

We are out with the fourth episode of *This Week in Intelligent Investing*, featuring Elliot Turner of RGA Investment Advisors, Phil Ordway of Anabatic Investment Partners, and Chris Bloomstran of Semper Augustus.

Enjoy the conversation!

In this episode, John hosts a discussion of:

- the intersection of position management and research (led by Elliot Turner)
- a preview of Larry Cunningham's guest appearance (led by Phil Ordway)
- a recap of Berkshire's Q2 earnings report (led by Chris Bloomstran)

Listener Perspective

Fellow MOI Global instructor Dave Sather, President of Victoria, Texas-based Sather Financial Group, shared the following thoughts after reflecting on this episode:

If it were not for the Great Recession — and the associated bank bailout and preferred securities Berkshire received, we have often wondered if Berkshire would have taken a position in Goldman. In our opinion, Goldman sold their souls when they did their IPO in 1999. Once the partners' capital was cashed out, the reach for money overwhelmed their desire for a clean reputation.

Buffett has often admired Jamie Dimon and used JP Morgan as a preferred banker to Berkshire. However, after the Solomon scandal he opined that investment banking was feast or famine depending upon who the rainmakers were. If you lost a rainmaker, it could really impact the bottom line. As such, given reputational risks, selling Goldman does not surprise us.

JP Morgan was a little less obvious. We know Buffett's admiration for Dimon and we know that Buffett, personally, has significant holdings in JP Morgan. However, would it be that attractive without Dimon? Maybe Dimon's age and recent cancer scare got Buffett's attention. For us, there have been easier decisions to make.

The Wells Fargo and Bank of New York decisions are not surprising, either. We vacated our bank holdings a year ago. Net interest margins continued to compress, compliance costs continued to increase....and this is before factoring in COVID related loan losses.

Add in the reputational risk to Wells Fargo and there has been much to dislike. Their investment division has struggled to hang on to people and customers. WFC was not allowed to participate in the PPP loans because of their "troubled bank" status. WFC has a much higher cost of compliance due to their numerous, and on-going, issues. The one good thing with WFC is that they stole Bank of NY's CEO, Charlie Scharf.

Bank of America, on the other hand, will touch 50% of US households via one of their products. Brian Moynihan has stabilized and revived BAC. He is well respected by peers and regulators. BAC is doing an admirable job of making fees versus net interest margin. For instance, a friend recently looked to refinance their home. The drop in rate was ok going from 3.875% to 2.9%. However, BAC got to bank a \$10,000 refinance fee on a \$275,000 house. That is fee revenue of nearly 4%. Compliance costs are impacting all banks. As such, it really requires significant size to survive. In the banking industry, only the largest will be able to pay up for compliance....and still have a decent rate of return.

With Bank of NY, we still think it is a wide moat business... but reminds us that even wide moat businesses can be sub-par investments. With BK also losing their CEO to WFC, it just added another headwind. With interest rates coming down, BK has even less opportunity to make money via interest float. The one good aspect for BK will remain the expansion of technology and a reduced need to rent real estate. Even then, there appear to be easier decisions to make.

The Apple decision and the airlines both have some liquidity similarities. Both allowed Buffett to deploy a fair amount of cash. With Apple, there is lots of daily volume as well as a significant amount of cash on Apples balance sheet that must give Buffett some peace of mind. However, it does appear that Berkshires cash is presenting a bit of an anchor on where/how Berkshire can deploy cash. For us, the airlines definitely identified a situation in which we wonder if the circumstances were the same... but Berkshire had much less cash... would Buffett still have allocated cash to the airlines?

The conversation on position sizing was quite good and very appreciated. We have often observed Don Yacktman scale up and down the same positions in a portfolio. It seemed like there was some similarity of strategy/philosophy voiced in your conversation.

The following transcript has been created by MOI Global. It has been edited slightly for clarity but may contain errors.

John Mihaljevic: A warm welcome to season one, episode four of This Week in Intelligent Investing. It's a great pleasure to have with me Elliot Turner, Phil Ordway, and Chris Bloomstran.

Elliot, we missed you last week, so we are glad to have you here this week. I'll ask you to go first because you have a topic that has been discussed a bit in the past, including at an MOI Global event you attended. It's a topic that resonated with everybody at that talk.

Elliot Turner: Thank you, John. I'm excited to be back with you guys. It's good to be connected to the world again, too. Stay-at-home orders with no power cable lines coming to your house takes it to a whole new level.

As for the topic, I asked a few of my friends what they wanted to hear me talk about. These people have heard me speak on this topic, and yet, they can't get enough of it. It's position

management and its intersection with the research process. There's little literature on the subject, and I feel like it doesn't get talked about a lot alongside investment. We have plenty of textbooks on how to invest and break down businesses in various ways but not much on position management. What I wanted to do is more prompt a conversation by sharing part of my framework and how I think about it. My framework is a work in progress, and I'm constantly trying to improve upon it, so I want to hear what other smart guys think so that I could get better at it.

To me, position management starts before you even own something. You have to do the work, get an idea of a price you want to get involved at, and follow something on your watch list. You have to keep learning more as time goes on. The more you follow something, the more you learn about it, and the more conviction you can inevitably get. Sometimes, what might have started as a very low price, waiting for stock X to fall 20%, the more conviction you could get, you could step up a little higher, but it also maybe works the other way. Either way, you're learning more over time, and the longer you do this, the deeper your wealth of knowledge on a given company. The more you know it, the higher your conviction can inevitably be if you do take the position.

Not enough investors appreciate George Soros, and I think he introduced the idea that every position you take in the market is a testable hypothesis. In other words, the market is giving you feedback every time you make an investment. The day you make an investment, you're effectively tossing a coin. You're hoping it goes up. Maybe you're hoping it goes down if you want to buy a lot more, but effectively, you're hoping it goes up. However, it could go down just as easily. It's a 50/50 chance that on that day, it's going to go up or down. Three days later, it's still close to a 50/50 chance, but the longer your timeframe goes, the more your work gets to stand for itself. That's the Ben Graham concept of "a voting machine in the short run, a weighing machine in the long run." You don't want the direction the market moves early on to sway you. However, you are making a testable hypothesis, and sometimes the feedback from price is something important you should be thinking about and synthesizing in your understanding of what's going on and what's driving a stock.

I think a lot about starting slow and building a position. In doing so, you learn about the position and yourself. I've settled on this idea for myself that if I ever fear that if something I own went meaningfully lower, I should sell that day and revisit later because I don't have conviction; I'm a weak hand, and I'm not knowledgeable enough in the idea. Another thing I think about is when you're in a stock, you are subject to different forces, and when you see things move around, you start getting an appreciation for what drives the stock and what people are looking for in it. Listening to earnings call in real time and hearing the tone of management and the analysts asking questions is quite different from going backwards and reading past transcripts. You start feeling differently about things and seeing them through a different light. I find some pretty good insights in there where you could identify those wedge issues and figure out where you have a truly divergent position from the consensus. Sometimes, that is an important signal where you should take that smaller position to something much larger when you believe strongly in that divergent position.

Ultimately, I think investing is a quest for conviction. Your goal is to find positions, not just ones you think are good risk/reward, but ones that you could see through even when things aren't necessarily working their best for you. The market is trying to impose its will on you, to take advantage of the fact that we as individuals are all fallible, and to expose our human biases. The more work you do, the more you understand a position, the more you have been exposed to the ups and downs in it, and the more you are able to stick through the hard times and hold things. For me, one nice thing coming out of a period like March is that you end up owning only the positions you have the most conviction behind, that you absolutely love, that you can stress-test and believe in under the most harshest conditions. That's my framework on a position level, and I'd love to hear your perspectives and anything that might be different.

Phil Ordway: What's the smallest position you'd be willing to take then?

Turner: To an extent, that's slightly outside this framework. So far, if something has a 10:1 chance of paying off and let's say the way it wouldn't work is it would be a zero, I'd probably size it as a 1% position, a 50/50 shot of a 10:1. In theory, if I had a series of infinite opportunities as such, I'd be much larger. The Kelly Criterion would suggest as much, but we don't have an infinite series of them. For the most part, 2% to 3% would be where I'd start in my core positions. Inevitably, we have a different mandate in SMEs than the hedge fund, but I'm looking to get everything up to 10% if I can.

Ordway: For me, the hardest part is finding those improbable but skewed in your favor positions where you're certainly not going to put 10% in them right away, but if you had a hundred of them, you'd probably neglect some of the work you'd need to do. Like you said, you're not going to find a hundred of them, but it's always an interesting debate for me.

Chris Bloomstran: We parallel your thinking quite a bit. We generally start with smaller positions, 1% or 2%. In some cases, I started at 4% or 5%. In nearly all cases, we've spent lots of time following the businesses we wind up buying because most of our process revolves around our intrinsic value measure and the discount to intrinsic. One thing we do is position size based on market cap or what we perceive to be as a little more or a little less riskiness of a position. We will never allow or tolerate much smaller cap businesses to be huge positions in the portfolio. Berkshire sits at the top of our portfolio as a big position. We've had several that have been between 10% and 15%, but those are very noble businesses with highly predictive earning power. I'm curious how you think about position size versus your perception of the riskiness of the business.

Turner: Not to say that I think of volatility as risk, but it definitely comes into play. I'll give you a specific example. With Roku, I had a hard time thinking about how to size it at first because I started small. I had quite a bit of conviction, but in the first 13 days of owning the stock, I didn't see a single green day. This was December 2018. I think I counted the days - it was 3/4 of the days in the first quarter. It had an intraday range greater than 6%, which is absolutely nuts, but my conviction was really high. I've tried to strip that away and think more in terms of stratifying the risks and the variance within the portfolio. If I built an entire portfolio of such securities, I'd probably never sleep at night, nor would my clients. When I build a portfolio, I want to take that into consideration and to diversify my market

caps and risks. I want to stratify the risks in the portfolio so that I don't have too much crowding around one single risk factor. I want to diversify the correlations to certain things, like the growthier names tend to move together and be tightly correlated in value and vice versa. I want to have a little of it all so that I could balance it out.

Bloomstran: I think everybody thinks and talks about position sizing when they're buying, but how do you think about it when you're selling? How do you think about portfolio management? What's your sell discipline, and how does that relate to position size?

Turner: That's the biggest work in progress here. I feel like I overstay my welcome half the time. The other half of the time, I sell too soon. It's definitely an intrinsic value framework, so I think in those terms. At a certain point, however, I will effectively treat it in a momentum way. Coming from a trading desk, I have a keen sense of following momentum signals for trailing stops. If I feel something has achieved my objectives, even if it's a little overvalued, I'll let it run with a mental trailing stop in there where I'll get out once I feel like I've squeezed every bit of juice out of the lemon. I'm curious to hear what you guys think on that front.

Bloomstran: There are many reasons why you'd wind up selling something. The best case would be your position has achieved 100% of intrinsic value, even trades north of intrinsic to where the downside outweighs the upside. The interesting aspect of position size is when you either think you're wrong, know you're wrong, or might be wrong. In our world — and I'm sure you guys look at capital management the same — if you're starting at 1% or 2%, clients have a hard time wrapping their heads around the notion that you want to see your positions decline in price. Famously, Mr. Munger will tell you that you only want high prices at the moment you need your capital and you're going to sell. If you've always got cash and cash flows in, you always want low prices, and you want to be buying things.

If you're starting at 1% or 2%, which tends to be how we do it as well, I'd cheer when price drives and I don't think there's any diminution of underlying earning power or value to the firm. Maybe it's an art or maybe it's the experience of doing this for a long time, but where we've cemented losses and lost money, we've tended to not chase positions lower. Best case is the price drops, nothing is wrong with the business, and you add to the position. The price drops more, you add to the position. It can either be a one-off earnings miss or a wholesale market decline.

I don't think there's any quantitative way to do this, but there's an instinct you get to where you don't chase position size down. Early in my career, I had a couple of occasions where I made positions bigger reflexively, and it tends to be a problem. Obviously, if you know you're wrong, you're going to sell a position entirely, but you don't want to get whipsawed around positions either. You don't want to be day traders. Ideally, you and I are trying to get into positions to own them for a long time. How do you do that when you think you're wrong, but you're not sure you're wrong?

Turner: I've played it the wrong way, so personally, I've come to the conclusion that if I think I'm wrong, I sell now because if the price goes down further, I'll question myself more, and it's even harder to build conviction. It doesn't mean I won't revisit the company later

on. I'm doing this within a framework of keeping turnover pretty low. We've been below 20% turnover almost every year until this year. For the most part, if I think I'm wrong, it's a signal to me that I don't know it the right way, and I'm probably not in the right spot because, ultimately, I'm on a quest for conviction, so that means I don't have it.

Bloomstran: How do you look at that, Phil?

Ordway: What pops to mind is a great part of Jeff Gramm's book *Dear Chairman*, which is an excellent book on activism. I still remember it because this was perhaps the first time I'd ever heard somebody call it out. If you're going to be an active investor, you have to develop that conviction, do the homework and have enough of an idea of what's going on to take that position in the first place. If you're going to do that, you can't have hundreds and hundreds of positions. For me, it's generally 8 to 12, at the very most, 15 positions. The fewer the better. It sounds like you guys might be a few dozen positions, but again, you're not talking about hundreds.

I thought Jeff Gramm put it extremely well. He said if you're Buffett and if you're a good investor, and you're doing the homework, conviction is your friend. If you're everyone else, it's going to be your worst enemy, and you're going to get absolutely destroyed by that conviction because it's incredibly hard to know when you're wrong until it's too late. If you have a lot of conviction and a big investment, being wrong will cost you a lot. Conversely, if you're agnostic about things and own your index, you're definitely not going to get hurt by your convictions because you don't have any by definition.

I don't have an answer. I'm always trying to get better at this, to look for reasons why I'm wrong. Going back to what we discussed a few weeks ago, I always try to do a pre-analysis on what it would look like to be wrong. That's why it helped lessen the blow when the virus hit in March, and I had to take three or four years of work and a very large position and sell it. Thankfully, it was a tolerable loss, but a loss nonetheless, and I had to get rid of our airline investments because it became clear to me immediately that I was wrong and things had changed. In situations where it's less clear, I've definitely made a mistake by acting too slowly because my natural inclination is to trade very infrequently. The year before last, we only made buy or sell decisions on 17 trading days. We generally make a buy or sell decision maybe two or three times a month at the very most. We've had four- and five-month stretches where we have done absolutely nothing. My natural inclination trends in that direction, but it can hurt me a lot if things are changing slowly, and I miss it. I think I'm always trying to find the things I'm missing and areas of evidence to prove me that I'm wrong, and you have to be intellectually honest. I wish I had a better formula or a better framework than that.

Bloomstran: How do you think about selling when things have gone as expected and a position size grows closer to your appraisal of intrinsic value but also disproportionately larger relative to the size of a portfolio?

Ordway: That's a great one too. I'll give you an answer by anecdote. Only yesterday, I sold a position that had more or less been a moderate size position for me, so 7%, 8%, 9% position. This year, it's one of the relative winners out there. It's more than doubled and was up to

about 16%-17% of the portfolio. It was at a level that I thought fully accounted for its future prospects. It's a good business that will grow and has everything I look for, but it's pretty much fully accounting for all those things, so I've started selling it because I don't think it will grow enough. Yesterday, I was selling quite aggressively when the stock was up a lot. I get those decisions wrong a lot, too. I do not have a monopoly on good decisions in that regard. I think selling something that's up, that's doing well and working in your favor is one of the most common mistakes people in our shoes make. We are generally too quick to sell on the way up in those situations.

Bloomstran: I agree. Over the course of 30 years doing this, the biggest mistakes I've made are selling something too soon, selling because you haven't moved up your appraisal of intrinsic value, selling because the size relative to a portfolio is larger. The real boneheaded mistakes have come when I've completely eliminated a position size. I've written and recently talked about Ross Stores. Having made 2.5x our money during the 2000/2002 downturn with the stock, it was really cheap. It looked fully valued then, so I sold it, thinking I'd come back to it, but I never did. It was a 20-bagger after we sold it.

With businesses we want to own for a long time, I will trim a position when the valuation gets extremely full. I tend to trim incrementally, but one thing I've learned over the years is to keep a name in the portfolio. If I'm going to come in with a new position on the buy side at 1% or 2%, sometimes more, I'll take a position from 4% to 3%, 3% to 2%, or 2% to 1%, as I've done with Dollar General this year. I would take a business like Nike, which has gotten fully valued, down towards about 0.5% of our capital today. At 0.5% or even at 1%, I'm not going to get harmed if it takes some time for the underlying fundamentals to grow into the valuation. In Dollar General's case, it is going to open 1,000 stores annually for the next 8 to 10 years, and it's going to be a much bigger business. It will grow into its valuation. I run the risk that if I blow out completely of Dollar General or Nike, I'll never come back to them. However, if I keep them in client accounts and portfolios, I'm more inclined to take them from 1% to 1.5% or 2% and incrementally buy them on more modest declines. It's probably the most valuable thing I've learned over the years.

Turner: Some of the best decisions I've made are buying more of companies that are working at higher prices because I have an appreciation for why it's up and how it's not necessarily up enough to accommodate how much the business has grown or how well it is executing. I'm curious how you guys think about that too because Chris has said he has a similar framework on that front, starting small and getting into it. Obviously, if you buy something and it's going up, if it's gotten bigger as a percent of your portfolio and performed relatively well so it's already bigger, you've got to make the decision to buy up.

I have gotten to this framework of thinking not in terms of what price I'm paying today in the market when it's higher, but where I want my average price to be when I buy more shares given I already have a position. Knowing what I know, where would I feel comfortable for my basis to be today? It's not necessarily a perfect framework, but it's pretty helpful for me in knowing how to size it when I'm paying up, how to think about it and feel comfortable paying, not anchoring to my starting point but paying what I think is an appropriate price for my stake. How do you think about that?

Bloomstran: The two things I'll do that really work are maintaining a discipline of going back to the things you own and revaluing those businesses, incrementally moving up and adjusting your intrinsic value measures. It's not a weekly or a daily thing. I go through the process on a quarterly basis. A lot of it is just maintenance because very little should change. If you own a good business, the stock price may bounce around a lot from quarter to quarter, but your appraisals of underlying intrinsic value tend not to move much. They'll grow with retained capital and organic sales, but you've got to move those numbers up. If you leave the appraisals static, and you've got a rising stock price, they tend to grow.

The great thing that has happened in my world over the duration of running capital is that we're fortunate enough to generally have a handful of new clients hiring us over the course of each year. New cash coming in, whether from an entirely new client relationship or a deposit into a client account, forces you to go back, rebalance, and initiate positions. If I've let a position run up in size, and I'm underweight in various client accounts, sitting on a new pile of capital forces me to go back across the portfolio for all of our clients and assess whether I want to add position size. I'd probably not be as disciplined as that if I didn't have ongoing flows into the portfolio. It's just the nature of the beast. You've got to do something with capital. You don't want to have new capital come in and sit with it for an overly long period of time. You need to have discipline and a process in place on how you put brand-new money and deposits to work. That helps keep everything tight enough to where your modeling tends to work for you.

Ordway: I totally agree that quarterly is probably the right frequency. That might even be too much in some cases, but it's good to keep an eye on things at least quarterly and reappraise. I keep a running log, literally a physical notebook, along with all of my digital files where I do that every quarter. I run my eyes over the results and reappraise what I think the business realistically can earn and what it's realistically worth in a pretty wide range. I then flip back to what I thought last quarter, last year, and however many years I've been following the company and use that as the benchmark to adjust and update the numbers and my ideas in real time. In my view, that's the most effective way to do it. Beyond that, it takes a lot of work and judgment, and you'll get that over time with experience, by looking at these things enough.

Bloomstran: I will take an intrinsic value calculation and adjust for balance sheet components of debt, cash, and shares outstanding. A lot of that quarterly maintenance isn't so much moving around the multiple I'm going to pay for something or the durable margin of a business but the quarterly maintenance of the incremental use of debt, either taking it on or paying it down. It's any incremental build in cash, and it's the net change in the share count. You'll see your intrinsic value per share nominally move up and down based on those metrics. You get into a pattern of two, three, or four quarters where your debt numbers are incrementally rising, and you go back and to see where it's coming from. A lot of times, when you adjust your appraisals on a regular basis, you can start to catch problems before they come to pass. It's not so much that I'm trying to make sure my intrinsic value is always moving up with the growth of the business but that I find it immensely helpful to throw various fundamental criteria into the valuation model.

Turner: I end up with a lot of companies where certain higher frequency data points move things a bit more, and I try to hone in on one specific variable. In most of these cases, I tend to isolate on engagement. Some of the moves on that on a quarterly basis could meaningfully skew how you think about intrinsic value if you want to extrapolate a change. Do you weight it from a Bayesian perspective and give more weight to what was there before instead of what's there now in that sense? I approach that exercise quite similarly in each quarter, updating the intrinsic value and how I think about it and trying to give more weight to what I thought before rather than what I think now.

Sometimes, however, you have meaningful shifts in how the business is and what it's worth. One interesting concept I was introduced to as a documented inefficiency in markets is the post-earnings announcement drift, so stocks with catalytic moves on earnings, either up or down. It was defined in the original study as an 8% or more move in either direction. The market tends to not price enough the extent of those catalytic moves one way or another, so it gives you opportunities to act and make changes on the fly. Thinking about that in terms of the exercise, there are times when you update your intrinsic value and you see a big move, and you're like, "Wow, that didn't move nearly enough." Those are some of the most interesting opportunities I encounter in going about the exercise. I think it's a big reason why it's so damn worthwhile, and I tend to think about it quite a bit.

Mihaljevic: Can you guys talk a bit more about the idea of buying a starter position and then increasing the position size? If I feel like I've done the work and have the conviction, I'll pretty much buy a full position right away, the idea being I'm afraid that if it starts working, I'll be forced to buy higher. Psychologically, I guess I have a problem with that. How do you think about a scenario where you buy a 1% or 2% position and then it starts to run away?

Turner: Personally, I like to check FOMO at the door. I don't want to feel those forces working on me. I've done several things in my process along the way that I call imposed patience. They're things designed to slow me down because my inclination tends to be more towards action. I want to slow myself down at every step of the way because the slower I operate, the better I tend to do and think, and the better my framework. More often than not, if you check the history of things, you'd have a second, a third, a fourth, a fifth, and so on chance at everything along the way. Even with the best of things, you'll have had another opportunity to have gotten in it — maybe not at the exact same price, but perhaps what would be a better IRR even were you to pay a higher price down the line. Things tend to oscillate quite a bit around a mean. A few things tend to absolutely run away from what I've seen. The longer I've done this, the more I've found the value in that imposed patience. That's something I've had to consciously train and retrain myself on.

Bloomstran: I'll say it boils down to intrinsic and discount to intrinsic. Generally in my world, you're sitting around for years and decades in some cases, waiting for price and value to mesh. The reason I'll start at 1% or 2% is usually because I don't have an extremely wide discount to what I think the appraised value of the business is. I'll stick a toe in at \$0.90 on the dollar at 1% or 1.5%, and that gives me 11% upside plus the ongoing growth of the business, assuming the stock trades at intrinsic value. At \$0.80, you've got a 25%

upside. If I'm starting at 1% or 2% and buying at \$0.80 on the dollar, I'd love for it to get down to \$0.70 where I've got a 40%-plus upside. Again, there are many mistakes, and a lot of this winds up being coin flips. Sometimes things work for you. When I say work for you on position sizing, I mean the marriage of stock price declining sufficiently to allow me to keep buying and increasing my cost basis and the size of the position in the portfolio.

I've got countless mistakes over the years where I have got 1% in a position, and it doesn't decline in price anymore, so you wind up making 2x, 3x, or 4x your money on too little capital. I've done that a couple of times with cyclicals and deepwater drillers years ago, and it's frustrating. I did it with Disney a couple of years ago. I got a little capital in Disney at about \$100 a share, ran up to \$150 at year-end. Fortunately (at least in terms of being able to buy some things cheap), we had COVID this year, and I was able to take Disney from 1% of our capital to 4%, but I was beating myself up over the fact that I knew what Disney was worth. In my opinion, it was trading at 2/3 of fair value a couple of years ago, and it was a huge mistake to only get 1% and not add to it and even buy it at higher prices. Rectifying that, early on in the economic downturn this year, I was able to increase the position size.

Some of it comes down to luck. I don't think there's any systematic way to do this perfectly quantitatively. Folks talk about an art aspect to it, and there really is, but some of it is luck. I learned over time that if I've got conviction on a name, I've waited for 10 or 15 years, and I've got enough of a discount, I am going to come in north of 1% or 2%. I'll start at 4% or 5%. I've done that with a lot more of my positions in the last 5 to 10 years.

Ordway: From my end, the conviction level I want is relatively high. The concentration I have in the portfolio is very high because I think, quantitatively, there's definitely an art. I think you can also quantitatively make an argument that most people are overdiversified in many ways. That's great for the vast majority of people, but it's not great for most active managers trying to do something. When you get above 15 or 20 positions, the benefits of diversification start to diminish quite rapidly, and I'm even more concentrated than that. For me, a starter position is something like 5%. I'm then horrible at buying higher, and it's one of the great psychological traps I fall into. There are plenty of times where I've started buying something, and it's moved up 5%, 10%, 20%, or 30%, maybe it's doubled. However, the information has made it so clear that I was right and the future is even much brighter so that I should be buying even more although it's already moved up. Probably 9 times out of 10, I fail to make the right decision there. That's something I try to work on and to be aware of, and I still struggle with it.

Turner: I want to share something that might help with examples like the Disney problem because it's been a meaningful shift in my framework for thinking about valuation. I used to have this isolation of an intrinsic value and looking for a percent discount. I started re-gearing my entire valuation approach towards an IRR framework, the thinking being my ceiling is about 20% turnover, which means I hold a position five years on average. I started thinking about what IRR I could get a bull, bear, base case going out to five years, and you notice the numbers get a little fuzzier, so you get more clarity on how you think about the position and, inevitably, your expectations for your expected duration with the position. The extent of the discount to intrinsic value between 20% and 30% doesn't move the needle that

far when you look out over five years what your expected return might be.

Mihaljevic: Chris, you talked about buying more when a stock goes down and sometimes wanting that to happen. I'm wondering if you guys consult the balance sheet when it comes to such decisions because I feel like if a company is solid on the balance sheet, has net cash and so forth, where you feel like this cannot be a zero, I'm far more comfortable buying more as it goes down than if it's a leveraged balance sheet where you could end up destroying all your capital because this thing could go to zero.

Bloomstran: A good example here is a Norwegian 3D seismic business I owned some year ago. It had an okay balance sheet. Post 2014, when the oil price declined from north of \$100 to \$20 or \$30 a barrel, you saw a lot of things. I saw okay balance sheets that had numerous off-balance sheet liabilities. In the case of the business I'm talking about, you wind up with capital commitments to take equipment you'd contracted out two, three, or four years. This would have been great in a normal operating environment where your capacity could be utilized, but it became obvious that capacity was not going to be utilized. When you stress-test that, you have to go to the balance sheet.

Albeit in oil and gas, Subsea 7, an engineering and construction business that is a big position of ours, runs a pristine balance sheet. It's a sufficiently strong balance sheet to give me survivability regardless of the duration and depth of the downturn. There, you're measuring opportunity cost. I'd never want to be in a position where I permanently impair capital. If a business with a great balance sheet has gotten cheaper but perhaps less cheap than the business with a balance sheet that was okay to begin with but is now deteriorating, I'm way more inclined to sell that position. I'd take my loss and not chase it down and increase it in size even though when oil turns and the company winds up utilizing capacity, you end up making a hell of a lot more money. I'd rather swap to the opportunity cost of the knowable.

You're right, I think you have to go to balance sheet. I'm not going to get into bad balance sheets right at the outset. In all the years I've done work on businesses, I've very seldom been concerned about a declining stock price from the start. In fact, more often than not, I'm only getting into a position because the stock price has been declining already, and I go into that environment with a notion that I'm never going to get the bottom. I've got to be willing to start at a higher discount than what I think intrinsic value is, and, contrary to how most clients think, cheer for a declining price because we've done enough work to know that we're not wrong. Still, you do get into environments where the macro climate can change and you might have disruption, and then you've got to do some thinking and question yourself as to whether you want to make a business and a position size that much larger.

A lot of it boils down to experience, but like both of you guys, I try to jam as much money into my best names and my best ideas. We were on something like 3/4 of our capital in our top 10 names. We've got a lot of conviction in those businesses, and generally, the discounts to what we think the fair value is there are sufficiently wide. The one percenters and the two percenters are there because they're new or because I've trimmed them back and now, you're waiting for anomaly lower price. You look at those one, two, or even half percenters

as your farm team. To that end, yes and no. You're constantly looking at the balance sheet, management, and business quality, but those things don't happen quickly. It takes a cyclical downturn like the one we've had in energy to force you to go stress-test and be willing to take losses on a position size in a company that would otherwise be fine except for the depth of the downturn.

Turner: Yes, and the COVID crash was uniquely challenging on that front because you could talk about what this thing might do or what anything might do in the wrong side of the cycle, but there are so many businesses that you might have perceived differently in an environment where they couldn't even open their doors to do business and the entire revenue base wasn't capable of operating in the way it was supposed to. The whole playbook gets ripped up depending on how things play out.

Bloomstran: We ran very deep, very credit-intensive stress tests on every business in the portfolio, as I'm sure you guys did, even on those businesses that operate with net cash and no debt on the balance sheet. When you're in a position where you may lose quarters' or even years' worth of revenues, operating and financial leverage become hugely important things all of a sudden. With every business, we had a 10-12-page report we put together, stress-testing what this business will look like. You never would have imagined this, but multiple quarters' or even years' worth of revenues down by anywhere from 50% to 100% is an extraordinary thing. Back to John's point, a business where you never thought you'd have to worry about balance sheet integrity has you worrying about this all of a sudden when you quantify the degree to which an otherwise wonderful company is burning cash.

Mihaljevic: One last question on this topic before we move on to Phil's topic for the week. I'm wondering whether you guys employ options to any extent because they can skew, move this from a linear discussion to an interesting discussion around having more on the upside than on the downside. Do you think about that at all related to position sizing?

Turner: I use options in very specific situations. I think they're pretty advantageous because there's an inefficiency. When I go into options as a stock replacement, and I could think through that framework, the person on the other side is pricing with Black-Scholes for the most part, and we don't have the same objectives. I don't necessarily like to catch a falling knife, but if it's something I really like and don't own it yet but intend to, I'll sell puts and take advantage of the premium I could capture there and begin to establish a position without putting that much capital at risk right away. If I really like it, I'll sell puts to fund the purchase of calls and effectively have no capital outlay, not have much exposure in the range between the put and call strike.

The other thing I like to do relates to something working pretty well. Roku is an example that could use position management in many different ways. The stock went up way farther and way faster than I ever imagined. One of the promises I've made to my clients is to focus more on long-term management, and I don't want to give them too big a short-term capital gains any year ever. I was able to sell calls at pretty high strikes for pretty juicy premiums, take out the first 20% of risk on the position when it was much higher, and I thought that was very nice.

The third one I'll do from time to time is in something that's not a very volatile security, and I have a really high level of conviction, in which case I'll buy deep in the money calls to get some cheap leverage on the position. Those are three ways I try to deploy options.

Mihaljevic: Phil, I'll turn it to you now for your discussion prompt for the week.

Ordway: Thanks, John. I thought this week we briefly finish up what we've been talking about on a corporate governance investor relations perspective and lead into the conversation we'll have next week with Larry Cunningham. He will be our first guest on the show, and we're very much looking forward to that. One thing that will all that together is the concept of an owner's manual. It's something we as investors can all do that's mutually beneficial because I think it will make us better as we go through the process and will strengthen all the companies we interact with in doing this.

I mentioned a couple of weeks ago the process I went through with Alaska. They engaged me in a dialogue about how to get better in this area, and I suggested that one foolproof way for them to make an improvement was the concept of an owner's manual. That specific phrase is stolen from the famous Berkshire Hathaway Owner's Manual, but it's much broader in scope. I had to stress repeatedly there is no cookie-cutter framework here. This has to be absolutely tailored to each and every company.

There are some areas that should be common for every owner's manual. It should be a continuously updated, refreshed, living document that explains what a company and its owners should expect from each other. It's such a basic concept, but it's so important because there are so many shareholders that are short term-oriented. Maybe they're index or high frequency traders, but there are so many actual shareholders out there that have no concept of what they own and what they should expect from the company. Likewise, the company doesn't call out its own shareholders for what they expect from them. This creates that two-way dialogue.

It should have clear language and a proper use of the right metrics to track a business, meaning whatever the actual key performance indicators are, not what they think Wall Street wants to hear, how management themselves evaluate the business on a daily, weekly, quarterly, annual, and decadal basis. You have to publish those metrics and track them consistently over time. It should include some measure of return on capital and how you calculate both sides of that equation. The numerator and denominator are very important, but it should be explained. There should be per-share metrics because I think that's absolutely crucial and often overlooked. It should include some sort of capital allocation framework. Larry was intricately involved in two of the best there. There should also be some statement of purpose, something tying the business back to what it does. This has nothing to do with quarterly guidance. It may have something to do with mid- or long-term guidance but skewed more toward what a true owner would care about instead of one quarter or even three or four quarters. I'd say at least three to four years on the short end.

One thing often brought up to me in this context is, "You should just read *The Outsiders*. It has everything you need to know about this." Will Thorndike wrote a great book, one of the very best books ever written about the framework of business and investing. I think the

problem there is that people view it almost formulaically, as if they could take that and apply it to any situation. Valiant was probably the most famous example of how easy it is to go wrong with a good idea. One of the key things that will branch out from the idea of an owner's manual and cultivating a good shareholder base is the concept of empowering quality shareholder.

Larry recently wrote a great paper titled "The Case for Empowering Shareholders," an academic-style paper that is freely available on the internet. In it, he defines quality shareholders as high conviction and long horizon. You must have a high conviction if you're going to be a high-quality shareholder. If you're just taking tiny little positions and have hundreds of them, you wouldn't qualify. You have to hold for a long period of time, in this case, years. On a two-by-two matrix basis, Larry's big idea, with quite a bit of evidence behind it, is that you should give those shareholders more votes. That's a controversial idea, but I think it's worthwhile in many ways although it's not a silver bullet. We'll discuss this in detail next week.

Mihaljevic: Thanks for that preview, Phil. We are so excited that Larry Cunningham will be joining us next week. I'm sure it will be a terrific discussion. Chris, I'll turn it to you now. I know you took away quite a lot from the Berkshire release. You previewed it here with us before it came out, and I would love your feedback on what was as expected and what was perhaps surprising to you.

Bloomstran: With Berkshire in particular, I do most of my heavy lifting only once a year. I sit down and write my annual client letter, but I've always gone through and rigorously built out my models and done my thinking on Berkshire's intrinsic value and all of the accounting and all the moving parts. It's interesting to see how other shareholders and the media react to what's disclosed in the quarterly earnings release. We are in the middle of this COVID crisis and who knows what shape the recovery will take, so it was interesting going through the press release and then the Q. There were some clear highlights as well as lowlights that jumped out to me. On balance, though, I think it was more positive of a quarter in terms of the progression of earning power than I would have expected. The railroad was surprisingly more positive, better than I expected. I thought income could have been down on the order of 25% to 27%, but it was down 15% and change, and revenues were down a little over 20%.

If you guys remember, the upper Midwest was massively flooded last year. There were a lot of disruptions to the Burlington system and even to Union Pacific system in the west, the Canadian Rails, so you were up against easy comps. Still, I was pleasantly surprised that agriculture continues to be pretty strong, down 10% or 12%. Coal was down close to 40%, which was expected. I thought rail was going to be worse than projected. They earned about \$650 million against what's normal in my world when I measure profitability, \$750 million, so below where they were, but there's enough variable cost in the structure that it looked good to me. Fuel costs were way down, by 50%, and that's volumes and price as well. Labor costs are more variable, surprisingly more variable to most people. The rail was in good shape, and I think the energy business was terrific. The top line and pre-tax income were down a bit.

If you get into the nuances, the tax rate went from something like negative 14% to negative

31%. The amount of credits the business is earning from all of the CapEx they're spending in wind and alternative energy drove the bottom line up while the pre-tax income line was driven down. The revenues were down single digits, and we expected that because of less industrial use of power, but in the case of the energy businesses, the utilities, zero long-term diminution of earning power. In a world of low interest rates, those collective businesses can earn an allowed 9% or 10% on capital. These are wonderful businesses.

On balance, the insurance operations were largely very positive, with very little harm from COVID and the economic downturn. Geico distorts the profitability, but most property/casualty insurers outside of auto are not going to write in an underwriting gain for the quarter. Berkshire's collective insurance operations wrote at \$800 million. I normalized that underwriting profitability at \$600 million, but Geico wrote at \$2 billion, and that was a loss ratio 20% better than normal. If you read the footnotes and get into the nuances, you know that Geico is offering credits to its customers prospectively, so a lot of that gain or current profit earned in the first quarter will be given back in the second quarter and even into the first portion of 2021. This high underwriting margin was going to flip, and it's quite possible, plausible really, that Geico underwrites at a loss in the back half of the year. Still, that's just going to be an offset against this period of time when frequencies are down, people aren't driving as many miles, and severities are up. Anyway, Geico was great.

Last week, we talked about the reinsurance industry and how COVID is affecting it. Our presumption has been that Berkshire's property/casualty reinsurance operation would not be overly harmed. The capital in the business is so wide that even if it underwrites very badly, there's no harm to the business. It's much overcapitalized with a couple hundred-plus billion dollars in statutory capital, 80%-plus of that residing in the reinsurance operation. On the straight property/casualty reinsurance line, it wrote at a 123% combined ratio, which would make you say "ouch." Half of that was COVID. The COVID development, which had been maybe \$225 million in the first quarter, got bumped up by \$350 million, so Berkshire's reinsurance losses are less than \$500 million. You see the big Europeans and various others that have already had IBNR claims of \$2.5 billion to \$3.5 billion. The insurance operations were a strong highlight, in my opinion.

Within the manufacturing, services, and retailing (MSR) businesses that we knew would be very weak, there were some clear highlights and some clear lowlights. Clayton Homes continues to knock the cover off the ball. It's been an amazingly good business. Revenues were up 8% and pre-tax earnings up 13%, and that was after the company set aside reserves for increasing credit losses. Sales for site-built homes were up over 20%, while the sale of manufactured homes was flat. Clayton, at least for the time being, has grown into being undoubtedly the best business within Berkshire's MSR group. In the auto segment (Van Tuyl, BH Automotive), which is 2/3 of the retail operations within MSR, revenues were only down 11%. Income was up, and the business has managed it overhead really well. SG&A was down by a bunch. Interest expense for floor plans were down, so I think that was a bright spot. The real estate brokerage within the energy business, closed units were down on the order of 20%, but the refi business was up a bunch.

In terms of lowlights, we all saw the \$10-plus billion write-down at Precision Castparts, and

there were some other write-downs. I think Precision has become the worst capital decision Berkshire has made in a long time. It bought the business in 2016 knowing that the turbine operation was already in trouble. It got scammed right out of the gate by a German business it bought that was manufacturing revenues out of thin air. The \$10-plus billion write-down is something you don't see in scale in the entire history of Berkshire, and that's on the order of 1/3 of the purchase price. That was not unexpected, but it's still very disappointing. Across the industrial businesses, Lubrizol, Marmon, and IMC were weak, which you'd expect with industrial production and trade sharply down.

The one that jumps out is Forest River, the camper and RV business. It was down 25% on revenues and almost 40% on earnings. The competitors, Winnebago and Thor, are knocking the cover off the ball. Every millennial in the world and families that can't travel and aren't going to Disneyland are buying campers and RVs. If Forest River can't make money today, you've got to wonder what's going on there. NetJets and FlightSafety had little write-offs and write-downs. McLane has been a problem for some years. It had some inventory write-downs, which wasn't unexpected given there was a lot of food left in the channel that wasn't ultimately shipped to restaurants because of closures. That business has been in decline for three or four years. The market is overly competitive. The company is losing money on a cost of capital basis, and it's not doing great.

Outside of the operating businesses, Apple is a huge highlight. Berkshire paid \$35 billion or thereabouts for Apple, and it's got almost an \$80 billion gain. When I think about the stock portfolio, and you take where your earnings come from, dividends are \$4 billion to \$5 billion. The way I look at it, you've got \$10 billion of retained earnings at the investees on an annual basis. If Berkshire has made \$80 billion, that's eight years' worth of retained earnings across the entire stock portfolio. At cost, Apple was something like 10% to 15%, but it's now 45% of the stock portfolio. It's been a massive homerun. During the quarter, I was thrilled to see the purchase of the Dominion distribution assets for \$10 billion, \$4 billion of which is equity. We all saw repurchases. The media was all over it. Berkshire bought back \$5 billion worth of shares, having only bought \$1.8 billion in the first quarter. If you follow the nuances of Mr. Buffett's charitable filings, it looks like it bought back another \$2 billion during the month of July.

The stock portfolio is quite interesting. We all know Berkshire sold the airlines, and I think we'll probably see the 13F filing tomorrow. If you get into the equity investments and common equity holdings, you can see the cost basis on the banks, insurance, and finance group dropped at the end of the first quarter from \$40.4 billion to \$31.1 billion. There was a \$9 billion shrinkage in the cost basis of that collective group. These are obviously your money center bank holdings.

My first instinct was Berkshire probably sold Wells Fargo. I went and did some further digging earlier today because I thought it through, and it didn't entirely make sense. Berkshire has owned Wells since 1989, buying it in various increments over time. It originally bought it beautifully during the SNL bank crisis in the late 1980s-1990. That's when I was getting out of school and into the business, and banks were in bad shape. The overall stock market was cheap, but Berkshire has collectively spent \$7 billion on Wells. If

you take that \$9-plus billion shrink in the cost basis, you would reflexively look at Wells, but it's easy to miss the fact that shrinking or eliminating the Wells position doesn't get you to what's actually a taxable loss.

There's a nuance on GAAP, obviously. You have realized gains and losses on a GAAP basis which are effectively, mark to market, your unrealized gains and losses. However, Berkshire disclosed in the footnote a second-quarter taxable loss relative to cost basis of \$4.5 billion, so you go through and play around what might have been sold. I don't think Wells was sold. It may have been sold in part, but my guess is Berkshire has sold perhaps all of the Bank of New York position and perhaps all or most of the JPMorgan position. As much trouble as Wells has been in with reputation, it has set aside \$9 billion in the first quarter, and those that follow Berkshire are probably expecting to see a shrink in Wells. When we see the numbers tomorrow, I wouldn't be surprised if Berkshire was blowing out of Bank of New York. Goldman Sachs will probably wind up being gone. There was about an \$800 million gain. It'll be interesting.

As we figured out several weeks ago, the other common stock position that was gone was Occidental Petroleum. If you look at the SEC filings, Occidental has had to effectively pay Berkshire \$200 million a quarter in common stock, and those shares had to be registered. In the interim, it had looked like not only had Berkshire collected the \$200 million in common stock but that it had increased its position size between the first and second quarter. If you get into the footnote itself, I think you'll realize it sold the entire position. The nuance there was the \$80 million warrant shares were not effectively exercisable, at least for reporting purposes, at the end of the first quarter, but they were at the second quarter. What looks like an increase in Berkshire's holding in OXY is probably going to wind up being an absolute blow out of those shares.

I'd like to hear your take on whether Wells might be gone because Berkshire has clearly sold on the order of \$8 billion or \$9 billion worth of the banks. My thinking has changed having read a little more into the nuance of the footnote.

Ordway: I wouldn't be totally shocked, but I would be surprised. The bet now is clearly on BofA, and for good reason, given what we know.

Turner: I'm curious about Wells, too. When Munger said he didn't think Scharf was fully committed working out of New York, it suggested that Berkshire had one foot out the door. I felt that was unfair to Scharf. He seems to be hiring a great team in New York as well. I'm also curious what you guys make in general of Buffett selling down the equity portfolio as the market bounced. He did some selling in Q1. What do you think more generally about perspective towards risk and market levels?

Bloomstran: I think he's terribly concerned, and you saw that with the sale of the airlines, which was on the order of \$5 billion to \$5.5 billion. My sense is the banks are not in as good a shape as most of the world thinks. We haven't even gotten to the mortgage forbearance running its course and the auto loans not being foreclosed on and repossessed. The capital levels are way higher than they were in 2007. Banks have less of balance sheet leverage in them, but the degree to which large swaths of the economy are not in great shape is

problematic. The short-term interest rate is at zero and likely to stay there.

Turner: He's buying more Bank of America since the quarter ended, right? If he's that concerned about banks in general, isn't that a bad place to be diving further into?

Ordway: Yes, it's interesting. I've thought a lot more over the last week that Wells was probably sold, and I'm trying to get my mind around it because if you look at Wells, it's trading at mid-single-digit multiples to what you'd call normalized earnings. I don't think these banks collectively are reserved sufficiently. They all increased reserves materially in the second quarter versus the first quarter, but go back to 2008 levels. If you take loan loss reserves up closer to 3% of outstanding loans versus 1%, they may be a third of the way there. Maybe they're half the way there, who knows? If you believe we'll get a complete V-shaped recovery, then the banks will be in great shape, but if not, the commercial mortgage world, C&I loans, and consumer loans will wind up having problems. When you couple that with a very compressed yield curve and net interest margins, the banks aren't that great.

I can't reconcile the notion of buying a BofA and selling off either JPMorgan or Wells. Mr. Buffett did sell off a small chunk of JPMorgan in the first quarter, and that's why I think, mathematically, it cannot have been Wells. The Wells position, which has a \$7 billion basis, still has a market value if you take year-end shares of about \$9 billion. I can't get to a \$4.5 billion capital loss relative to cost basis during the quarter without having sold JPMorgan or the BK or BNY position. It's hard to reconcile. I wouldn't own any of the big money center banks, but I've always thought you sure know what the liability side of the balance sheet looks like. You don't know, especially with these big boys, what the asset side of the balance sheet looks like. When you get into a stress test environment like now, with a lot of economic uncertainty, I'd rather pass. It's really interesting to see the increase in BofA.

Turner: Do you think something like American Express was touched during this period?

Bloomstran: No, there's no way. Berkshire took a realized to cost basis capital loss during the quarter of \$4.5 billion and a taxable gain of a little over \$800 million. The embedded gain inside of American Express is too wide. Berkshire hasn't bought any American Express in years and years. No, I don't think American Express was touched at all. I believe it's BK and JPMorgan. I thought it would have been Wells given the problems it has. Its reputation was starting to harm at some level the reputation of Berkshire and Mr. Buffett, and I thought maybe he'd gotten frustrated with that, but the math doesn't work. Given that there was a \$2 billion embedded residual capital gain relative to the cost basis, I don't think it was Wells. I do think Berkshire sold JPMorgan. I hold Jamie Dimon in the highest regard in the banking industry as far as the money center banks go and was surprised to see the sale of JPMorgan because you weren't close to a filing position at 10%. I'd say JPMorgan is gone and probably Bank of New York, which has had its own sets of problems. Phil, what do you think?

Ordway: I don't know how much I can add, to be honest. I owned some Wells Fargo via TARP warrants more than four years ago. It drifted a lot over time, and I'm sure Berkshire is disappointed in it. I think the comment about Scharf working from New York is telling, as is the fact that Berkshire has sold a bit. We'll have to see. What BofA has done and the

consumer franchise it has are truly impressive. Its operating efficiency at the community bank level is as good as any bank's in the country. JPMorgan and Jamie Dimon are fantastic in many ways, but it's a more institutional business. What's probably most important is that Buffet would feel like he's going to get, with higher certainty, a good outcome from whatever he's buying vis-a-vis whatever he's selling. He's not trying to hit big home runs with these positions.

Bloomstran: It's amazing just looking at the long-term stock charts of all these things. JPMorgan did the best job of all the money banks coming out of 2008/2009. It had the least damage done. Citi was effectively fully diluted, and that was nearly a wipeout. They all had to raise some capital. Some was forced on them. Looking at a 20-plus-year chart of Wells Fargo, it's amazing to me that the stock is below where it was in 1999/2000. It's also amazing to me that Berkshire has owned Wells Fargo all the way back to 1989, but on a cost basis of \$7 billion, the position size is only \$9 billion now. There's just very little growth of value over a very long period of time, which surprises me. Reflexively, I thought Wells was gone. I'm surprised otherwise. I agree, JP is a lot more institutional. Bank of America has got a lot more diversified streams of income, particularly on the consumer side, outside of bread-and-butter spread lending. Two hours ago, I was convinced the Wells position was gone, and now I think it's probably JPMorgan. I could wind up being totally wrong. When the F comes out, we may find that I didn't know what the hell I was talking about. I thought Wells was the candidate to go given the problems it has and a lot of the mismanagement over the last decade.

Turner: Munger should have some familiarity with Scharf from the Visa days, which is why I was so weirded out by his remark. Scharf seems to be bringing in some good new blood, a bunch of old Jamie Dimon lieutenants. Plus, it's cheap, no matter which way you slice it. God, it's hard to know.

Bloomstran: I'm surprised the world didn't take the aggregate earnings release better than it did. If you balance out my net positives and negatives, I thought it was an outstanding quarter, and I was thrilled to see the share repurchases. Now that the stock has run back up north of the prices at which it being acquired in the first half of 2019, I wonder if the sense is that the economy will wind up being on a better footing.

I still have the stock at a deep discount to what I think the intrinsic value is. There's still such an enormous amount of cash sitting there that I really wish the share repurchases had been much more material than they'd been. There was probably another \$2 billion bought in July, which is great, but the stock is up a lot from its lows a few weeks ago and north of the price at which Berkshire was buying. If we're indeed on better economic footing, I'll be prospectively disappointed if the share repurchase program doesn't continue at the current run rate of what Berkshire was buying in the most recent quarter and during the first month of Q3.

Mihaljevic: Chris, I'm curious how you think about the future of the Apple position, which is very large. Apple hit another all-time high today, trading at more than 7x sales. At what point do you think Berkshire would start trimming?

Bloomstran: I don't know, John. It's been a huge homerun. It's such an outsized position in the stock portfolio. He's got to deal with this position size the same way the three of us deal with our own position sizes when you've had success and the stock runs up. The reality is Apple was very inexpensive for the better part of the last decade. It's only during the last couple of years that it has run up to where it's trading at north of 30x what the company is going to earn next year. Last week, we established an over-under of 5%. You've got to replace your product cycle on a regular basis. I don't know how you move a \$300 billion revenue business that generates a 20% after-tax profit margin, how you're going to grow it at high single-digit or low double-digit returns organically. Mr. Buffett's proven to not be overly excited about booking net long-term capital gains. Berkshire is more adept at swapping operating subsidiaries. I don't know what you could swap and shrink the position size down. Perhaps it's okay if Apple can grow at high single digits and doesn't have much pushback on price on the App Store, but at 30x, it's a huge business with a robust margin structure. It's a high-class problem.

The stock has produced \$80 billion in capital gain in a short period of time. My bias would be to take some capital off the table and pay some capital gains tax. In 1998, when Coca-Cola represented the same relative position size to the overall stock portfolio, and the overall stock portfolio was wildly expensive, Berkshire bought Gen Re and diversified away from common stocks by picking up Gen Re's bond portfolio. However, some years ago, Mr. Buffett did say that not selling the Coke position was a mistake. It traded at close to 50x its earning power. Who would have known that the world would get healthier and gravitate away from sugary drinks? Coke has done what it can to diversify into different beverages and has played games with its distribution assets, but Buffett said it was a mistake to not sell it. Given the success Apple has had and that it's now north of a \$110 billion position on \$800-plus billion in assets in the business, my druthers would be to harvest some gains because I think the stock is more than fully valued at these points. God love him for all the success. He's proven capable of investing in tech, turning out wildly successful with a huge investment. He chunked 15% of the stock portfolio down and turned a \$35 billion position into \$110 billion. I wouldn't say that reeks of not knowing what you're doing in tech investing.

Turner: It's quite interesting to think of Apple as a massive pool of liquidity. I was running in my head how quickly Berkshire could blow out of the Apple position if it so chose. Starting to sell could sometimes have an effect on the stock once people pick up that's what Berkshire is doing. As big as the Apple position is, Berkshire could sell it within eight days of average daily volume. The next biggest position, which is Bank of America, would take 45 full days of taking up 100% of average volume to blow out of it. Apple as a pool of liquidity for Berkshire seems to have some value in its own right, notwithstanding the valuation of the company and stock itself. It's crazy to think how much liquidity you could push around without moving the needle there.

Ordway: Yes, it is. I think the bias here will be to probably sit tight because of the tax hit and the massive cash pile that already exists. It's a good business and is probably going to do fine. In similar situations, the strong preference has been to sit tight, so I wouldn't expect a whole lot to be different this time. I don't have a strong opinion either way on the

valuation. I mean, it's obviously done well. It's a huge position. I don't think it's an unduly large or overly risky position in that regard, but I think they'll probably sit tight.

Mihaljevic: Speaking of it being highly liquid, maybe Buffett is almost indifferent at this point about trimming. He could just keep it but view it as almost akin to cash. In other words, it would feel like having a much bigger war chest than the cash position alone might suggest. Maybe Berkshire is out there with a really big elephant gun.

Turner: It's an interesting thought, especially considering you could sell without moving. The 10-year is what, 1%, so what's the difference? The dividend yield of Apple is about there too, so it's an intriguing thought. Hard to know how exactly he's thinking of it, but based on the annual meeting and the recent Q, Berkshire clearly seems to think that rates are going to stay low for a pretty long time. That might be factoring into it, too. I would imagine you've got to think of the price as pretty volatile compared to all the other options, so that's slightly problematic.

Bloomstran: The other consideration is given his tax sensitivity and aversion to paying capital gains taxes over the years, Berkshire did book net capital losses in the second quarter. If you look at the portfolio, there's been a number of investments that have not been great where you could take realized capital losses to offset any gains. If I were running the business, I would shrink the position back from 45% of the equity portfolio, at least cutting it in half and making it 20%-25%. You could do some things tax-wise within the operations to use some losses and offset some of those gains.

Mihaljevic: To switch a bit on Geico, how do you think about its life cycle and where we are in it, Chris? What I have in the back of my mind is that at some point, the landscape could change dramatically if you do get self-driving cars. What's a way to think about the valuation of that business?

Bloomstran: I've heard the case that auto insurance disappears in the event of self-driving cars, and that's not right. Pricing will change, but you're still going to have an industry that writes premium volume. Premiums might decline in dollar terms because your losses would develop, theoretically, at a much lower level, but you're still going to write property insurance for a rock falling off of a cement mixer truck or a tree falling on your car. You're still going to have property damage claims, and so you would just see a resetting to an allowed rate of return across the industry. I think more concerning would be private passenger auto, where there's been phenomenal growth in market share over the last few decades. You've got both Geico and Progressive close behind it taking enough market share from State Farm within only a handful of years. Frankly, I don't know what you do when you get to call it a 20% market share. I find it hard to believe you can grow nationally much north of 20% or 25%.

They don't write homeowners. I've seen businesses that have struggled to grow their auto book and have taken homeowners business. Right now, you can buy a Geico auto policy, but it's underwritten by Travelers. I wonder if it starts taking on some different lines, like writing homeowners, which has not been as attractive of a line. In the last two or three years, you saw some management changes at Geico. I think Progressive has done a much

better job in terms of growing its book intelligently and profitably. Geico had some issues, but these things all grow in fits and starts. To me, it's less an issue of disruption. The market will adjust accordingly. Premium dollars may adjust, but it'll take less capital to write those policies. At any rate, you'll have to write property losses and to insure a vehicle.

Geico is the product of its own success. It's bumping up along the law of large numbers, as is the case with so many of the subsidiaries inside the business and Berkshire itself. It's just a bigger animal, and it's harder to grow. A lot of those scale advantages it had when it was young have already run their course, and it gets harder to take market share. The good news is maybe if we're in this winner-take-all environment, the reality is most underwriters in auto, private passenger especially but commercial as well, are crappy underwriters and don't earn their cost of capital. Geico has enough cost advantages with the way it distributes and the conservatism of its underwriting that it will make a 10% underwriting margin where the industry is losing money. Maybe I'm wrong, and it can get to 30% and continue growing through it. The insurance commissioners in the states will have to get comfortable with a business growing into that large of a market share, and I don't know how they deal with that animal when they get there. It's an interesting question to which I don't have an answer. I think there's still a runway to grow, but the disruption won't come from some of the places people expect.

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