survival. In mid-2020 the Hertz rental car company, hanging on to existence with the last nail, sold $1 billion of new shares to retail investors bidding up the bankrupt company's stock price. Tesla, another heavily-shorted stock, raised $5 billion through the sale of new shares at a valuation in the hundreds of billions of dollars. Which leads to the next…

Okay one more thing. Since I don't sell short I needed to get creative to bet against Tesla. Long Bets is a non-profit that arranges long-term bets with an unlimited timeframe. The predictor and challenger agree on an amount and the winner's charity gets the money. Tesla is a great example of the disconnect between company and stock price. I'm a big fan of Tesla, but the stock price reflects something other than reality. You can find my full prediction at longbets.org/854. (So far, no takers.)

THE ARENA FOR ACCOUNTABLE PREDICTIONS

LONG BETS

BET 854 DURATION 10 years (02020-02030)

"The market capitalization of Berkshire Hathaway will be greater than Tesla on Warren Buffett's 100th birthday."

PREDICTOR Adam J Mead

CHALLENGER Unchallenged

longbets.org/854/ theoraclesclassroom.com

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Portfolio Updates:

Last year (see 2019 memo here) I walked through the portfolio in a detailed way and explained what we owned and why we owned it. With the exception of Trupanion, which was sold midway through 2020, the components of the portfolio haven't changed. In fact, the turmoil of March/April 2020 provided an opportunity to increase certain holdings at attractive valuations.

Sloth—rightfully to be avoided in every other aspect of life—is okay in investing. Business owners focus on business progress not quoted stock prices. Our goal is to buy pieces of wonderful businesses and hold them through thick and thin, allowing their superior competitive positions to do the work of building wealth. Macro events, interest rate changes, or the madness of crowds on the prices of stocks create lots of headlines and fill the 24/7 news cycle. But trying to take these things and translate them into a trading strategy is folly, in my view.

"An investor should act as though he had a lifetime decision card with just twenty punches on it."

Warren Buffett

What to focus on, then? Business progress. Even in a benign year stock prices will fluctuate 50% or more between their high and lows. Business results rarely change that fast. Last year may have been an exception. The pandemic brought important changes and happened very quickly. Fortunately, the businesses we own are resilient, although they were impacted in various ways.

Berkshire Hathaway

At about 50% of client portfolios, Berkshire is our largest holding. As such, I'll spend a little more time discussing its business results from last year. Note that the results presented below are the twelve months ended September 30, which encompass 2019Q4 through 2020Q3. The 2020 annual report/10K will be out at the end of this month.

The table below illustrates the degree to which Berkshire's many businesses were affected by last year's business conditions. The most noticeable are the many MSR businesses. As a whole their earnings were down about 23% compared to the same period last year. A big component of the MSR segment is Precision Castparts, which is tied to the aviation industry and which was acutely impacted by the severe reduction in air travel. Otherwise, these businesses probably reflect the experience of many businesses across America.

Insurance underwriting was down compared to last year but positive and indicative of very good results. Even breakeven insurance underwriting produces huge economic benefits to Berkshire through use of float. The railroad is an essential business but suffered a slight drop. The utility segment actually increased earnings by 10%, which reflects additional buildout of the stable asset within Berkshire.

On the whole, Berkshire's after-tax operating earnings fell 9% year over year. The investment and derivative gains/losses and the net earnings figures are largely noise. Accounting standards require unrealized and realized gains flow through the income statement, which distorts the financial picture. Focus on the operating earnings line.

Through the first nine months of 2020 Berkshire repurchased $15.7 billion of its own shares. This represents about 3% of outstanding shares and will be a benefit to continuing shareholders. I would expect to see that total rise closer to $20 billion for the entire year. In a market that has quickly run up and left Berkshire's cash sitting idle, one benefit has been its own relatively stagnant stock price. *This is a welcome state of affairs*. We plan to own Berkshire for a long time. If the company can repurchase shares below intrinsic value our holdings are enhanced that much more.

	Oct. 1, 2019- Sept. 30, 2020		Oct. 1, 2018- Sept. 30, 2019	
Berkshire Hathaway After-Tax Earnings	*($ millions)*		*($ millions)*	
Insurance - underwriting	$99	*0%*	$957	*4%*
Insurance - investment income	5,212	*24%*	5,248	*22%*
Railroad	5,092	*24%*	5,429	*23%*
Utilities and energy	3,039	*14%*	2,754	*12%*
Manufacturing, service and retailing	8,063	*38%*	10,446	*45%*
Other	(223)	*-1%*	(1,392)	*-6%*
Operating earnings, after tax	**$21,282**	***100%***	**$23,442**	***100%***
		0%		
Investment and derivative gains/losses	($25,504)	*n/a*	$4,617	*20%*
Net earnings (loss)	($4,222)	*-20%*	$28,059	*120%*

Note: Other adds back goodwill/intangible impairments of $10,863 for the TTM 2020 period.

The market appears to be pricing Berkshire at a 10% going-forward return. For such a high-quality conglomeration of businesses that is a very good return. But it gets even better. That would appear to be a minimum return. It assumes earnings from the MSR businesses remain at a level 25% below what they earned in the prior TTM period. It also assumes no insurance underwriting gains, which Berkshire has historically generated. It doesn't include any optionality from the significant cash resources on the books, nor any benefit from growth in float, which is a possibility. In sum, Berkshire is a wonderful collection of many very good businesses that remains attractively valued.[1]

[1] An argument can be made that the valuation of Apple, which represents 50% of Berkshire's investment portfolio, is rich and should be adjusted down. Even after such adjustments, which may be offset by undervaluation elsewhere in the portfolio, the overall conclusion stands.

Breaking down Berkshire Hathaway's market value

What do we get for our money?

($ millions)		*% market cap*
Market capitalization on January 14, 2021	$560,000	*100%*
Balance sheet totals as of September 30, 2020:		
Insurance cash & Treasuries	$141,984	*25%*
Equity securities (net of deferred tax)	215,983	*39%*
Equity method investments	17,152	*3%*
Fixed maturity investments	19,435	*3%*
Subtotal cash & investments	$394,554	*70%*
Implied residual value of operating businesses	$165,446	*30%*
After-tax earnings (12 mo. 9/30/20):		
BNSF Railroad	$5,092	
Utilities & energy	3,039	
Manufacturing, service, and retailing	8,063	
Subtotal - after-tax earnings	$16,194	
Value assuming 10x	$161,940	*29%*

Assumes:
1. Equity & debt securities are fairly-valued.
2. Breakeven insurance underwriting ($1bn profit not included above).
3. MSR business results represent normalized earnings power.

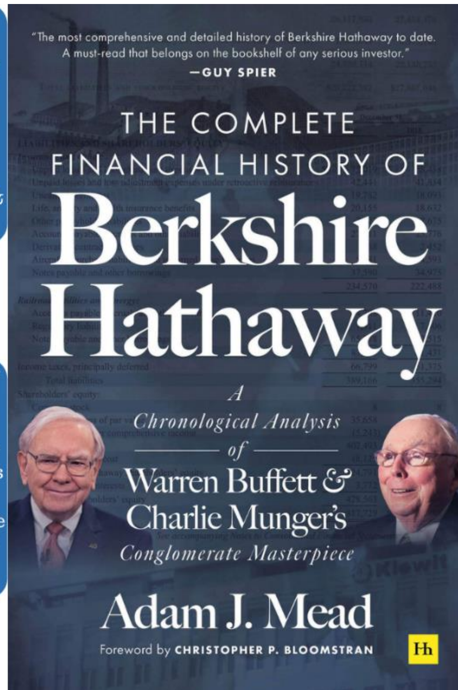
Lastly on the subject of Berkshire, you may have heard I wrote a book on the company. I bring this up not just to plug the book (which can be purchased here: https://amzn.to/3a5SEpW) but also for another important reason.

"For students of history, especially the history of Berkshire Hathaway's early days, Adam Mead's book is a must-read. I thoroughly enjoyed the chance to visit Berkshire's past through this wonderful book. I recommend it highly."

-Thomas A. Russo, Gardner Russo & Gardner LLC

"Few activities can be more rewarding for any value investor than studying the history and evolution of Warren Buffett and Berkshire Hathaway. Adam has done us all a huge favor with his yeoman efforts in producing this treatise. Since it is chronologically ordered, it is an invaluable reference guide for all things Berkshire."

-Mohnish Pabrai



"I and my teammates at the Gabelli Organization have been tracking Warren's success for some 50 years. Adam's book captures the work and highlights the history of Berkshire and the hard and diligent work of Buffett and Munger."

-Mario Gabelli, Chairman and CEO, Gabelli Funds

"With this project, Adam has a done a wonderful job extending the Berkshire Classroom by providing a comprehensive analysis of the rich corporate history and unique entrepreneurial leadership."

-Mac Sykes, Gabelli Funds

Writing the book made me appreciate the many nuances that add significant value to Berkshire. But there's a risk that putting so many words on paper and telling the world about it will cause me to act irrationally. Could I really sell an investment I just told the world was the greatest conglomerate? Will I be blind to disconfirming evidence that might indicate a permanent negative outlook for the company's future? These are important questions.

My hope is by talking about it like this I'll not only set the stage for maintaining rational thinking in the future but alert you, my clients, to the possible issue. Any manager who talks about his/her investments is subject to the risk I just outlined. Even writing a letter to clients about the positive attributes of current holdings creates the conditions for rational thought to be subverted by consistency/commitment bias. Such is the active part of active management: maintaining vigilance over investments *and* oneself.

Other Businesses

The other businesses in our portfolio, which I won't detail, demonstrate the resiliency of their business models and the long-term thinking of their management. Most of the businesses were impacted in some way by the pandemic and the resultant shut downs. But each has adapted in their own way to the challenges presented by their businesses and industries.

Each business has also maintained an eye on the horizon. The pandemic brought unique opportunities for strong businesses to expand. Such opportunities are the result of long-term thinking and preparation, long beforehand, to be in a position to use a strong balance sheet opportunistically.

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What is the market going to do?

Last year I went through an exercise explaining my thoughts on the market using an approach I learned from Howard Marks, chairman of Oaktree Capital Management.

In his excellent book, *The Most Important Thing*, Marks explains his approach to assessing the markets for their degree of attractiveness. Rather than plug in numbers to a formula that provides him with a number, Marks looks for an undefined but not unimportant *feel*.

- What are investors' attitudes generally: are they nervous, excited, neither?
- Are credit markets accommodative, tight, somewhere in between?
- Where are interest rates, are they high or low historically?
- What do valuations look like relative to long-term earnings?
- Where are we in the business cycle?

Marks' approach is one of taking the market's temperature and looking to see if many metrics point to the same conclusion. My conclusion is there is little to buy today that will carry reasonable prospects of above-average returns. To be sure, it's my own clearly subjective "feel" of the market. What's pretty clear, however, is the lack of any green indicators.

	Indicator of which type of market scenario:		
	Overvalued	**Neutral**	**Undervalued**
What are investors' attitudes to the market, generally?	Optimism/speculation		
Are credit markets accommodative, tight, or somewhere in-between?	Generally accommodative		
What is the general level of interest rates? Low, high, or somewhere in-between?	Historically very low		
What do valuations look like relative to long-term earnings?	High, but not as high if interest rates stay low		
Where are we in the business cycle?		Could be on the upswing; or, problems could mount	
Are profit margins high, low, or in-between?		Earnings impacted by COVID; tech margins high	

A closer look at the S&P 500…

Another exercise I went through last year, which I'll summarize/update this year, was an analysis of the S&P 500. The Standard and Poor's website provides some interesting raw data on the index, open for anyone to see. These include operating earnings, net earnings, dividends, buybacks, and data on book value, among many other data points. A closer look is very illuminating.

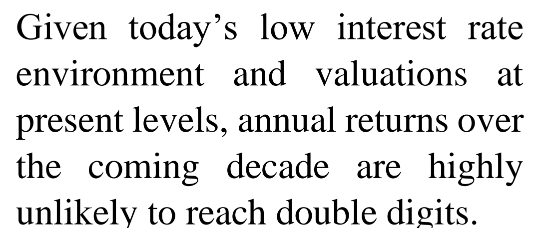
A few observations with the updated data:

- The price/earnings ratio continues to climb. Some of that increase is likely due to the "rational" expansion due to low interest rates. Another part is likely due to the fact that earnings dipped due to the pandemic, a condition that the numbers would imply was/is temporary.
- The balance sheet of the S&P 500 as a whole continues to deteriorate. While cash per share has increased, so too has debt. I wouldn't be surprised to see the debt/equity ratio top 70% by 12/31/20 when that data is available.

Now three points from last year that I'll repeat with some light editing/updating:

- If inflation and/or a return to "normal" interest rates occur, returns may well be negative over the next ten years as multiples revert. This may happen in spite of underlying earnings growth.
- It seems improbable that total returns in the future match those of 2020 (the total return of the S&P 500 was 18.4% in 2020). That would require a large upswing in earnings and/or a valuation change. For the index to return 20% from its point in September 2020, earnings would have to rebound to the same level as 2019 (about $148) with the same 27x multiple of earnings. Conversely, the price/earnings multiple would have to increase to 33x. Or some combination of the two. I'm not saying it can't happen (anything can happen in markets over the short run) only that it's unlikely. We've entered an area of the curve that's asymptotic (approaching zero)—it's inherently unstable.
- Compounding the valuation risk above is balance sheet risk. The companies in the index are collectively more highly leveraged than six or seven years ago.

In short, the trends in the index over the past half-decade or so are unsustainable. Trees cannot grow to the sky. Given today's low interest rate environment and valuations at present levels, annual returns over the coming decade are highly unlikely to reach double digits.



S&P 500 Per Share Analysis

	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	9/30/2020
S&P 500 Index	$1,426	$1,848	$2,059	$2,044	$2,239	$2,674	$2,507	$3,231	$3,363
Price return	*13.41%*	*29.60%*	*11.39%*	*-0.73%*	*9.54%*	*19.42%*	*-6.24%*	*28.88%*	*4.09%*
Dividend %	*2.60%*	*2.78%*	*2.30%*	*2.11%*	*2.42%*	*2.41%*	*1.85%*	*2.61%*	*1.48%*
Total return	*16.00%*	*32.38%*	*13.69%*	*1.38%*	*11.96%*	*21.83%*	*-4.39%*	*31.49%*	*5.57%*
Operating EPS 12mo	$97	$107	$113	$100	$106	$125	$152	$157	$123
Multiple	*14.7x*	*17.2x*	*18.2x*	*20.3x*	*21.1x*	*21.5x*	*16.5x*	*20.6x*	*27.3x*
Book value per share[1]	$667	$716	$727	$740	$769	$827	$852	$914	$902
Debt per share[2]	$270	$327	$366	$426	$430	$456	$500	$609	
Cash per share[2]	144	174	184	192	203	228	196	222	
Net debt per share	126	153	182	234	227	229	305	387	
Debt-to-equity	40%	46%	50%	58%	56%	55%	59%	67%	
Debt-to-total cap	29%	31%	33%	37%	36%	36%	37%	40%	

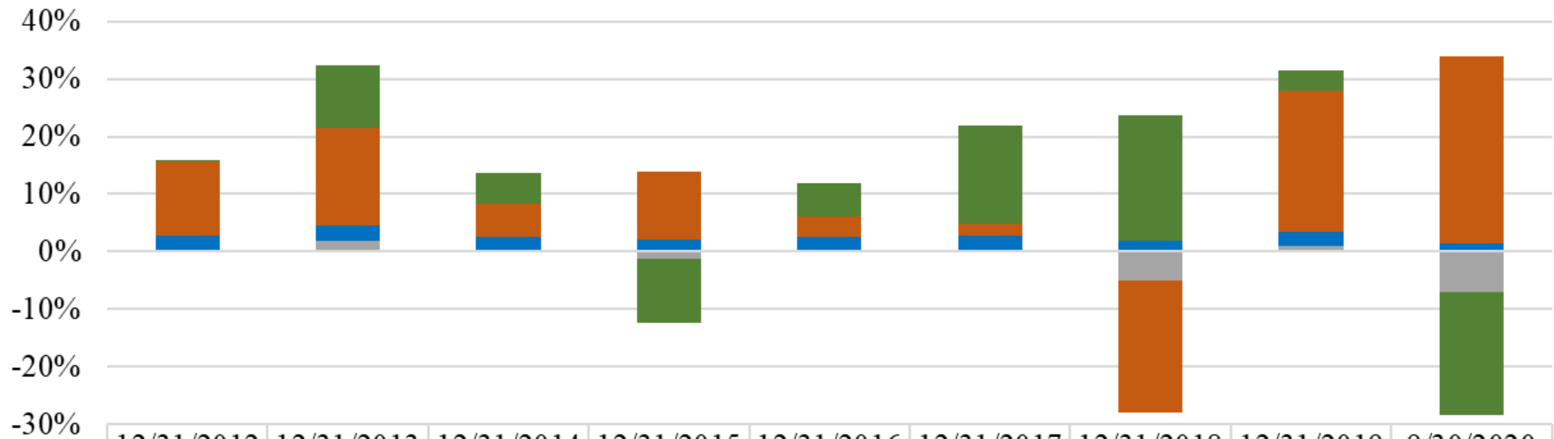
1. June 30, 2020 value used as Sept. 30, 2020 not available.

2. I've elected not to include these figures for the 9/30/20 column since the latest available is 3/30/20.

Sources: S&P Indices data on S&P 500, and author's calculations.

Note: The S&P 500 total return for calendar year 2020 was 18.4%.

S&P 500 Components of Total Return



	12/31/2012	12/31/2013	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	9/30/2020
Change in Operating EPS %	0.39%	10.82%	5.33%	-11.12%	5.78%	17.17%	21.76%	3.64%	-21.48%
Change in multiple %	12.96%	16.94%	5.75%	11.70%	3.55%	1.92%	-22.99%	24.35%	32.57%
Dividends	2.60%	2.78%	2.30%	2.11%	2.42%	2.41%	1.85%	2.61%	1.48%
Compounding effect	0.05%	1.83%	0.31%	-1.30%	0.21%	0.33%	-5.00%	0.89%	-7.00%

Compounding effect   Dividends   Change in multiple %   Change in Operating EPS %

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Conclusion:

There are many indicators pointing to an unfavorable investment climate at present, but as the sage said, "this too shall pass," and I'll be ready.

That doesn't mean I'm sitting around, however. Quite the contrary, my investment process has continued unchanged – and it won't change no matter what the stock market does. That process is one of building a roster of excellent companies that I know and understand deeply, regardless of price, and waiting for them to go on sale. I know full well that we may never get to purchase all of them at prices that provide a high probability of satisfactory returns with a built-in margin of safety. But some eventually will meet all my criteria, and I'll be ready. There is little to buy today at current prices, but much to do to prepare, to expand the roster of great businesses, and deepen my knowledge of those already on the list.

Thank you for your continued faith and trust in me with your hard-earned capital. I look forward to reporting to you in another year.

Rationally yours,

February 15, 2021

Important Disclosures:

Mead Capital Management, LLC is a registered investment adviser based in Derry, New Hampshire. Adam J. Mead is its principal, CEO, Chief Investment Officer, and managing member.

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Investments involve risk and, unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.

Past performance is not indicative of future performance.