

Berkshire Hathaway BRK.B

SELL recommendation

Target Price: 55-60 (~ 30%)



Time frame: 6 months

Adoration is *not* an investment strategy

Worship of the greatest investment icon of the *last* few decades

≠

Buying his stock at the tail end of his career

Don't chase past returns

The buffet is cold, stale and ending (pun intended!)

"The future is never clear, and you pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the buyer of long-term values."-- Warren Buffett

Folksy charm is just a carefully cultivated marketing tool

Buffett's Tips for Individual Investors

Keep things simple. It helps to talk about a company's stock in a charming, folksy manner. Meanwhile, behind the scenes, quietly accumulate the company's publicly-traded debt, swapping fixed rate obligations for inverse floaters with five-year maturities at a 6% floor with no cap. By the time your "by-golly-shucks & dang" act wears thin you'll have the poor bastards leveraged 36 times LIBOR plus 50 bps, pouring Maalox in their coffee in the morning, and keeping a barf bucket by their bed at night worrying about which unsecured tranches they default on next. That's when you move. First, take down as much of their preferred stock as you can through your Cayman hedge fund shell. They'll never see it coming. Next, feed the floating rate swaps back onto the open market. This will create a sense of panic in their senior secured debt, which you wanna buy. If you get a CFO that thinks he's Charles Bronson, send him a cadaver's finger in the mail. That will make everybody in corporate accounting jump. Nobody says jack after that. You might get some COO talk smack to you, but send him a note saying his finger's next, watch him shut up real quick. Now, CEO's usually know better than to mess around after you flush their stock down 10%. If you get one that's giving you static, he probably thinks he's a real cowboy, so you gotta break that S.O.B. in two. If you wanna move on the takeover and he's not budging, squeeze him on their short-term credit facilities. Tell him his pension liabilities are next. After that he'll tell you if he wears ladies underwear. I'm hungry. Let's get a taco.



Patrick McFerson



Hat tip: Kevin Depew of Minyanville

You want the truth? You can't handle the truth. – Jack Nicholson in A Few Good Men

Berkshire is a bailout baby

Not a rock solid all-weather American icon

Buffett's stake in 8 companies that received \$133 billion in bailout

Company	Berkshire Hathaway Holdings*	Buffett's stake in BRK holdings	TARP	Taxpayer Guaranteed Debt**	% of total debt issuance since guarantee launched
Goldman Sachs	\$8,800	\$2,367	\$10,000	\$19,521	76%
Wells Fargo	\$7,302	\$1,964	\$25,000	\$9,496	92%
American Express	\$4,197	\$1,129	\$3,389	\$5,897	60%
General Electric	\$3,779	\$1,017	\$0	\$48,997	80%
US Bancorp	\$1,499	\$403	\$6,600	\$2,681	73%
M&T Bank	\$351	\$94	\$600	\$0	0%
Bank of America	\$67	\$18	\$45,000	\$44,026	70%
Sun Trust Bank	\$56	\$15	\$4,850	\$3,320	100%
TOTAL	\$26,050	\$7,008	\$95,439	\$133,938	75%

Dollar values in millions

*Stocks/warrants priced at close, 7/28/09.

**Excludes Commercial Paper

Sources: Thomson Reuters, SEC filings, Prof. Linus Wilson

blogs.reuters.com/rolfe-winkler

No atheists in foxholes; no sage icons in financial crisis

Buffett = Welfare Queen

Buffett letter to Paulson to bailout financial institutions at the height of financial crisis

BERKSHIRE HATHAWAY INC.

1440 KIEWIT PLAZA
OMAHA, NEBRASKA 68131
TELEPHONE (402) 546-1400
FAX (402) 546-0476

WARREN E. BUFFETT, CHAIRMAN

October 6, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Hank:

I have previously mentioned to you my thought that an investment fund could be formed that would address some of the public's concerns about Treasury's plans to purchase illiquid mortgages. In this letter, I will spell out my thinking in greater detail.

Some critics have worried that Treasury won't buy mortgages at prices close to the market but will instead buy at higher "theoretical" prices that would please selling institutions. Critics have also questioned how Treasury would manage the mortgages purchased: Would Treasury act as a true investor or would it be overly influenced by pressures from Congress or the media? For example, would Treasury be slow to foreclose on properties or too bureaucratic in judging requests for loan forbearance? Additionally, many who are comfortable with a Department of the Treasury headed by someone with your market knowledge are worried about how the investment program would be administered by a future Treasury Secretary who had to rely on a bureaucracy to make important market decisions.

What I would like to suggest is a program that allows Treasury to buy more than the \$700 billion of assets presently anticipated and allows it to do so in a way that dramatically reduces the risk – to almost zero – that Treasury will lose money on its purchases. Indeed, the program I recommend is highly likely to produce profits. Let's call my proposed entity the Public-Private Partnership Fund (PPPF).

See Appendix for Page 2 to 4

Oracle of Omaha says Berkshire is overvalued **now**

Buffett criticizes Kraft for using stock to acquire Cadbury

To state the matter simply, a shareholder voting “yes” today is authorizing a huge transaction without knowing its cost or the means of payment.

What we know with certainty, however, is that Kraft stock, at its current price of \$27, is a very expensive “currency” to be used in an acquisition.

In 2007, in fact, Kraft spent \$3.6 billion to repurchase shares at about \$33 per share, presumably because the directors and management thought the shares to be worth more....

Buffett regretting using stock for past acquisitions in 2007 shareholder letter

*Finally, I made an even worse mistake when I said “yes” to Dexter, a shoe business I bought in 1993 for \$433 million in Berkshire stock (**25,203 shares of A**). What I had assessed as durable competitive advantage vanished within a few years. But that’s just the beginning: By using Berkshire stock, I compounded this error hugely. **That move made the cost to Berkshire shareholders not \$400 million, but rather \$3.5 billion.** In essence, I gave away 1.6% of a wonderful business – one now valued at \$220 billion – to buy a worthless business.*

But pays Berkshire stock to buy Burlington !

\$26.5 billion for the roughly 77.5 percent it did not already own.....

.....40 percent of the price or \$10 billion in Berkshire **stock**, increasing Berkshire’s share count by 6.1 percent.

Actions speak louder than words

Ticking time bombs in Berkshire balance sheet

Berkshire Annual Report 2002

I view derivatives as time bombs, both for the parties that deal in them and the economic system. Reported earnings on derivatives are often wildly overstated. The errors usually reflect the human tendency to take an optimistic view of one's commitments. But the parties to derivatives also have enormous incentives to cheat in accounting for them.

Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal – Warren Buffett

Berkshire Shareholder Letter 2008

Berkshire is a party to 251 derivatives contracts. Our put contracts total \$37 billion and are spread among the S&P, FTSE 100, Euro Stoxx 50, Nikkei 225. *Our first contract comes due on September 9, 2019 and our last on January 24, 2028.* In 2008 we began to write “credit default swaps” on individual companies....\$4 billion of contracts covering 42 corporations.....bond insurance contracts that are structured as derivatives.

Berkshire Shareholder Letter 2009

At Berkshire, I both initiate and monitor *every derivatives* contract on our books..... If Berkshire ever gets in trouble, it will be *my fault*. It will not be because of misjudgments made by a Risk Committee or Chief Risk Officer

Hypocrisy, thy name is Buffett

Who can fill the shoes? David 'who' Sokol?

Warren Buffett



Age: 79

Charlie Munger



Age: 86

Male Life Expectancy in US : 74 years

Look on my works, ye Mighty, and despair!
Nothing beside remains. Round the decay
Of that colossal wreck, boundless and bare
The lone and level sands stretch far away."
- Shelley in Ozymandias

Berkshire Reinsurance operation is a riddle, wrapped in a mystery inside an enigma

And it is all in Ajit Jain's head

Berkshire Shareholder Letter 2009

If Charlie, I and Ajit are ever in a sinking boat – and you can only save one of us – swim to Ajit.

*Staffed today by only 30 people, Ajit's operation has set records for transaction size in several areas of insurance. Ajit writes billion-dollar limits – and **then keeps every dime of the risk** instead of laying it off with other insurers.*

During 2009, Ajit negotiated a life reinsurance contract that could produce \$50 billion of premium over the next 50 years.

Ajit Jain



Age 60

Key Man Risk



Is Burlington deal the final act of an investing saga?

- Ben Graham turns in his grave
 - A 30% plus premium and 20 times earnings for self-admitted regulated *utility* company!

	EV/FCF	Return on Capital
Burlington Northern	29	11%
Union Pacific	24	10%
Norfolk Southern	18	10%

- Berkshire stock as currency
 - Backtracking on stated principles or covert signal about current valuation?
- Regulated and Capital Intensive
 - At the mercy of government's whims for the next 100 years (stated holding period)
 - Between 1999-2009, BNI spent 68% of operating cash flow in Capex
- Fuel cost hedging reason is convoluted
 - A ton of freight for 470 miles on only one gallon of diesel; but why not buy energy companies directly?

Inevitable
Conclusion



Buffett is *protecting* his Berkshire franchise by a mammoth acquisition of a regulated, stable, boring, utility company as a final act before he hands over the reins

Berkshire out of a walled fortress

- Addition to S&P 500 will increase volatility
- Stock Split
 - 50:1 split will make Berkshire stock a run-of-the-mill Wall Street football
- Index funds will lead the herd
 - 565,000 Berkshire shareholders will follow (including 40,000 Burlington employees)
- Gates Foundation will sell their Berkshire Hathaway stock
 - They sold approximately 17,000 "B" shares every month for past three months
- Options market makers will have a field day, leading to volatility
 - Construct synthetic options on BRK

Implication



Volatile middle-aged and mature stock

'Law of Large Numbers' will catch up

Most true bargains are not available in large blocks. – Ben Graham

Berkshire Shareholder Letter 2009

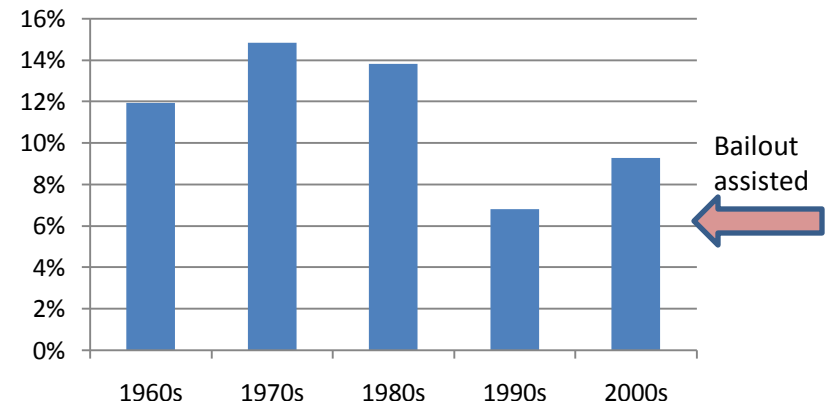
*The big minus is that our performance advantage has shrunk dramatically as our size has grown, an unpleasant trend that is **certain** to continue.huge sums forge their own anchor and our future advantage, if any, will be a small fraction of our historical edge.*

It's lonely at the top; only way is down

11 largest companies in S&P 500

Name	Ticker	Market Cap in Billions
Exxon Mobil Corp	XOM	313
Microsoft Corp	MSFT	250
Berkshire Hathaway	BRK.B	206
Apple Inc.	AAPL	198
Procter & Gamble	PG	185
Johnson & Johnson	JNJ	176
General Electric Co	GE	175
JP Morgan Chase & Co	JPM	170
Intl Business Machines Corp	IBM	165
Bank of America Corp	BAC	167
Chevron Corp	CVX	149

Berkshire Book Value increase per year versus S&P 500 including dividends



Implication



Outperformance versus market unlikely in future

Mass delusion after stock split and S&P 500 addition



Irrational Price spike

Crazy dumb retail investor volume

The Bottomline

Buying Hope

- Just a bet on the motivation of individual companies CEOs to not disappoint Buffett

US centric

- Coke, BYD etc is just a small part of the value

Succession

- Too BIG Shoes! David *who* Sokol? Ajit *who* Jain?

Murky Balance Sheet

- Insurance, Reinsurance

Derivative Time Bombs

- Everything from index puts, CDS on companies to bond insurance derivatives

Sitting Elephant or Duck

- Too big in the market; Will be raided by traders soon

Utility chimera

- Staid utility company masquerading as a value play
- BNSF acquisition is a desperate measure to put safeguard Berkshire franchise

Conglomerate Behemoth

- 200 companies in everything from carpets, candies to catastrophe reinsurance.
- Should have heavy 'conglomerate discount'

Mass Delusion

- Recent bid-up of price before and after stock split and addition to S&P is irrational

Buffett letter to Paulson (Page 1-2)

BERKSHIRE HATHAWAY INC.
1440 KIEWIT PLAZA
OMAHA, NEBRASKA 68131
TELEPHONE (402) 946-1400
FAX (402) 946-0476

WARREN E. BUFFETT, CHAIRMAN

October 6, 2008

The Honorable Henry M. Paulson, Jr.
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Hank:

I have previously mentioned to you my thought that an investment fund could be formed that would address some of the public's concerns about Treasury's plans to purchase illiquid mortgages. In this letter, I will spell out my thinking in greater detail.

Some critics have worried that Treasury won't buy mortgages at prices close to the market but will instead buy at higher "theoretical" prices that would please selling institutions. Critics have also questioned how Treasury would manage the mortgages purchased: Would Treasury act as a true investor or would it be overly influenced by pressures from Congress or the media? For example, would Treasury be slow to foreclose on properties or too bureaucratic in judging requests for loan forbearance? Additionally, many who are comfortable with a Department of the Treasury headed by someone with your market knowledge are worried about how the investment program would be administered by a future Treasury Secretary who had to rely on a bureaucracy to make important market decisions.

What I would like to suggest is a program that allows Treasury to buy more than the \$700 billion of assets presently anticipated and allows it to do so in a way that dramatically reduces the risk – to almost zero – that Treasury will lose money on its purchases. Indeed, the program I recommend is highly likely to produce profits. Let's call my proposed entity the Public-Private Partnership Fund (PPPF).

The Honorable Henry M. Paulson, Jr.
October 6, 2008
Page 2

This entity would initially be capitalized with \$10 billion of common stock held by the private sector and \$40 billion of notes owned by Treasury. The notes would be due in ten years and carry an interest rate equal to the rate being paid by Treasury on its ten-year bond at the time PPPF was created. These notes would have absolute seniority. That is, they would be paid in full before the common stock would receive a nickel.

PPPF would operate as a REIT, LLC or in some other form that would receive flow-through tax treatment.

With the funds it had raised, PPPF would buy \$50 billion of mortgages (with a far greater principal amount of course). It would focus on whole loans and residential mortgage-backed securities (RMBS) and stay away from second mortgages and exotic instruments such as CDOs squared. Going by today's prices, much of what PPPF would buy would likely be priced at 50-80% of par.

In time, the mortgages and securities in the portfolio would produce cash, through paydowns or later sales, that could be paid to Treasury and the private investors. The cash would first go to pay off Treasury, until it had recovered its entire investment along with interest. That having been accomplished, the private shareholders would be entitled to recoup both their \$10 billion and a rate of interest equal to that received by Treasury. Finally, any profits would be split with three-fourths going to the shareholders and one-fourth going to Treasury.

Let me sum up the effects of this plan: PPPF's capitalization would turn \$40 billion of Treasury money into \$50 billion of mortgage purchases. More important, Treasury would operate with a \$10 billion "cushion" from loss, because the private money in PPPF would be on the front line, eating that amount of net loss if losses were sustained.

Given this structure, PPPF's shareholders would have every incentive to make intelligent purchases. It should be clear to the American public that purchases are not being made at "bail-out" prices for imprudent institutions, but rather at "intelligent investor" prices for Treasury and PPPF shareholders.

Buffett letter to Paulson (page 3-4)

The Honorable Henry M. Paulson, Jr.
October 6, 2008
Page 3

Exploring the merits of this plan, I have talked with Bill Gross and Mohamed El-Erian of PIMCO, and they have told me they would manage this operation on a pro-bono basis. The managing entity would need a small staff, of course. But overall costs would be minimal and, in any event, would be borne by the common stock, since all expenses and losses would go against their \$10 billion.

I've also talked with Lloyd Blankfein at Goldman, Sachs, who says that firm would work on a pro-bono basis to secure the \$10 billion of equity capital. The company I head, Berkshire Hathaway, would be pleased to invest \$500 million, and I think the remainder of the funds needed would be quickly committed by major institutional investors – perhaps especially pension funds.

The reason why I expect the funds to be readily available is simple: If mortgages are purchased at current levels by an entity employing significant leverage and working with dependable, low-cost funds supplied by the U. S. Treasury, profits are very likely to be good—and perhaps even exceptional. That is true because prices have fallen to a level that reflects the inability of other buyers to obtain leverage. Thus returns for an investment operation that has access to long-term Treasury-type funding should be particularly interesting. Unlevered returns of 10% -- and present buyers are seeking more than this -- can turn into 25% returns with the leverage I propose.

Once this program is off the ground, I would suggest that the capitalization of PPPF – both equity and debt – be doubled. In this instance, however, Wall Street firms – again on a pro-bono basis – would offer \$10 billion of PPPF's common stock to the American public on exactly the same terms as those granted the initial institutional investors. If PPPF is going to be a good deal for equity holders – and I believe it will be – I would want to be sure that the average American has a chance to share in such an investment on a basis equal to that secured by Berkshire Hathaway and other institutional investors. If this offer is fully subscribed, Treasury would purchase an additional \$40 billion of notes, giving PPPF total buying power of \$100 billion.

I would be willing to personally buy \$100 million of stock in this public offering. (This constitutes about 20% of my net worth outside of my Berkshire holdings, which as you know are promised to charity.)

The Honorable Henry M. Paulson, Jr.
October 6, 2008
Page 4

Another detail: In the initial offering to institutions, I would bar hedge funds or other vehicles in which the manager receives an override of profits from investing. I think that in a government-connected enterprise such as this, you would want to have investors receive all of the profits available instead of splitting them with managers taking fat overrides.

The most likely scenario under which PPPF would prove disappointing is one in which market prices make it impossible for it to buy the contemplated \$100 billion of mortgages at risk-adjusted prices that promise good returns. To cover this possibility, the plan could stipulate that money be proportionately returned to Treasury and to common shareholders if after two years PPPF had been unsuccessful in reaching its goal for purchases.

Alternatively, PPPF could become a purchaser of new “non-conforming” mortgages – those whose size exceeds Freddie and Fannie limits. This move would stimulate the housing market and reduce the high interest rates that non-conforming mortgages now carry (compared to Treasury yields). Any move that PPPF made in this direction would need to be approved by both Treasury and the majority of the common stock. Were this plan to be put into effect, moreover, PPPF should only deal with borrowers putting up downpayments of size, earning comfortable incomes relative to debt service requirements, and supplying documentation of their creditworthiness.

Hank, these are all tentative ideas. But I think it's enormously important that the public have confidence that Treasury's activities in the mortgage field are sound and potentially profitable. The public is skeptical – indeed, disbelieving – about this point now, but I believe PPPF could go a long way toward correcting this misconception.

If this plan, or some variation, appears to be feasible, Bill, Mohamed, Lloyd and I – and I'm sure a myriad of others – are ready to help.

Sincerely,



Warren E. Buffett