

CLIENT MEMO

FINANCIAL & INVESTMENT MANAGEMENT GROUP, LTD. • FEE-ONLY WEALTH MANAGEMENT

To Select Clients

From: Paul Sutherland & the FIM Group Investment Committee

Regarding: Purchase of Berkshire Hathaway stock in your portfolio,

Last Friday we added Berkshire Hathaway (BRK/B) common stock to your portfolio. This is a large, well-known company run by Warren Buffet, a well respected manager, philanthropist and investor. Berkshire is considered a “blue chip” holding, which is defined as a stock of a well established and financially sound company. We bought the share(s) at a price that was about 20% less than their high of last December. Rather than give a narrative about this company, I thought it would be fun to just let “The Man” speak for himself, so I have reprinted some quotes from his annual meeting held earlier this year. I especially liked the See’s candy investment story, titled “*Be Fruitful and Multiply*”, which talks about the need to think long-term and let investments compound and multiply. We have had a few loser investments this year and it is interesting to read Mr. Buffet’s descrip-

tion of his loser Dexter Purchase. We have owned BRK/B previously, when the company appeared to falling on bad times and out of step with the world. From June 1998 to March 2000 BRK/B dropped 47%. While others were criticizing Mr. Buffet for avoiding dot-com stocks, we saw an opportunity to buy shares at a great price. In fact BRK/b was our largest holding at one time. We like the 76 different business that make up BRK/B and feel blessed to be able to once again buy this great investment at the right price. Will it go down 47% like it did from its 1998 high to 2000 low? Nobody knows. If it does, it would most likely become our largest holding. At today’s price it is a bargain, yet buying at another 25% lower would be another fantastic opportunity, similar to the opportunity of 2000.

Excerpts from Berkshire Hathaway’s Annual Shareholder Meeting - May 2008



by Warren Buffett

Setbacks, minor and temporary, Our gain in net worth during 2007 was \$12.3 billion, which increased the per-share book value of both our Class A and Class B stock by 11%. Over the last 43 years (that is, since present management took over) book value has grown from \$19 to \$78,008, a rate of 21.1% compounded annually. Overall, our 76 operating businesses did well last year. The few that had problems were primarily those linked to housing, among them our brick, carpet and real estate brokerage operations. Their setbacks are minor and temporary. Our competitive position in these businesses remains strong, and we have first-class CEOs who run them right, in good

times or bad. Some major financial institutions have, however, experienced staggering problems because they engaged in the “weakened lending practices” I described in last year’s letter. John Stumpf, CEO of Wells Fargo, aptly dissected the recent behavior of many lenders: “It is interesting that the industry has invented new ways to lose money when the old ways seemed to work just fine.” You may recall a 2003 Silicon Valley bumper sticker that implored, “Please, God, Just One More Bubble.” Unfortunately, this wish was promptly granted, as just about all Americans came to believe that house prices would forever rise. That conviction made a borrower’s income and cash equity seem unimportant to

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lenders, who shoveled out money, confident that HPA – house price appreciation – would cure all problems.

Today, our country is experiencing widespread pain because of that erroneous belief. As house prices fall, a huge amount of financial folly is being exposed. You only learn who has been swimming naked when the tide goes out – and what we are witnessing at some of our largest financial institutions is an ugly sight. The party is over finally, our insurance business – the cornerstone of Berkshire – had an excellent year. Part of the reason is that we have the best collection of insurance managers in the business – more about them later. But we also were very lucky in 2007, the second year in a row free of major insured catastrophes.

That party is over. It's a certainty that insurance-industry profit margins, including ours, will fall significantly in 2008. Prices are down, and exposures inexorably rise. Even if the U.S. has its third consecutive catastrophe-light year, industry profit margins will probably shrink by four percentage points or so. If the winds roar or the earth trembles, results could be far worse. So be prepared for lower insurance earnings during the next few years. Though we can't come close to duplicating the past, we will do our best to make sure the future is not disappointing.

Businesses – The Great, the Good and the Gruesome

Let's take a look at what kind of businesses turn us on. And while we're at it, let's also discuss what we wish to avoid. Charlie and I look for companies that have a) a business we understand; b) favorable long-term economics; c) able and trustworthy management; and d) a sensible price tag. We like to buy the whole business or, if management is our partner, at least 80%. When control-type purchases of quality aren't available, though, we are also happy to simply

buy small portions of great businesses by way of stock market purchases. It's better to have a part interest in the Hope Diamond than to own all of a rhinestone.

Great and Enduring Businesses

A truly great business must have an enduring "moat" that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business "castle" that is earning high returns. Therefore a formidable barrier such as a company's being the low cost producer (GEICO, Costco) or possessing a powerful worldwide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with "Roman Candles," companies whose moats proved illusory and were soon crossed. Our criterion of "enduring" causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's "creative destruction" is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all. Additionally, this criterion eliminates the business whose success depends on having a great manager.

Be Fruitful and Multiply

Let's look at the prototype of a dream business, our own See's Candy. The boxed-chocolates industry in which it operates is unexciting: Per-capita consumption in the U.S. is extremely low and doesn't grow. Many once-important brands have disappeared, and only three companies have earned more than token profits over the last forty years. Indeed, I believe that See's, though it obtains the bulk of its revenues from only a few states, accounts for nearly half of the entire industry's earnings. At See's, annual sales were 16 million pounds of candy when Blue Chip Stamps purchased the company in 1972. (Charlie and I controlled Blue Chip at the time

and later merged it into Berkshire.) Last year See's sold 31 million pounds, a growth rate of only 2% annually. Yet its durable competitive advantage, built by the See's family over a 50-year period, and strengthened subsequently by Chuck Huggins and Brad Kinstler, has produced extraordinary results for Berkshire. We bought See's for \$25 million when its sales were \$30 million and pre-tax earnings were less than \$5 million. The capital then required to conduct the business was \$8 million. (Modest seasonal debt was also needed for a few months each year.) Consequently, the company was earning 60% pre-tax on invested capital. Two factors helped to minimize the funds required for operations. First, the product was sold for cash, and that eliminated accounts receivable. Second, the production and distribution cycle was short, which minimized inventories.

Last year See's sales were \$383 million, and pre-tax profits were \$82 million. The capital now required to run the business is \$40 million. This means we have had to reinvest only \$32 million since 1972 to handle the modest physical growth – and somewhat immodest financial growth – of the business. In the meantime pre-tax earnings have totaled \$1.35 billion. All of that, except for the \$32 million, has been sent to Berkshire (or, in the early years, to Blue Chip). After paying corporate taxes on the profits, we have used the rest to buy other attractive businesses. Just as Adam and Eve kick-started an activity that led to six billion humans, See's has given birth to multiple new streams of cash for us. (The biblical command to “be fruitful and multiply” is one we take seriously at Berkshire.)

Confession time....Unforced errors To begin with, I almost blew the See's purchase. The seller was asking \$30 million, and I was adamant about not going above \$25 million. Fortunately, he caved. Otherwise I would have balked, and that \$1.35 billion would have gone to somebody else. About the time of the See's purchase, Tom

Murphy, then running Capital Cities Broadcasting, called and offered me the Dallas-Fort Worth NBC station for \$35 million. The station came with the Fort Worth paper that Capital Cities was buying, and under the “cross-ownership” rules Murph had to divest it. I knew that TV stations were See's-like businesses that required virtually no capital investment and had excellent prospects for growth. They were simple to run and showered cash on their owners. Moreover, Murph, then as now, was a close friend, a man I admired as an extraordinary manager and outstanding human being. He knew the television business forward and backward and would not have called me unless he felt a purchase was certain to work. In effect Murph whispered “buy” into my ear. But I didn't listen. In 2006, the station earned \$73 million pre-tax, bringing its total earnings since I turned down the deal to at least \$1 billion – almost all available to its owner for other purposes. Moreover, the property now has a capital value of about \$800 million. Why did I say “no”? The only explanation is that my brain had gone on vacation and forgot to notify me. (My behavior resembled that of a politician Molly Ivins once described: “If his I.Q. was any lower, you would have to water him twice a day.”)

Dexter...the worst deal so far!

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. To date, Dexter is the worst deal that I've made. But I'll make more mistakes in the future – you can bet on

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that. A line from Bobby Bare's country song explains what too often happens with acquisitions: "I've never gone to bed with an ugly woman, but I've sure woke up with a few."

Insurance

The best anecdote I've heard during the current presidential campaign came from Mitt Romney, who asked his wife, Ann, "When we were young, did you ever in your wildest dreams think I might be president?" To which she replied, "Honey, you weren't in my wildest dreams." When we first entered the property/casualty insurance business in 1967, my wildest dreams did not envision our current operation. To put it charitably, we were a slow starter. But things changed. This metamorphosis has been accomplished by some extraordinary managers. How do you measure a company.... I should emphasize that we do not measure the progress of our investments by what their market prices do during any given year. Rather, we evaluate their performance by the two methods we apply to the businesses we own. The first test is improvement in earnings, with our making due allowance for industry conditions. The second test, more subjective, is whether their "moats" – a metaphor for the superiorities they possess that make life difficult for their competitors – have widened during the year.

Petro China...selling at a worthy price

We made one large sale last year. In 2002 and 2003 Berkshire bought 1.3% of PetroChina for \$488 million, a price that valued the entire business at about \$37 billion. Charlie and I then felt that the company was worth about \$100 billion. By 2007, two factors had materially increased its value: the price of oil had climbed significantly, and PetroChina's management had done a great job in building oil and gas reserves. In the second half of last year, the market value of the company rose to \$275 billion, about what we

thought it was worth compared to other giant oil companies. So we sold our holdings for \$4 billion. A footnote: We paid the IRS tax of \$1.2 billion on our PetroChina gain. This sum paid all costs of the U.S. government – defense, social security, you name it – for about four hours.

Dollar...no mystery!

The US dollar weakened further in 2007 against major currencies, and it's no mystery why: Americans like buying products made elsewhere more than the rest of the world likes buying products made in the U.S. Inevitably, that causes America to ship about \$2 billion of IOUs and assets daily to the rest of the world. And over time, that puts pressure on the dollar. When the dollar falls, it both makes our products cheaper for foreigners to buy and their products more expensive for U.S. citizens. That's why a falling currency is supposed to cure a trade deficit. Indeed, the U.S. deficit has undoubtedly been tempered by the large drop in the dollar. But ponder this: In 2002 when the Euro averaged 94.6¢, our trade deficit with Germany (the fifth largest of our trading partners) was \$36 billion, whereas in 2007, with the Euro averaging \$1.37, our deficit with Germany was up to \$45 billion. Similarly, the Canadian dollar averaged 64¢ in 2002 and 93¢ in 2007. Yet our trade deficit with Canada rose as well, from \$50 billion in 2002 to \$64 billion in 2007. So far, at least, a plunging g dollar has not done much to bring our trade activity into balance. Our country's weakening currency is not the fault of OPEC, China, etc. Other developed countries rely on imported oil and compete against Chinese imports just as we do.

Succession...two sure

We have for some time been well-prepared for CEO succession because we have three outstanding internal candidates. The board knows exactly whom it would pick if I were to become

unavailable, either because of death or diminishing abilities. And that would still leave the board with two backups. Last year I told you that we would also promptly complete a succession plan for the investment job at Berkshire, and we have indeed now identified four candidates who could succeed me in managing investments. All manage substantial sums currently, and all have indicated a strong interest in coming to Berkshire if called. The board knows the strengths of the four and would expect to hire one or more if the need arises. The candidates are young to middle -aged, well-to-do to rich, and all wish to work for Berkshire for reasons that go beyond compensation. (I've reluctantly discarded the notion of my continuing to manage the portfolio after my death – abandoning my hope to give new meaning to the term “thinking outside the box.”).

Rented suits...keep paying

A story I told you some years back illustrates our problem in accurately estimating our loss liability: A fellow was on an important business trip in Europe when his sister called to

tell him that their dad had died. Her brother explained that he couldn't get back but said to spare nothing on the funeral, whose cost he would cover. When he returned, his sister told him that the service had been beautiful and presented him with bills totaling \$8,000. He paid up but a month later received a bill from the mortuary for \$10. He paid that, too – and still another \$10 charge he received a month later. When a third \$10 invoice was sent to him the following month, the perplexed man called his sister to ask what was going on. “Oh,” she replied, “I forgot to tell you. We buried Dad in a rented suit.”

At our insurance companies we have an unknown, but most certainly large, number of “rented suits” buried around the world. We try to estimate the bill for them accurately. In ten or twenty years, we will even be able to make a good guess as to how inaccurate our present guess is. But even that guess will be subject to surprises. I personally believe our stated reserves are adequate, but I've been wrong several times in the past.

Some parting words from Paul Sutherland

I have always greatly admired Mr. Buffet and his passion for investing. He is long-term oriented, patient, and does not get rattled by “the day to day fluctuation “in the market. I wonder what his shareholders thought in 2000 when they were down nearly 50% from their former all time high. Those that held on were well rewarded and those that recognized the opportunity to buy this great company at great price were even better off a few patient years later. I hope if you have not read any of his comments, that you enjoyed this Labor Day treat.

The kids will be off to school soon, and my wife, Amy keeps pointing out the changing leaves on some of our Northern Michigan trees. Summer has gone by fast, as usual. I still can't believe how long ago it was that on behalf of our clients we owned Berkshire. It is nice to add a familiar friend to our portfolio's once again.

*Blessings,
Paul*