Reflections on the April 2000 Berkshire Hathaway Annual Meeting Insurance - Volume 3

Industry	Diversified/Insurance
Ticker	BRKa/BRKb
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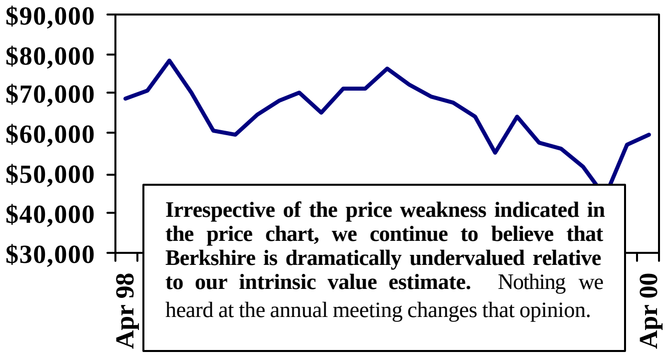
Berkshire Hathaway(Cl A) Monthly Share Price



Source of Price Data: Yahoo

Introduction and Context

- **We are presenting information, opinions, interpretation, and conclusions gathered from our recent visit to the Berkshire Hathaway annual meeting in a series of "research notes", of which this is the third.** We thought it would be useful and interesting to share some thoughts and ideas associated with this visit with our clients, shareholders, prospective clients and other parties in the hope of communicating a greater understanding of our rational, research-based investing.

Insurance Industry and Operations

- Buffett asserted that the financial performance of the average insurance company will be "awful," but that Berkshire competes in the insurance marketplace with offerings that are much better than average. Buffett indicated that good, if not fantastic, returns can be earned in insurance by those with aptitude and discipline. We agree, and have exerted extreme discipline in choosing insurance investments consistent with this view that insurance can be a very nasty business for unskilled operators. **We have been commensurately selective in picking insurance stocks and believe the true competitive advantages inside of Berkshire's insurance operations in particular should lead to good results over time (particularly so from current purchase prices for the stock).**

- Buffett put forth that he would do the same deal he did for General Reinsurance (Gen Re, General Re) even after experiencing a 1999 underwriting loss of $1.4 billion. **In our opinion, that says quite a bit about the confidence he has in the strength of Gen Re as a profitable distribution platform over which to extend Berkshire's plentiful capital base as a meaningful competitive weapon over time.**

- Over time, Buffett expects GEICO's low cost advantage to allow Berkshire to extract value from a large nationwide market for auto insurance. The incentive system for GEICO employees is focused on only two variables: 1) growth of new business and 2) profitability of that business. Buffett is counting on the alignment of employee interests with these two variables, plus GEICO's cost advantage and a huge advertising budget, to drive profitable long term growth. **While we view it as a hackneyed business term, the interplay between great growth at GEICO and the model of what Berkshire can do by investing the scads of low-cost funds that growth creates is as close to the true meaning of synergy as we can imagine.**

- We believe Berkshire's important competitive advantages:

  - Þ **low-cost operator status at GEICO**
  - Þ **distribution and good underwriting at** Gen Re
  - Þ **huge capital base, invested with acumen and discipline**
  - Þ **scale and reputation in super-catastrophe**
  - Þ **superior capital allocation skills**

are intact and entrenched and should secure its place as a great investment in an industry where bad competitors won't do well at all and some will likely fail in spectacular fashion.

- Through Berkshire, Buffett can exercise more patience and opportunism than perhaps any other investor of size on the planet. **We view that flexibility, coupled with the ability to generate a huge amount of low-cost investment capital (**float**) to fuel the investing furnace, as a truly one-of-a-kind advantage for Berkshire shareholders. Putting it in the hands of an investor with Buffett's demonstrated prowess at allocating capital over a long investment horizon is simply sauce for the goose.**

Introduction and Context

Q What can you share with us that might be interesting or different from conventional analysis about what you heard at the Berkshire meeting?

A We have attempted to synthesize a number of relevant issues we gleaned in the course of a five-plus hour Q&A session plus our later impressions. We focus particularly on those points we think:

- are relevant for Berkshire as an investment,
- have an impact on other portfolio investments, or
- foster an understanding of aspects of our investment philosophy.

General Re is a global holding company for reinsurance (essentially insurance provided to other insurance companies rather than directly to consumers) and related risk management operations. Gen Re is one of the leading reinsurers in the world and is represented globally by a network of 70 offices and subsidiaries in key global markets.

Insurance Industry and Operations

Q Insurance is always an important topic at the Berkshire meeting, increasingly so in the wake of the General Reinsurance acquisition and its attendant challenges. Various questions and comments throughout the day touched on a range of insurance-related topics including Berkshire's float, industry conditions, competition, and thoughts on the long-term success measurement for the Gen Re deal.

A In response to questions about General Re's Unicover underwriting, Buffett acknowledged the event as a mistake by Gen Re's management, but indicated that in his view such items tend to periodically happen in the insurance business. (In the so-called Unicover affair, Gen Re's usually competent underwriting team apparently were either mislead about - or they simply misread - the amount of risk they were taking on for an inadequate amount of premium, causing a loss for which Berkshire has created a $275 million reserve that Buffett re-affirmed as appropriate; the matter is in litigation and the actual extent of the loss is unlikely to be clear for many years.) In emphasizing his point about insurance's tendency to have negative surprises, Buffett even went so far as to fairly disagree with Charlie (who had said he wouldn't expect another surprise like this one) by suggesting he (Buffett) was <u>sure</u> there would be another one in the future. His semantic twist on Charlie's comment was that it would be a <u>different</u> mistake next time, **but that such mistakes aren't likely to be eradicated entirely in the insurance business.** To paraphrase, Buffett conveyed something to the effect of: *there are crooked people in insurance (and so) various kinds of fraud periodically exist. It's a field that attracts chicanery. And sometimes it's the same people again and again.*

A Berkshire's defense against this inherent industry negative is a huge capital base, a long time horizon, and great but obviously not infallible history of managing risk. Essentially, if you are in the insurance business in a meaningful way, occasionally, you're going to get caught by something that costs money. Buffett posited that if Berkshire does enough transactions with the math in its favor, over time it should do well. The diversification that comes from doing many such deals over many years, most of which provide reasonable returns, helps build a cushion for the practical inevitability of some problem or other. Basically, the results of some of the good years are used to subsidize the lean ones. In summation of the whole Gen Re discussion, and we think importantly, Buffett indicated that he would do the Gen Re deal again today, regardless of the short term challenges. **We think this is one of the examples of statements that, without an appropriate context for evaluating Berkshire, may appear small but to us loom large.** We suspect that many people pass right over such a comment without absorbing its full impact. We believe it is a deceptively simple comment - after all, many managements casually support previous actions, no matter how ill-advised - but that it actually speaks volumes. **In our opinion, to put forth that he would do the same deal he did for a business that experienced a 1999 underwriting loss of $1.4 billion says quite a bit about the confidence Buffett has in the strength of Gen Re as a distribution platform over which to extend Berkshire's not inconsiderable capital base over time.** In our view, that advantage should be an engine of shareholder wealth creation for some time to come.

Berkshire's Advantage

A Notwithstanding that optimism, Buffett aired some important caveats about insurance operations. He indicated that insurance is an industry periodically plagued by excess capacity and bad competitors. Insurance isn't a business that allows for outsized returns in Buffett's view, because many poor operators and lots of capital are attracted to a business in which, essentially, you give someone a piece of paper and they hand you cash. Buffett opined that most people like a deal like that. He asserted that in general the financial results for the average company in the insurance business will be "awful", <u>but that Berkshire competes in the insurance marketplace with offerings that are much better than average</u>. Buffett indicated that good, if not fantastic, returns can be earned in insurance by those with aptitude and discipline. **We**

agree and for this reason have exerted extreme discipline in choosing insurance investments consistent with the view that insurance can be a very nasty business for those who don't know what they are doing. We have been commensurately selective in picking insurance stocks and believe the true competitive advantages inside of Berkshire's insurance operations should lead to good results over time, particularly from its currently depressed share price.

A We submit that several superior competitive advantages exist for Berkshire's insurance operations. To wit:

- Low-cost provider status at GEICO, through a direct-to-consumer business model.
- Broad distribution and disciplined underwriting at Gen Re backed by a huge capital base.
- An appetite for appropriately-priced risk at Berkshire overall to support both Gen Re and the less-predictable but typically rewarding super-catastrophe deal.
- A reputational advantage of being the "only game in town" for certain such large transactions in the form of a rock solid ability and willingness to pay. (Buffett indicated that he thought the reality in this area was even stronger than the reputation.)
- An attitudinal advantage in the form of the structural discipline to seek only <u>profitable</u> growth in these areas coupled with the restraint to shrink when appropriate.

In our view, these advantages are absolutely intact and entrenched and should secure Berkshire's place as a good competitor in an industry where bad competitors won't do well at all and some will likely fail in spectacular fashion.

<u>Investing the Float: Buffett's One-Two Punch</u>

A As there is every year, and probably appropriately, there was significant discussion dedicated to insurance "float." (For those not well versed with the minutiae of insurance economics, we direct you to Buffett's own explanation of how float works in insurance operations, found in Berkshire's 1999 annual report – letter to shareholders, page 6.) Buffett indicated that Berkshire's float will grow over time, at times substantially, but that it is unlikely to do so at the less-than-zero cost that it has previously. We have always loved this "opposite of a bank" aspect of a well-run insurance operation - a bank must pay depositors interest for the privilege of raising funds to invest; insurance companies with underwriting profits get paid to hold your money. The phenomenon is as attractive to a pure capitalist as it is rare, and in the case of Berkshire, the scale involved ($25 billion of float at year end 1999) makes it all the more impressive. Buffett referred to "layers" of float within the various Berkshire insurance subsidiaries, each with a different cost structure, and indicated that while growth of float was important, its cost was a more critical variable to him. As long as Berkshire can generate float at a rate lower than its borrowing cost of funds in the capital markets, its insurance operations will add value.

A Berkshire's ability to generate lots of low cost float (though Buffett indicated probably not no-cost float, as in the past) is intact. That is a decided competitive advantage for Berkshire to exploit, particularly assuming that the money can be wisely invested over time. Few competitors can match this advantage, which only grows larger over time, particularly if Buffett can exploit the investable funds in a fashion that offers a spread above the typical insurance company investment, i.e., bonds. Of course, Buffett's expressed views on the overall equity market augur reduced expectations (see the *Fortune* article (**http://www.fortune.com/fortune/1999/11/22/buf.html**). **It is important for us to note: for this reason and due to generally expressed concerns that Buffett obviously won't live forever, we don't count on a repeat of Berkshire's historical returns in our evaluation of Berkshire; in fact, our valuation work assumes much more modest investment results.** Nonetheless, Berkshire's ability to create low-cost investment funds is a sustainable advantage, and one Buffett indicated he will press, preferring a higher growth rate in float at a reasonable cost to a lower growth rate at a lower cost. And Berkshire retains extreme flexibility in its investment menu, including the huge cash-equivalent hoard it currently holds while it evaluates alternatives, as well as bonds, publicly traded equities, and wholly-owned private businesses. **Berkshire's conservative balance sheet, large capital base, and cash earnings stream give it an unprecedented ability to de-couple its asset investment decisions from the typical insurance company's direct linkage with its underlying liabilities. Bottom line: this indicates that Buffett can be both more patient and more opportunistic than perhaps any other investor of size on the planet. We view that flexibility, coupled with the ability to generate a huge amount of low-cost investment capital to fuel the investing furnace as described above, as a truly one-of-a-kind advantage for Berkshire shareholders.** Putting it in the hands of an investor with Buffett's demonstrated prowess at allocating capital over a long investment horizon is simply sauce for the goose.

GEICO – Warren "Pedal to the Metal" Buffett

A Last but most certainly not least, GEICO generated a fair amount of conversation. Buffett has called the money Berkshire is spending at GEICO the best investment Berkshire can make. And they are spending it, with no let up in sight on advertising expenditures to build GEICO's brand and convince more customers to have a direct business relationship with the company. Buffett was asked about any concern he might have about all of this coming at a time of decreasing profit margins for auto insurers. In a fashion we think is typical of Buffett's sometimes counter-intuitive and long term approach, he indicated that he doesn't mind a more difficult competitive environment, because it will help flush out weaker competitors. Over time, Berkshire expects its low cost advantage to allow it to extract value from a large nationwide market for auto insurance. Buffett outlined GEICO's employees incentive system that is focused on only two variables: growth of new business and profitability of that business. Intelligent and simple incentives plus GEICO's inherent cost advantage appear to be rational drivers of growth. Buffett and GEICO CEO Tony Nicely are counting on the alignment of employee interests with the variables that impact shareholder value to fuel profitable business growth – and to create massive amounts of low-cost float.

A "What does all this mean to a Berkshire shareholder?" you might reasonably ask. Again, here is where we think our overall context for understanding Berkshire helps us get beyond amusement at GEICO's ubiquitous ads and see the opportunity in an otherwise pedestrian story about growing an auto insurance business. It seems clear that Buffett's expectations for growth of Berkshire's total float have an embedded assumption about growing the business at GEICO. Market share figures indicate that the ad campaign is working to make more drivers customers of GEICO. **If the business plan continues to be well-executed, a sizable amount of additional float enters the overall Berkshire investing machine, feeding a virtuous circle and enhancing the powerful benefits described in the** Investing the Float **section (above) highlighting the importance of float to Berkshire as an investment. Synergy is an overused business term, but the interplay between great growth at GEICO and the model of what Berkshire does in investing the associated gobs of low-cost funds is as close to the true meaning of that term as we can imagine.** Because of Berkshire's unique structure, we analogize this circumstance to one in which two plus two may in fact equal five inside of the Berkshire family of companies, though one can only get to four arithmetically. Readers should recognize that we are not known to support such alchemistic mathematics, but in the limited case of the Berkshire machine, we think the metaphor carries weight and implies massive value creation for shareholders over time.