Southeastern Asset Management

Our last note focused on mistakes in value investing through the lens of our Business, People, Price approach. We will now go in a different direction honoring the biggest investing news this year: Warren Buffett's retirement as CEO of Berkshire Hathaway (BRK). It is hard to say much new about him and BRK, but we will try by focusing on our "most undervalued" Buffett lessons.

Let's start with how Buffett started, as this 1990s exchange shows:
"Adam Smith (pseudonymous author of *Supermoney* and other classics): If a younger Warren Buffett were coming into the investment field today, what areas would you tell him to point himself in?
Warren Buffett: …I'd tell him to do exactly what I did 40-odd years ago, which is to learn about every company in the United States that has publicly traded securities, and that bank of knowledge will do him or her terrific good over time.
Smith: But there's 27,000 public companies.
Buffett: Well, start with the A's."
The unglamorous part of our job at Southeastern is best defined by "start with the A's." We must keep going down the list of stocks to build our master list. In the early 1950s, you could find great stocks at low single-digit multiples of growing earnings by flipping through a Moody's Manual and then following up with shoe leather research. We have computers today, but discipline remains important to the research process. The good news is that investing is a powerfully cumulative business if you can stay at it. This is still the best way to get ideas vs. "hey somebody told me" investing. Buffett has said that he spent 80-90% of his time in his earlier days reading, and the rest of his time was spent in brief talks on the phone and meetings. As BRK got bigger and had to shift its focus, Buffett has spoken (wistfully?) about still finding smaller market cap companies in the USA (a '99 stock tip from him for a contest winner was a small REIT) and going down the list in other countries, speaking to the need to keep learning as things change.

Our second lesson comes from 1969. Buffett said the following in a Forbes interview that year: "I'm 15% Phil Fisher and 85% Benjamin Graham." When he said this, he was in the process of closing down the Buffett Partnerships and focusing on BRK. His assets under management at the time were roughly $100 million. While that might not sound like a lot today when trillions of dollars are thrown around, it is roughly equivalent to $20 billion in today's stock market (using a 10% Compound Annual Growth Rate (CAGR) on that $100 million since then to keep up with S&P500's ~10% CAGR over that timeframe). It indeed would have been hard for Buffett to keep doing his unique mix of generally undervalued stocks + "workouts" and "controls" at that size. He moved away from his initial approach of stock-picking to one that incorporates more 80-100% business-ownership out of necessity to keep growing BRK's value per share at scale, not because 85/15 Graham/Fisher (or maybe even something closer to 50/50, which is how we would describe our approach) would not work today. It is also worth noting that BRK had a rough stretch vs. the market as he made this adjustment (we were founded in 1975 in the midst of the brutal '66-'82 market), and we see a lot of parallels to the early '70s overvalued, top-heavy market and today's, which is exciting to us for the coming years.

If we had to pick one single page from all the BRK shareholder letters over the years that has been most impactful with our investees, it would be from 1984's letter on share repurchase. With our unique style of engagement, we have sent this to investees many times in the past and will do so many times in the future. Most management teams and boards do not understand when to buy their own shares. Thus, overall corporate share repurchase has been shown in studies to destroy value because it is done too often when things are going well and it feels like a safe way to juice short term earnings per share in order to help hit an annual comp target or "offset dilution." The truth is that paying a discount for what you know better than anyone else is the lowest risk, highest return form of capital allocation. It does not always feel like an easy decision when times are tough, but that is how you get a bargain. This correct kind of share repurchase also has the benefit of narrowing the future gap in Price to Value (P/V) by instilling confidence in future capital allocation, which is why BRK itself has rarely traded at a discount. There is nothing wrong with holding a quality company like BRK at fair value, segueing to…

Our last lesson has been learned in real time over the last 10-15 years. Both Buffett and Munger at the 2012 and 2013 BRK meetings riffed on how Google and Apple were "extraordinary companies," but they could not get there on them as investments. By the 2017 meeting, Buffett was saying the following: "Apple is much more of a consumer products business, in terms of analyzing the moats around it… in terms of laying out what their prospective customers will do in the future, as opposed to, say IBM's [which BRK owned unsuccessfully earlier in the 2010s], it's a different sort of analysis." This turned out to be a very correct call at 10-15x Free Cash Flow (FCF) per share (and we were glad that we at least bought Google/Alphabet in 2015 at a similar effective price), which is a powerful reminder to be willing to change your mind as the facts build. We have also been intrigued to see BRK selling Apple recently. Buffett has said less about the reasons for these sales, as is his right. But we think these sales are driven by Apple trading materially above its fair value along with other large cap growth stocks. Buffett has talked before about his regrets on not taking some off the table at an overvalued Coca-Cola in the late '90s, and he is smart enough not to make the same mistake multiple times.

The market has only gotten more speculative since our last Research Perspectives note in August, so it is a good time to highlight the most-BRK-like companies in our portfolios today. **Graham Holdings Company** (GHC), **White Mountains Insurance Group** (WTM) and **Exor** are 3 that have been inspired by BRK. We believe these holdings can keep our money safe while growing it over the long term. The **Business** case for all 3 cannot be described briefly enough for our 2-page limit, but the summary is that these are diversified companies owning understandable assets that can grow FCF per share.

Two of these companies have BRK links on the **People** side, and we think the other would make BRK proud. GHC came first for BRK, as they invested back when it was called the Washington Post in the midst of a tough economy and Nixon's ire. Buffett partnered with Kay Graham and her son Don to compound at a teens CAGR over roughly 40 years before parting ways in a mutually beneficial asset swap transaction. Today, CEO Tim O'Shaughnessy is focused on value per share and executing strongly. BRK made another great 1970s investment in Geico, thanks in large part to WTM's founder Jack Byrne. It is hard to understate how precarious Geico's position was before Jack began turning it around in the late 1970s. Given how BRK's initial investment in Geico of less than $50 million plus a buy of the remaining 49% for $2.3 billion in 1995 turned into something today probably worth well over $100 billion, Jack is a first-ballot BRK hall of fame partner. Today, WTM serves as a model for how the post-Buffett BRK can keep its culture going, and we are grateful for the smooth CEO transfer underway after Manning Rountree's exceptional work for shareholders has set Liam Caffrey up to succeed. Exor does not have any BRK links to those degrees in its history, but CEO John Elkann has a BRK-like approach to capital allocation. When he got on the case in the late 2000s, Exor was an inferior way to own one of the worst car companies in the world (Fiat), much like Berkshire's initial textile asset base. Through wise moves since then, Exor has grown its value per share at a high teens CAGR for almost 20 years. This is all while materially improving the qualitative mix of assets at the company – there is now more luxury (Ferrari) and healthcare (Philips and bioMerieux) than Fiat.

Price is attractive on all 3, especially on a Price to Enterprise Value (P/EV) basis where each company scores strongly in the 60s% zone. As Buffett and BRK have taught the world, not all P/Vs are created equal, and if you have a low P/EV with the right partners on offense, value per share will keep growing in ways that do not show up in today's spreadsheets.

Thank you for reading. We believe the best way to connect is through meaningful discussions about companies, so please reach out to info@seasset.com if you would like to continue the conversation.