# Thoughts on Recent Market Volatility

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August is typically a slow month on Wall Street, as investors and traders take their families on vacation before the start of the school year. This August is obviously off to a different start. After peaking in July, the S&P 500 stock market index fell nearly -20% through its trough on August 9th (ultimately finishing down -13% from the peak through August 12th). The week of August 8th was incredibly volatile,[1] with the index down -6.66% on Monday, up +4.74% on Tuesday, down -4.42% on Wednesday and up +4.63% on Thursday before a quiet Friday session saw the market advance +0.53%. While stocks only lost -1.72% over the week on a cumulative basis, the extreme volatility of the market obviously spooked some investors.

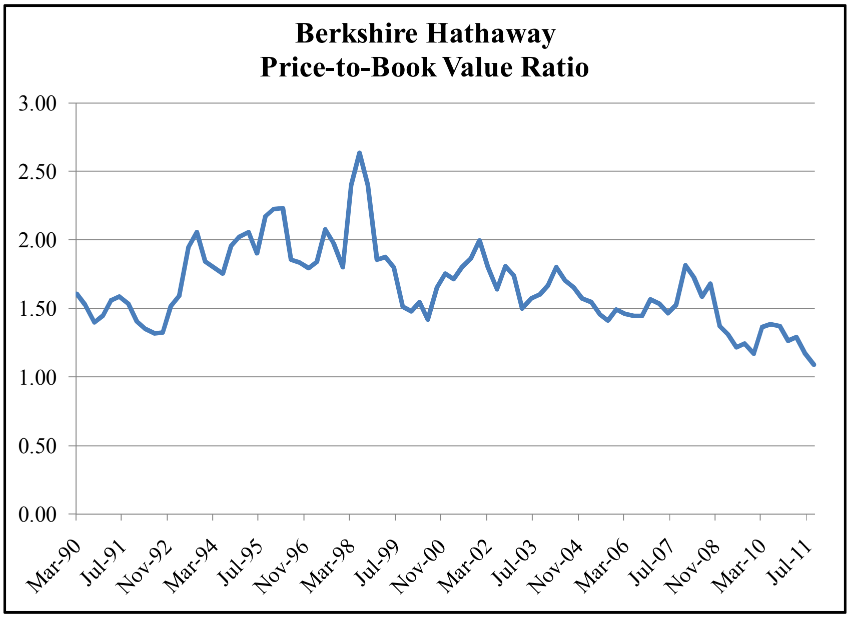
The market has been roiled by several ongoing developments:

- Economic data, while not indicating a contraction, slowed notably in recent months. Real economic growth in the second quarter was just +0.4%, unemployment has yet to show any signs of improvement and manufacturing figures for July showed the sector expanding at its slowest pace in two years. Housing starts continue to bounce along historical lows. Though these figures were likely held back by short-term pressures in the second quarter, including high gas prices and fallout from the Japanese tsunami, investors became concerned that poor economic data would continue in the back half of the year.
- The debt debate debacle in Washington inflicted a real cost on the economy. The political wrangling and inability to come to a credible agreement on how to address long-term deficits led Standard & Poor's to downgrade the country's credit ratings from its long-held position of AAA. While the direct impact on financial markets looks to be contained, the hit to consumer and investor confidence is real, painful and potentially very costly.
- The fiscal challenges in Europe have yet to be effectively addressed. At risk countries like Greece and Portugal have not been able to appease markets and risks are starting to spill over into larger, more important countries such as Italy and Spain. Investors are unsure how any potential contagion could affect U.S. financial markets.
- Litigation against U.S. banks and brokers stemming from the subprime mortgage crisis has yet to show signs of abating, adding to market uncertainties regarding the ultimate loss exposure of key domestic financial institutions.

These risks have increased the market's worries over a potential double-dip recession. Our expectations since 2008 have been consistent, calling for a subdued recovery below that of previous recoveries owing to the need for consumers to continue repairing balance sheets and a prolonged (though eventual) recovery in housing markets. Recent developments have not changed our core thesis, although downside risks have grown. As much as economic models might suggest otherwise, the economy hinges on business and consumer confidence. If recent developments, some of which are self-inflicted, cause businesses and consumers to retrench, the economy could step backwards. Further, while we strongly believe that the U.S. needs to reform its long-term fiscal path, any immediate cuts to government spending will have adverse impacts on the wider economy.

[1] Stock market volatility is a measure for the variation of stock prices. Higher volatility represents larger movements, both up and down, in stock prices.

These risks, coupled with extreme volatility in the financial markets, have lead investors to fret about a potential repeat of 2008-09. After living through the worst financial crisis in a few generations, investors have no desire to repeat the experience. Adding to investor fear, market prognosticators have not failed to make boldly pessimistic proclamations.



**Berkshire Hathaway Price-to-Book Value Ratio**

There is no way to know how events will unfold, but at the risk of pulling a General Custer,[2] we believe that although the chances of a double-dip are now higher, the risk of another financial crisis remains subdued. Most importantly, our country's financial system is much healthier now than it was in 2008. Banks are much better capitalized, with significantly higher loan loss reserves, improved funding mixes, higher quality loan portfolios and capital levels at historic highs. Off-balance sheet financing and leveraged loan products have largely been eschewed. Access to short-term funding, the absence of which triggered the financial crisis, is in much better shape. CreditSights, an independent fixed income research firm, recently wrote:

> Big banks/brokers have ample liquidity stockpiles to deal with contingent liquidity situations. Balance sheet liquidity has become much more robust over the past 3 years since 2008 crisis conditions.[3]

We also believe that stocks are priced at much more reasonable levels, in both an absolute and relative sense, than those seen prior to the 2008-09 crisis. Many high-quality, blue-chip names boast dividends yields above the rates obtainable on long-term bonds while simultaneously offering reasonable inflation protection. While there will be no shortage of "top-down" market analysts arguing that stocks should be avoided, our "bottom-up" analysis – driven by our research of individual companies – suggests that even if the economy does sputter, stocks are still a good value. As evidence of this, corporate executives have been buying up stock in their own businesses, using both company and personal resources, at levels not seen since March of 2009.

Take as an example Berkshire Hathaway. The conglomerate operated by Warren Buffett owns (either wholly or partially) a number of high quality, strong cash flow generating businesses, including GEICO, Burlington Northern, Coca-Cola, Wells Fargo and Dairy Queen, among others. Because of its size and complexity, Berkshire can be a difficult stock to value. Buffett, recognizing the challenges in performing such a calculation, writes:

> To eliminate subjectivity, we therefore use an *understated* proxy for intrinsic-value – book value – when measuring our performance. *To be sure, some of our businesses are worth far more than their carrying value on our books*.[4] [emphasis added]

The chart on this page shows Berkshire Hathaway's price-to-book value ratio.[5] Based on this measure, Berkshire Hathaway is trading at its lowest valuation in 20 years, including the depths of the 2008-09 financial crisis! While Berkshire's stock price has risen from its 2009 lows, the value of its businesses has increased even faster as a result of Buffett's capital allocation decisions/opportunities during the crisis. During last week's market sell-off, Berkshire's stock price hit $66, roughly equal to Berkshire's book value at the end of the second quarter. Further, the company had $43 billion in cash that Buffett no doubt has been putting hard to work during the recent sell-off. In an interview with *Fortune* magazine last week, Buffett stated "The lower things go, the more I buy."[6] In

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[2] General George Custer reportedly proclaimed, "Hurrah Boys! Let's get these last few [Indians] then head on back to camp. Hurrah!" before his famed "Last Stand."

[3] *Banks: Repo Ripples & Liquidity Buffers*, CreditSights, August 9, 2011.

[4] *Annual letter to Berkshire Hathaway shareholders*, Warren Buffett, February 26, 2011.

[5] Bloomberg Financial Data.

[6] *Buffett: The lower stocks go, the more I buy*, Andy Serwer, Fortune, August 11, 2011.

an interview with Charlie Rose this past Monday, Buffett revealed that Berkshire bought more stock on Monday, August 8th, the day the market was down -6.66%, than any other day of the year. Buffett also took advantage of ultra-low interest rates to issue new bonds. Based upon our own analysis as well as a study of Buffett's past comments regarding the company's stock price, we believe that Berkshire should trade at higher levels.

Of course Berkshire is not a risk-free investment. If the economy slows, Berkshire's earnings will recede. Its insurance units will post losses if severe natural catastrophes occur. Buffett is 80 years old and his ultimate death will hit the stock price (though we believe that at least a portion of this risk is already priced into the stock and the company will continue to thrive after he is gone). Most importantly, Berkshire's large size will make past outsized gains in book value much harder to replicate in the future. Yet in an environment of ultra-low interest rates and economic uncertainty, Berkshire stock looks like an attractive investment providing the opportunity for strong risk-adjusted returns in a variety of economic scenarios.

Just over a month ago we penned a note titled *Banking and Building – Is There Value?* where we argued that stocks in the financial and building-related sectors presented good long-term potential. We still believe that this thesis will prove to be correct and the market sell-off has allowed us to build our investments in businesses that we believe offer strong long-term prospects despite short-term pressures.

These recent investments, however, have been a headwind to the performance of our stock portfolios in the short-term as these unloved sectors have been beaten up more than the broader market. We are bound to produce occasional bouts of stock market underperformance – the only way to beat the market longer-term is to invest where others do not, which inevitably leads to short-term deviations from the market. This short-term underperformance may persist a bit longer, but we believe that we will be well rewarded for our patience.

While our stock market performance has been a slight drag on our overall performance recently, our other investment policies implemented over the past few years have had beneficial consequences:

- We have built above-average cash balances. This cash has come from both stocks and bonds. In the first quarter of this year, commenting on our decision to hold higher cash positions, we wrote:

  > [T]he elevated level of debt present in developed economies should lead to heightened economic volatility, which will hopefully present future opportunities for favorable investments. We hope to employ this cash on an attractive basis when more favorable investment opportunities arise.[7]

  The recent sell-off in stocks represents the kind of volatility we envisioned and our cash balances allow us to react quickly to market opportunities.
- We have worked hard to build high quality fixed income portfolios, focusing on diversification and strong balance sheets. We believe that fixed income portfolios are designed to provide income and stability and believe that our portfolios are well positioned for any impending market stress. We also did not reduce our exposure to interest rates, reasoning they were poised to stay low for an extended period before moving higher. As bonds have rallied this decision has paid off. We do continue to hold reduced allocations to fixed income in general, however, in light of historically low interest rates (10-year Treasury rates at just 2.24% with 30-year Treasury rates at only 3.72%). As bond prices rise, our underweight position costs us some upside, but longer-term we believe this is well worth the price.
- We have built positions in alternative investments to lessen exposure to stock market fluctuations and to create more robust portfolios. When the stock market exhibits strong short-term rallies, these investments may trail. But by substituting uncorrelated investments with positive return expectations in place of stock (and bond) market exposure, we believe that we will be able to achieve higher returns *and* lower risk longer-term. The recent market sell-off illustrates their value – since the stock market peaked in July, our alternative investment portfolio is down just -0.10% versus -12.73% for the S&P 500.[8]

Going forward, we will stick with these policies and continue to invest in high quality stocks that we think are undervalued. While economic risks have increased, we believe that high-quality, undervalued companies represent attractive absolute and relative long-term investment prospects. Heightened volatility will continue, so it is paramount for investors to think critically about their true

[7] *First Quarter Investment Commentary*, AMI Investment Management, Inc., April 2011.
[8] July 7, 2011 through August 12, 2011. Based upon a model portfolio, does not represent actual results.

risk tolerance. Big declines in the market are typically the time to buy, not sell, which requires emotional objectivity and a strong stomach. If an investor is unable to withstand short-term price movements in stock holdings, either because of sizable near-term spending requirements relative to his portfolio or the inability to sleep at night in the face of market declines, then his portfolio allocation should be re-examined. But for investors who are able and willing to focus on longer-term results, Benjamin Graham counsels:

> A serious investor is not likely to believe that the day-to-day or even month-to-month fluctuations of the stock market make him richer or poorer…He can take advantage of the daily market price or leave it alone, as dictated by his own judgment and inclination…Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.[9]

We will keep a level head and focus on creating long-term value. As always, we thank you for your continued confidence. If you have any questions please do not hesitate to contact us.

[9] *The Intelligent Investor*, Benjamin Graham, p. 196, 205.