August 14, 2020

"If you can't predict what tomorrow will bring, you must be prepared for whatever it does." – Warren Buffett, 2014 Berkshire Annual Letter

Dear Partners,

It's hard to believe we are less than two-thirds of the way through 2020. Some commentators have suggested that we've experienced multiple years or more worth of events in less than a year. But are such periods of disruption and rapid change unusual? History suggests not. In fact, periods of *calm* are unusual.

Human history is replete with examples of war, pestilence, disease. The Antonine Plague in Rome lasted a whopping 15 years between 165 and 180AD – and it was far worse than what we are currently experiencing. Epidemics were quite literally a part of everyday life in Rome and other ancient cities. Fast forward to more modern times (1800s-present) and we see countless examples of financial panics and economic calamities brought on by excess, speculation, and international capital flows (for a survey of such events Kindleberger's *Mania's, Panics, and Crashes* is a classic). We tend to view these events as exogenous, or as outside of the system, disrupting all our good work to bring wealth and prosperity to all. In reality these shocks are a part of the system.

Today we face a global pandemic complicated by modern globalization and technology. We've quite literally never been here before because the combination of factors is new. We've faced a pandemic before, in the early 1900s. We've faced significant unemployment before, in the 1930s and again a decade ago. We've faced certain asset and stock market bubbles too (as the present general market appears), again under different circumstances. How this combination of factors will play out no one with any humility can tell. And we have no idea, like in chemistry, whether A + B will lead different results than B + A (order matters).

The question then becomes, how do we invest in such a world? How do we invest in the face of great uncertainty?

- The first step is to acknowledge that uncertainty is always present, whether we recognize it (and act accordingly) or not. The sun is always shining; it's the rotation of the earth that periodically shields our view.

- Next, we must separate business results from the stock market. The former drives the latter over time, though it is the latter that gets disproportionate attention. We want businesses that will do well over time, delivering a good or service that's needed or desired, with some sort of protected economic position, and conservatively financed to withstand the shocks that are sure to come. We want managers that share our views.
- We must then act long-term aggressive. Good businesses are rare. Buying them when they are available at a rational price should be done regardless of current uncertainties and outlook, provided all risks are reasonably weighed. Owning good businesses over the long-term is far safer than almost any alternative, ***given a long enough time horizon.***
- Crucially, we must then act to protect the time needed for long-term business results to materialize. This means keeping ample cash on hand to withstand the vagaries of the present so as not to disrupt long-term holdings.

What I've just described is a sort of barbell strategy. On one end are long-term commitments to good businesses. On the other is a supply of liquid resources that serve to protect the other end, and when appropriate, shift into long-term commitments. The short answer is we must be both conservative and aggressive, in the right combination. Trying to dabble in the middle by setting up stop loss orders, constructing hedges, etc., lead to mediocrity and introduce chances for mistakes.

Before ending this general commentary I'll leave you with Buffett's full quote:

> "The reason for our conservatism, which may impress some people as extreme, is that it is entirely predictable that people will occasionally panic, but not at all predictable when this will happen. Though practically all days are relatively uneventful, tomorrow is always uncertain. (I felt no special apprehension on December 6, 1941 or September 10, 2001.) **And if you can't predict what tomorrow will bring, you must be prepared for whatever it does." [Emphasis added]**

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Sold Trupanion; Berkshire Update

I won't spend too much time on our current portfolio. But two updates seem warranted. During the quarter I sold our holdings of Trupanion. In typical fashion the stock promptly rose by double digits. That's okay. I maintain my admiration of Trupanion and the work its management team are doing to bring simple, affordable pet insurance to market. But the valuation the stock market placed on the company was far greater than I felt warranted, even for a long-term holding. We sold at a valuation of $2 billion. The company is reinvesting heavily so its free cash flow is hampered, but I couldn't see the company having the *ability* to deliver even $100 million a year in earnings so I sold it – for now.

With Berkshire a ~50% holding across accounts a quick update is in order. Berkshire just released its second quarter results. The conglomerate, being so widely diversified, is also a good general barometer for the American economy. Here are the highlights:

- Operating earnings of $5.5 billion (down 10%)
- $10 billion goodwill write down related to Precision Castparts (not included above)
- Share repurchases of $5.1 billion
- $147 billion of cash at quarter end
- $227 billion of investments at quarter end
- $131 billion insurance float

Let's dig in:

		% change from:	
After-tax earnings	6/30/2020	6/30/2019	3/31/2020
Insurance - underwriting	806	128%	122%
Insurance - investment income	1,368	0%	(1%)
Railroad	1,131	(15%)	(5%)
Utilities and energy	633	4%	13%
Manufacturing, service and retailing	1,449	(42%)	(29%)
Investment and derivative gains/losses	31,645	299%	(157%)
Other	(10,737)	nm	nm
Net earnings (loss)	26,295	87%	(153%)
Remove: investment gains/losses	(31,645)	nm	nm
Add back: goodwill/intangible impairment	10,863		
Operating earnings, after tax	**5,513**	(10%)	(6%)

- **Insurance underwriting:** Insurance results from quarter to quarter are almost meaningless due to the impact of reinsurance. That's no different today, though GEICO had an unusual quarter. GEICO's $2 billion quarterly profit was abnormally high. This was in part due to lower losses related to drivers not on the road. The accounting of GEICO's 15% giveback is such that earned premiums will face a $200 million *monthly* hit over the next year. If losses remain low this should all wash out (mostly), but if losses revert GEICO could face actual losses. Reinsurance recorded a $1.1 billion loss for the quarter which is not at all uncommon. Some of that was due to deferred charge amortization (a non-cash item), and some was due to unfavorable loss development. COVID-19 claims were $350 million in the quarter.

- **Float:** Related, insurance float was $131 billion, a $1 billion increase for the quarter. Putting everything in context, Berkshire has use of $131 billion and get paid to hold it, to the tune of $806 million in Q2. Even a diminution of GEICO's profits shouldn't hurt that stellar result.
- **Railroad:** BNSF experienced an 18% drop in volumes during Q2, which translated into the 15% drop in year-over-year profits. Rail remains an essential business and should track general economic results over time. The cost advantages of rail over truck aren't going away.
- **Utilities:** The energy business improved profits largely due to a tax credit related to sustainable energy development. Volumes in some units did decline. Overall, the energy business as an essential service should be immune to major disruptions.
- **MSR:** The real action happened in this category. Here's a snapshot from the Q2 report:

	Second Quarter			
	Revenues		Pre-tax earnings	
	2020	2019	2020	2019
Industrial products	$ 5,789	$ 7,887	$ 535	$ 1,552
Building products	4,968	5,369	696	726
Consumer products	2,276	2,950	168	249
	$ 13,033	$ 16,206	$ 1,399	$ 2,527

Precision Castparts, the aerospace company Berkshire acquired in 2016, led the industrial products decline. PCC's revenues declined 33% and it reported a $78 million loss during the quarter. As a result of the magnitude and duration of the hit to its business, Berkshire took a $10 billion write-down of the goodwill asset account setup upon its acquisition. That write down is real in the sense that it reflects the real decline in earnings power of PCC, but is non-cash in nature and not included in the table above. Lubrizol, Marmon, and IMC, other industrial companies in the category, also suffered large double-digit declines in revenues and earnings.

One bright spot within building products was Clayton Homes. The significant housing stock shortage nationally continues to be a tailwind for Clayton. Its revenues increased 8% quarter-over-quarter, and tis earnings increased 13%.

Consumer products revenues and earnings took a 23% and 33% hit, respectively. This isn't surprising given the pullback in purchases of such items as furniture, jewelry, and apparel/footwear. Somewhat surprisingly, Forest River, a manufacturer of RVs and other recreational equipment, saw a 26% decline in sales. The press highlighted strong sales of such products as consumers found ways to take vacations away from people. The discrepancy probably lies with the lag between purchases of showroom inventory and manufacturing.

Revenues and earnings at the service businesses fell 22% and 48%, respectively. This group contains such businesses as FlightSafety and NetJets, two very capital intensive businesses. Declines in revenues have a disproportionate effect on earnings.

Berkshire Hathaway remains our largest holding for a reason. The short answer is Berkshire has resilient businesses *and* an attractive valuation. A large part of Berkshire is its railroad and utility businesses, which are not immune but certainly are resistant to economic conditions. The manufacturing, service, and retailing businesses are for the most part the very best businesses anywhere (perhaps outside of tech) and will do well over time. They will be subject to disruptions to be sure, but all are financed conservatively and operated by managers with an eye squarely on the long-term.

Berkshire's valuation remains attractive. A rough "back of the envelope" valuation: Consider the $147 billion in cash and $227 billion in securities (mostly stocks but some fixed income; knock off ~$20 billion for tax on unrealized gains if you want). Those two "buckets" sum to $374 billion. The market is currently valuing Berkshire at $500 billion. That means all of those businesses just mentioned have an implied value of about $125 billion. Even assuming the current quarter holds as the new permanent base of earning power, assuming breakeven underwriting, and giving no credit for investment income (so as not to double count), annualized after-tax earnings would be $13.5 billion. That means the market is saying all of Berkshire's businesses are worth less than ten times earnings. It's no surprise at all Buffett and Munger thought the best investment in the quarter to be Berkshire itself, buying back about 1% of the company.

Berkshire remains the best risk-adjusted investment I can currently find, and one I'm comfortable holding no matter what comes next. The general sentiment goes for all of our holdings. **Uncertainty – even great uncertainty – is no reason to part with great businesses and management teams.**

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The remainder of 2020 is sure to bring new surprises and strong (and vocal) opinions. Most will be noise hiding a small amount of valuable signal. Will such events and the commentary/opinions around them create market disruptions? Probably, but I have no idea. But we should be ready for them. I'll leave this letter with a segment from my June letter that holds true:

"The market fluctuations at the beginning of this year should fortify you for what may come again this year—and will surely come again at some point. In short, I think it could get very bumpy. But therein lies our opportunity to buy good businesses for the long term … Owning businesses through the stock market requires part financial acumen and a psychological makeup that allows for fortitude in the depths of apparent crisis. We will have future crises again, that is certain. When is anyone's guess. We'll be ready."

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I wish you all a safe and enjoyable close of summer.

Warmly,

Adam

<u>Important Disclosures:</u>

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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