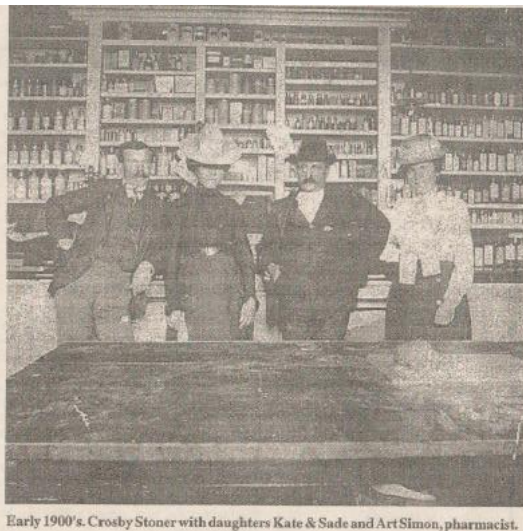
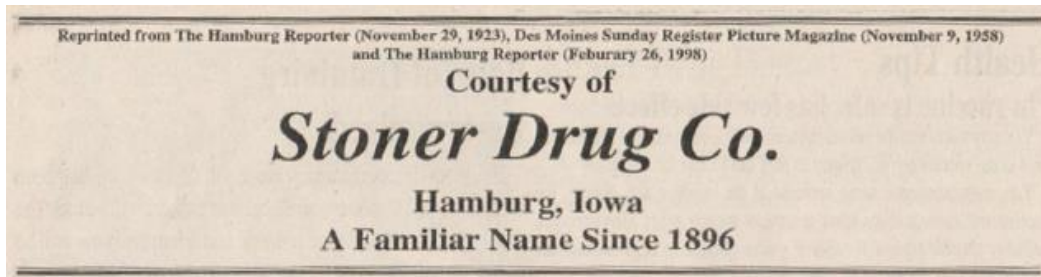


Investment Insight

BETTING THE DRUGSTORE ON BERKSHIRE

Reflections on the 2018 Berkshire Hathaway Annual Meeting in Omaha, Nebraska



Early 1900's. Crosby Stoner with daughters Kate & Sade and Art Simon, pharmacist.

Driving to Omaha from Kansas City recently was a poignant reminder of the natural resources and enterprise that form the basis for the prosperity the US has achieved. The highlight was stopping en route at the aptly named Stoner Drug Store in Hamburg, Iowa. Founded by Crosby Stoner in 1896, it is now a small chain of drugstores spread across the region. We sat at the soda fountain of this classic American drugstore and chatted to one of the pharmacists. Having told him we were heading to Omaha for the Berkshire Hathaway annual meeting he mentioned that their employee profit sharing fund had been invested with Warren Buffett and his team for a long time.

I spent the remainder of the journey to Omaha thinking about the maths behind that statement, including what proportion of earnings would be retained and invested, for how many people, and for how long. Several decades of compounding Berkshire would lead to great returns, and likely high employee retention. We will try to find out who made that decision to invest in Berkshire and to verify our calculations if we have a chance to return to Stoners Drug Store, but suffice it to say that the pension pool of this small chain is likely a significant investment worth millions.

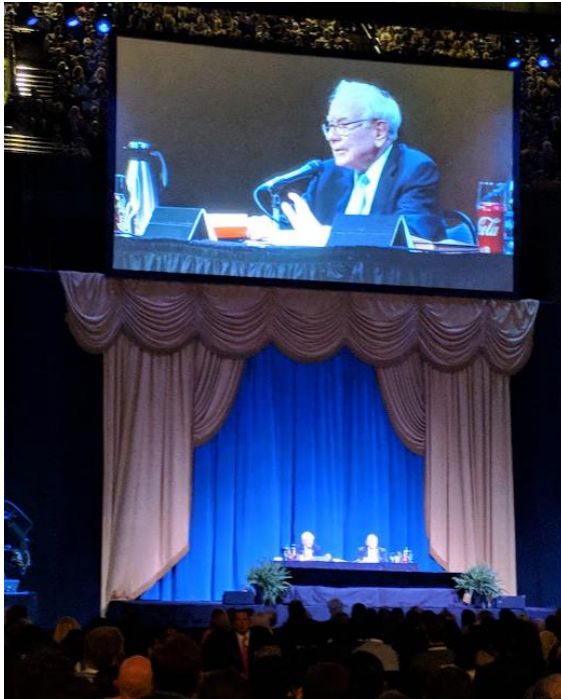
The meeting itself was packed. People came from all over, but the increasing number of shareholders asking questions from mainland China was striking, and a healthy reminder of where demographic and economic power is shifting. Given the numbers of people, and the level of their interest, it would seem that Berkshire is well positioned to benefit from this trend.



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Warren and Charlie were going strong, fuelled by their usual Coca-Cola and See's peanut brittle, espousing their unchanging philosophy of investing as strongly and decisively as ever and, if anything, also being more pragmatic than we have seen them previously. One of the lasting impressions from recent years has been their emphasis on making the right decisions given the ever-changing circumstances. That applies both to the familiar investments in businesses they are at home with, but also those companies they do not own, and which they therefore have to make compromises with in order to ensure they have a seat at the table.



Standouts from the subsequent Q&A included the size and scale of Berkshire's wholly-owned businesses, the strength of the franchises of the large companies in particular, and the industrial exposure of businesses like Precision Castparts, Iskar and Marmon. Other leading industrial leaders getting air time included Burlington Northern and Mid American Utility, both of which are capital intensive and regulated businesses closely tied to the US economy and industry.

These are the businesses that generate the recurring cash flows Berkshire uses to reinvest in other opportunities. For example, when Goldman Sachs decided it needed capital to shore up its balance sheet and the confidence of its shareholders during the credit crisis, the phone rang on the 16th floor of the Peter

Kiewit building on Farnam Street. Buffett took the call and had the resources to invest thanks to holdings such as Burlington Northern - his most successful investment during the crisis. We would expect that same phone to ring and Berkshire to react in the same way when the next crisis emerges.

Some of the questions also addressed the other big news from Omaha; namely that Apple is now the single largest holding in Berkshire. Just because we admire Buffett and Munger, it does not mean we agree with every decision they take. Apple is one we have disagreed with from the outset. Our long-standing view of investing in quality and value means "It is better to buy a great company at a good price than a good company at a great price."

That is a familiar quote in Omaha, and means we are prepared to pay more in price-to-earnings and other valuation multiples for a business with higher growth prospects than one that offers lower growth. We took the argument to the Financial Times which published a market insight that some of you may have already seen. We have enclosed it here because it encapsulates our views in a sensible and succinct way.

The Apple debate is not new. Back in 2014, when Amazon was at \$300, we got into an argument with the FT's Lex column which ended with them saying that they would have to wait for the next 35 years to see if it could achieve what it set out to do. It did not take nearly as long for it to prove its mettle, with the share price now at \$1,600.

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For us, if you look at Berkshire's first purchase of Apple in April 2016, the jury is still out. On a money-weighted basis it appears that Google and Amazon have already done better in aggregate, with Amazon having done better and Google worse, particularly in light of the latest privacy issues to impact it. We are long-term investors but our hunch is we will not have to wait that long for Amazon and Google to do better than Apple either.

Would we bet against Buffett on it? The situation is reminiscent of a time when Protégé, a hedge fund of funds, went toe-to-toe with Buffett over their outperformance versus the S&P. That ended with a (predictable) disaster for the long/short brigade. As we are long-term holders of all three companies we would win either way, but it is worth a thought...

*Christopher Rossbach
May 2018*

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Is Warren Buffett's Apple bet a value trap?

Berkshire Hathaway has lifted its stake in the iPhone maker but could be missing out on better options

Christopher Rossbach MAY 9, 2018

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Is \$100bn a lot of money? "I used to think so too!" Warren Buffett quipped at Berkshire Hathaway's annual meeting last weekend in Omaha.

Berkshire holds that much in cash, and generates billions more every year. The need to invest it explains the other big news from Omaha: Mr Buffett bought another 75m shares in [Apple](#), taking its stake to \$42bn. He is now Apple's third-largest shareholder.

But is Apple a great long-term investment or a value trap?

The two cornerstones of good investing are quality and value. Without quality — the strength of a business — there is no sustainable growth. Without value — paying the right price — there is no investor return. Investors are defined by how they strike the balance. As Mr Buffett said in Omaha, [Benjamin Graham's *Intelligent Investor*](#) and [Philip Fisher's *Common Stocks, Uncommon Profits*](#) are the great investing texts to help solve this equation.

[Berkshire's first investment in Apple](#) was a classic value trade. The stock had fallen on concerns about its ability to keep on selling high-priced phones in the wake of greater competition. Mr Buffett bought his big stakes after that — the most recent one at Apple's all-time high.

Mr Buffett made clear on Saturday why he likes Apple: he thinks it is the [world's largest consumer company](#). It makes great products that it can sell at high margins, and ancillary services such as iTunes and Apple pay tie people in to repeat purchases. He compares it to Coca-Cola, Kraft Heinz or Anheuser Busch, other consumer businesses he understands and owns.

Yet there is another way to see the business: as selling a high priced want-to-have (not need-to-have) product that is only a once in two- or three-year purchase for most. Recurring revenues are a small part of its profits, and have little impact on its valuation.

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There are much higher quality businesses out there, with growth that is higher and more sustainable: Amazon and [Alphabet](#), Google's parent company. They have exceptionally strong competitive positions in businesses (ecommerce and cloud computing at Amazon and search at Google) where scale and network-effects are everything. Both benefit from advertising revenues that come in at almost 100 per cent profit.

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Amazon does not rely on a single sale every couple of years, it has more than 100m prime customers on whom it just has raised prices 20 per cent in the US and its cloud business is several times the size of Alphabet's or Microsoft's. It is just beginning to grow its advertising, valuable because it is at point of purchase.

Google faces challenges around data protection and use of customer data, but as it adapts and users become more selective about what information they disclose, their services will only improve.

The opportunity at Amazon and Google is not about the next three to five years, but the next 25 years of digital transformation. In Mr Buffett's terms, these businesses have much wider moats than Apple, and therefore higher prospects for long-term growth.

Apple is great company. It will make more and more money until a competitor develops a much better phone — or customers decide that a \$2,000 phone is not that much better than a \$1,000 one. That is why it is likely a value trap, set to be eclipsed by Amazon and Google. They are the true new great consumer companies, just starting to deliver services we use every day of our lives and set to compound as Coca-Cola did in its day.

"Always keep learning" was Warren Buffett's and his partner Charlie Munger's advice to the many children in the audience. The two of them are famous for doing just that: Mr Munger calls it "rubbing our noses in our mistakes". Last year Mr Buffett apologised to shareholders for missing Amazon and Google. He said that Amazon was excusable because he did not think Jeff Bezos could achieve what he set out to do but Google was not, because he could see how much Berkshire's own companies were paying to it for advertising.

Why has he not changed his mind? Admitting your mistakes is hard. Reversing yourself is harder yet. The great news for Berkshire — and the rest of us — is that there is still time to do so.