

# Hiding in plain sight! Noticing the unnoticed with our different, but disciplined approach

by **Alvar Fernandez, CFA, Analyst**

We pride ourselves in looking at investments in unconventional ways and following a rigid, value-driven discipline. Intuitively this approach leads us to prioritise areas of the market, or companies, that either are out of favour or where inefficiencies are more likely to arise.

However, this doesn't mean that we don't pay attention to the largest and best-known companies in the world. Indeed, at times the opportunity lies right before our eyes but only those willing to dig beneath the surface will be able to capitalise on it.

One of the most recent examples of this is illustrated with the shares of the multi-national conglomerate holding company, Berkshire Hathaway (Berkshire). This is by no means a company where one would expect to easily find price inefficiencies and yet we think that the current share price is not consistent with such a high-quality business.

So what could the market be missing? In our view a lot of investors are easily dissuaded by what appears to be demanding headline multiples on metrics such as Earnings or Book Value.

Our contrarian view is that Berkshire Hathaway's GAAP\* earnings are not consistent with the underlying economics of the business. For instance, if you adjust its 2018 GAAP earnings by removing unrealised profit and loss from the decrease in the share price of Berkshire's portfolio of public stocks, net income alone increases by \$17.7bn, from \$4bn to \$22bn.

Another perhaps under-appreciated characteristic is that Berkshire may be earning considerably below its potential. Berkshire currently holds around \$130bn in cash (or short-term fixed income securities) earning an average of 1.4% p.a. According to its Chairman and CEO, Warren Buffett, all of these funds are ready to be deployed for investment purposes with the exception of \$20bn in cash which has been set aside to cover unexpected losses arising in its insurance businesses.

In order to account for this, one could simply remove \$110bn in excess cash from Berkshire's market cap. An alternative approach, and one that we advocate, would be to assume that this \$110bn will eventually be invested, earning an average market return, somewhere in the region of between 7 and 9% p.a. This would lead to incremental earning power of between \$7 and \$9bn per year.

We think Berkshire's reputation and scale confers a structurally advantageous position to close deals on highly favourable terms. A timely illustration of this is the recent deal closed with Occidental to finance its bid to take-over Anadarko. If the takeover is finally accepted, Berkshire will provide \$10bn in exchange for \$10bn worth of Preferred Shares with an 8% yield in addition to 80 million warrants on Occidental shares with a strike price close to the current market price. We believe that few market players have this degree of bargaining power.

In conclusion, once we have adjusted Berkshire's financials to unveil its true economic worth, we find that we are actually buying a wonderful business (or pool of businesses) at an attractive 15x Earnings or 12x Earnings if we remove the excess cash from its capitalisation. This is a price that we are very happy to pay for Berkshire's shares and believe it is only possible because a lot of investors are getting discouraged by an optically-high valuation.

\*Generally Accepted Accounting Principles (GAAP or U.S. GAAP) is the accounting standard adopted by the U.S. Securities and Exchange Commission (SEC).

Past performance is not a guide to future performance.

Issued and approved by Sanlam Investments. Sanlam Investments is the trading name for our two Financial Conduct Authority (FCA) regulated entities: Sanlam Investments UK Limited (FRN 459237), having its registered office at 24 Monument Street, London, EC3R 8AJ and Sanlam Private Investments (UK) Ltd (FRN 122588) having its registered office at 16 South Park, Sevenoaks, Kent, TN13 1AN.

The opinions are those of the author at the time of publication and are subject to change, without notice, at any time due to changes in market or economic conditions. Whilst care has been taken in compiling the content of this

document, neither Sanlam nor any other person makes any guarantee, representation or warranty, express or implied as to its accuracy, completeness or fairness of the information and opinions contained in this document, which has been prepared in good faith, and to the fullest extent permissible under UK law.