

## The 2019 Berkshire Hathaway Annual Meeting and US Company Visits

*San Francisco, Austin and Omaha*



### *The High Quality Businesses Continue to Surprise You on the Upside*

At Contact Asset Management, we are always striving to act within a framework of staying curious, to ensure we evolve as Fund Managers.

In staying curious, over 10 days we travelled throughout the United States to seek answers to three key questions on our minds:

- (1) How is the US Economy performing?
- (2) How are companies within our portfolio potentially performing?
- (3) In attending our 7th Annual Berkshire Annual General Meeting (“AGM”), what could we learn that will continue to improve our investment process?

The United States is the world’s largest economy by Gross Domestic Product (GDP), with market consensus Earnings per Share (EPS) growth for 2019 of 11%. This growth rate is the highest in the industrialized world. The USA is becoming

increasingly important to our portfolio returns. The BKI portfolio has 23 companies (or 49% of the total portfolio) with revenue exposure to the USA.

We were fortunate during the visit to meet over 17 companies, investment managers and competitors that have direct links to our portfolio. This has enabled us to return with insights into the operating performance of our investments and combine that with a deeper understanding of the performance of the US economy, including areas of potential disruption.

To protect the intellectual property of the learnings from our USA trip, we will not in this letter go into extensive detail on our specific company meetings. As Buffett noted on proprietary information, “*We aren’t giving away what belongs to our shareholders for nothing.*” However, as we have provided in prior years in our Annual Berkshire letter, below is a short summary of our trip.



### The 55<sup>th</sup> Berkshire Hathaway Annual Meeting

The Berkshire Annual General Meeting ("AGM") was certainly the highlight of our trip and will be of most interest to our readers. This year was the 7<sup>th</sup> year Contact Asset Management has attended Berkshire and each year we continue to learn more. Berkshire attracted this year a record 42,000 people from all over the world. After Warren Buffet first invested in Berkshire in December 1962 for \$7.50 per share, today a single Berkshire Class A share trades for c\$327,765. Berkshire, with a market capitalisation of US\$537 billion, is today the most valuable non-technology company in the world. With phenomenal returns, it is no surprise that people travel across the world to hear Warren Buffett and Charlie Munger speak.



Warren Buffett (left) and Charlie Munger (right).  
Photographer: Nati Harnik

Although many come to hear the "Oracle of Omaha" speak, many shareholders just come for the Expo, which is a spectacle in itself. The Expo is a where the Berkshire family of companies, have stalls and provide very healthy discounts to shareholders. Not only do the Expo stalls prosper but the surrounding Berkshire owned companies in Omaha also do well, such as Nebraska Furniture Mart which did a record \$9.3m in sales in one day - an amount some furniture stores would do annually.

Before the AGM, we like to attend the Expo, which is valuable in learning how the USA economy is performing. We spent a lot of time talking to the Management of different Berkshire Companies. This provides a useful litmus test into the overall economy.

We spoke with industry leaders from BNSF, Berkshire Energy, Brooks, Justin Boots, Clayton Homes and Greg Abel (vice-Chairman of Berkshire – Greg runs all the non-insurance Berkshire businesses).



Berkshire Vice Chairman Greg Abel (centre) with Contact Portfolio Managers Tom Millner (left) and Will Culbert (right)

The USA economy continues to perform strongly and note two key discussions:

- Clayton Homes CEO said they had its best year ever. With housing starts at 1.2m in the USA and low unemployment, complemented with the build cost for a consumer at only US\$159k to build a new home, to us this result seemed no surprise. For context the long run housing start value over the last 30 years is c1.5m.
- Berkshire Energy CEO noted that in Oregon, California and Washington State they have all now ceased coal exports, as the focus shifts to renewables. Much of the coal now needs to go via the port of Vancouver in BC Canada, adding a significant amount to the cost of production. They believe that coal exports from the US will shortly cease and won't be able to be reopened any time soon. He also said, *"If you're in coal in Australia then that's good news for you guys."*

On the day of the Meeting, we rose early to ensure we are among the first entrants. The doors open at 7:00am, for an 8:30am start, and it becomes a frantic stampede like the running of the bulls. We were fortunate this year to be in the 6th row.

The format of the AGM is a six-hour question and answer session, with an introductory video. There are three journalists, three broking analysts and then a number of microphones around the Centre for shareholders. The questions rotate between the groups throughout the meeting. Buffett and Munger fueled by Coke and See's Candy Peanut Brittle are quite remarkable as they field any questions the audience wishes to pose. Each year the content of the introductory video is a little different, however at the end they always play Buffett testifying on



behalf of Salomon in 1991 and saying *"If you lose money for the firm, I will be understanding. If you lose a shred of reputation for the firm, I will be ruthless."* A timely reminder that reputation takes a lifetime to build, but can be destroyed in a single act.

After the corporate video, the meeting begins with Berkshire reporting its annual result. Berkshire reported Net Earnings of \$21.6b compared to -\$1.1b in the year prior. First and foremost, Buffett starts by decrying the new accounting rule that specifically, forces companies to mark-to-market the value of their stock portfolios, and given Berkshire's portfolio is large, wild swings in earnings can present themselves. Warren Buffett said *"The bottom line figures are going to be totally capricious. What I worry about is the interpretation. I just hope nobody gets misled."*

The AGM is not one where one can expect to walk out with a handful of stock tips, rather it is both Buffett's and Munger's distinctive teaching style, which tends to instruct people how to think rather than what to think, is a critical point of difference. For us, the Berkshire session, is a way for us to refocus on our investment philosophy and reminds us of what we view as important. That is, long-term investment, transparency and alignment with our shareholders.

Charlie and Warren faced 48 questions ranging from Bitcoin to precision rail roading, yet a dominant theme was questions around share buybacks. For most companies, that might be old news but Berkshire tweaked its policy last year, opening up that avenue for more potential capital deployment. It's key for Berkshire because of the swelling cash pile. Warren also tried to address the future of Berkshire more at the meeting, with shareholders getting to hear Ajit Jain and Greg Abel speak, who were named last year as Vice Chairmen. That could assuage any potential concerns about succession at Berkshire as Buffett, 88, and Munger, 95, gave the pair more speaking room. Below are the key comments.

### **Massive cash pile**

Berkshire disclosed that is currently sitting on a float of \$124 billion – up from \$116 billion a year ago. Buffett noted that, *"We are comfortable holding a lot of cash because we are operating on the assumption that we will have an opportunity to deploy it at very attractive rates"*. Berkshire likes to have a lot of money to be able to make big moves

fast. Opportunities tend to come in clumps when other people don't want to deploy cash.

### **Buying back Berkshire stock**

There were five questions that addressed Berkshire buying back stock. Buffett noted on top of the \$1.7b already bought, more buybacks could eventuate, saying *"We will buy stock when it is trading below a conservative estimate of its intrinsic value, we want to be sure when we repurchase stock that those that have not sold are better off than they were before."* *"We are certainly willing to spend \$100b - that is not a problem - spending it intelligently is a huge problem,"* Buffett said.

### **Online Retailers**

Buffett said the jury is still out on how well online retailers will do over time. He said that investors seem willing to look at losses as acceptable as long as sales are increasing, hoping better days are ahead. Buffet noted that the Nebraska Furniture Mart in Omaha does a significant dollar volume in online sales, with people still coming to the store to pick up what they buy online. *"We don't want to be a showroom for online operations. We have to have the right prices and we're good at that at the Furniture Mart,"* Buffett said.

### **Kraft Heinz**

Amid the challenges facing Kraft Heinz, Buffett endorsed the fundamentals of the company. In response to a question that criticized Berkshire as missing changing consumer preferences within the brands, Buffett noted Kraft Heinz is earning more than it did six or seven years ago, and its products are still used in many households. *"Kraft Heinz is still doing very well operationally, but you can turn any investment into a bad deal by paying too much."* Charlie Munger added: *"It's not a tragedy. Two transactions: One worked wonderfully and the other didn't work so well. That happens."*

### **Succession**

When asked at one point why shareholders don't hear more from other Berkshire executives, Munger said *"It's largely a function of Berkshire's streamlined, unbureaucratic way of making decisions,"* adding *"You're just going to have to endure us."* However, Buffett responded that hearing from Ajit Jain and Greg Abel was probably a good idea, saying the format for the Q&A session was *"not set in stone at all."* Buffett then invited shareholders to ask questions of the executives, with Buffett calling on Ajit to respond to a question



on pricing of insurance risk and Abel on who leads Berkshire's energy units, to respond to a couple of energy-related questions.

### Corporate Governance

On modern corporate governance, Buffett said *"How in the world a \$US250,000 salary feeds independence I don't know. I can't recall any 'independent' director ever doing anything that was counter to the interests of the chief executive: why would they upset the apple cart?"* Buffett added in response to criticism the company didn't provide enough reporting on its environmental and social goals. *"We're not spending time or energy on needless reporting (to satisfy activists). I prefer individuals to institutional shareholders."*

### Amazon

Buffett's disclosure that one of his two investing offshoots (Todd Combs or Ted Weschler) bought Amazon stock created a lot of interest. In response to concerns that it is a deviation away from Berkshires strategy, Buffett highlighted he sees it as a value bet: *"The money managers who bought Amazon shares took into consideration a slew of financial metrics including the company's sales, margins tangible assets and excess cash. The considerations are identical when you buy Amazon shares versus say a bank stock that looks cheap against book value or earnings of some sort."* The nature of business quality seems to have been another feature of the Amazon investment case: *"Brands and retailers have always struggled for who has the upper hand. Recently the power has been shifting in the direction of the retailers like Amazon and Walmart."*

### Value Investing

Expanding on the Amazon example, Buffett noted that *"The decision to buy Amazon's stock was just as much based on value investing principles as a decision to buy a statistically cheap stock. Value investing is about estimating and valuing future cash flows, not about how low a Price to Book or a Price to Earnings ratio is for a stock."* A focus on price remains an important tenet *"You can pay too much for a wonderful business. There is a price where we could have paid too much for See's Candies and it wouldn't have worked out well as an investment. You can turn any investment into a bad deal by paying too much. What you can't do is turn any investment into a good deal by paying a cheap price."*

### Learning and Compounding Knowledge

Buffett said, *"If you want to grow your investment circle of competence you want to read a lot and study a lot of businesses. It is more competitive now than it was when we started investing, but if you build your circle and have the discipline to be patient and do nothing a lot of the time you can still do well."* Munger said, *"It is amazing how much we learned over the years. If we hadn't, the results wouldn't have been anywhere near as good. We needed to improve at each step to take it to a new level."*

### Be rational

Each year, we have walked away from the Meeting with a better understanding of how important it is to be rational and not overcomplicate things. Charlie Munger said, *"It's hard to be reasonable. There are a million tricks the human mind plays on its owner. That's what causes stupidity. Think of how many times you've said to yourself, 'Why in the hell did I do that?'"* Munger also noted, *"Both Warren and I feel it's our moral duty to be as rational as we can possibly be. A lot of people who are brilliant in some ways tend to make these utterly asinine decisions in other ways. We both tend to collect the asinities of the world in a kind of checklist. And we try to avoid everything on the checklist."*

## Notes from our Company Meetings and Site Tours

### Treasury Wines Estates Ltd (TWE:ASX)

We visited both the Beringer and Stags' Leap Vineyards in Napa Valley, California, which are two key brands in the TWE portfolio for both the US and China markets. The Beringer Vineyard was first acquired in 1875, by the Beringer family and has since only had 8 wine makers over time, with 5th generation Mark Beringer returning in 2015 as Chief Winemaker. Beringer has a deep history of delivering high quality award winning wines, particularly its flagship Private Reserve label which can sell at US\$3,000 a bottle for older vintages. The Stags' Leap Vineyard is a high margin, high quality brand shipped globally. The current winemaker of Stags' Leap is Christophe Paubert, whom is highly regarded in the industry having grown up just outside of Sauternes in Bordeaux. Post visiting TWE vineyards, we also met with a leading distributor of wine into Asia and the Americas, who shared insight into the distribution model changes for TWE in both China and the Americas.





#### **Pivotal Systems (PVS:ASX) and Revasum (RVS:ASX)**

The Pivotal and Revasum meetings took us to Silicon Valley. Neither stock is owned by BKI but the meetings provided interesting insights into the semiconductor industry and the increasing importance of 5G. RVS is forecasting the semiconductor industry to grow at 50% p.a. for several years. The silicone carbonate wafers that RVS produces can save the construction cost for an electric vehicle of between US\$1,300 - \$1,500. PVS is building flow controllers, which is a bottleneck for the semiconductor industry, as it helps speed up processors, which is something a future 5G network requires. Both companies are located in close proximity to the Tesla factory.

#### **Boral Limited (BLD:ASX)**

We visited the Boral North America Innovation Factory in San Antonio, Texas. The Innovation factory was created for the specific purpose of driving transformational innovation across Boral North America and to serve as an incubator for emergent businesses based on technology advancements. With a dedicated team on site of industry leading chemists, material scientists, physicists, geologists, biologists and research engineers at a state of the art materials laboratory, the culture on site, is solely focused on creating customer centric solutions and products.

The priorities are:

- (1) Ease of use
- (2) Performance and functionality
- (3) Cost improvement, and
- (4) Sustainability.

Boral is working on new products at the Factory for

the wider benefit of all North Americans, with one launched at the recent IBS show California.

#### **Lendlease Limited (LLC:ASX)**

Last year we met the Lendlease team in Chicago and this year we visited the San Francisco office. We are optimistic on the global urbanisation thematic for LLC. Chicago and San Francisco are two important Gateway cities.

In San Francisco, LLC is looking to develop the Van Ness site, a 47 floor mixed use space, involving residential living and seven floors of office space. The site is just a short walk from the Financial District. There is a generational shift to apartment housing taking place in San Francisco, as Millennials and Technology based workers prefer CBD living than further out in Silicon Valley. The market is strong – rents have been growing at 10% p.a. due to a material shortage of supply with a vacancy rate of 5.4% compared to the prior 10-year average of 9.0%. In Office, there is significant pent up demand as local authorities only allow 950,000 square feet of new development versus a 8.9m square foot backlog of demand. The conditions in San Francisco for property remain very favourable.



Photo: Van Ness project, San Francisco. Source: Lendlease

#### **Amazon (AMZN:NASDAQ)**

We visited the new concept Amazon Go concept store in San Francisco as well as the Amazon Fulfilment Centre, in San Marcos, Texas (one of 26 located in the USA. Given Amazon is now in Australia, yet has not yet built a fulfilment center, we continue to develop our thinking in this space for the potential impacts to Australian retailers. Although we visited a fulfilment center last year as part of the Berkshire visit, this year our Senior Investment Analyst, Rodney Forrest joined us on the trip.



Rodney was previously the Head of Finance at both Coles and Woolworths, with operational experience as well at ALDI. Rodney's operational background will serve us well to understand the future impacts of Amazon for Australia. Amazon fulfilment centers are highly automated, with over 100,000 robots and a picking system built on high efficiency, and the ability to provide granular SKU level itemisation. Post our visitation, we see who are winners and losers for certain categories. There are also learnings into the Industrial property space.



Photo: Inside the Amazon Go store in San Francisco



Amazon Fulfillment Center, San Marcos, Texas

## Investment Managers

As well as meeting companies, we met some highly regarded Global Investment Managers including Chuck Akre, Francois Rochon, Mohnish Pabrai, Tom Gayner, Robert Hagstrom and panelists from the 11th Annual Value Investing Conference.

Chuck Akre was particularly interesting and generous with his time. Akre is a big believer in identifying "compounding machines" to describe businesses that are capable of compounding the shareholders' capital at high rates for long periods of time with little risk of permanent loss.

*"Quality businesses will continue to surprise to the upside. The good ones are too hard to find, so why sell."*

*"Advice for young people: Be curious. Be curious. Be curious. This is a learning experience. Figure out in your own life how you want to achieve your financial goals. You have to find your own path and what works for you."*

*"The markets focus on consensus too much and beating by a penny or missing by a penny."*

*"Focus on a really small number of great businesses and load yourself up."*

*"If you are going to sell and then try to buy back cheaper, then you need to be right on two decisions."*

### Other comments that we found particularly insightful during our discussions included:

*"Talk to customers, talk to competitors. The answer is not in the financials."*

*"We want businesses with high return on incremental capital. In high ROIC industries. Then when the industry rises, you get that and the company rise."*

*"Whether a technology takes off depends on being better, being faster and being cheaper - in the past you could get away with having two, but now to succeed you need all three."*

*"We continue to follow our longstanding four part equity investment discipline of seeking investments in 1) profitable businesses with good returns on capital and not much leverage 2) management teams with equal measures of talent and integrity 3)*



*with reinvestment opportunities and capital discipline at 4) reasonable prices."*

*"I didn't study train wrecks. One needs to understand traps. In the past I used to have 75% valuation and 25% quality, instead I should have looked 75% quality and 25% valuation."*

On what are the best businesses: *"Monopoly type assets, with high ROC and generate high FCF. Yet understand what works for you. Once you own a company care less about the valuation and ask is it still a good business?"*

On how to buy, *"The person owning it has owned it much longer and so you should ask why are they selling it. When you know why you are different to the market that is key."*

On the dichotomy of Growth v Value, *"The economics of the business is key. Low Price to Earnings are typically high CAPEX and low ROIC so high Price to Earnings are light CAPEX and high ROIC. There is a misnomer that low Price to Earnings is a good business."*

There were consistent themes playing out when meeting with the various Investment Managers. It reminded us, the focus should always be on buying good high quality businesses and then allowing for compounding to work. These collaborative sessions we believe will provide us with ongoing reminders that will help the Contact Asset Management team, on the journey to maximise returns for our shareholders.

## Conclusion

Our trip to the US has brought a sense of confidence to some of our existing positions. We will continue to assess opportunities to deploy capital into ASX listed names with US exposure (both existing and new), as we continue to do more work and await the right price for entry. We were very encouraged during the trip by the resilience of the US economy.

With Warren Buffett and Charlie Munger regarded by many as the greatest living Investors of all time, the wisdom they provide each year at Berkshire, will continue to help us at Contact Asset Management, to improve our process of investing. We also want to ensure we stay true to the process that works for us.

In doing so we will aim to ensure that we follow three core principles that are part of our investment process.

- (1) We will look to buy high quality businesses at prices where we see them trading materially below our intrinsic value calculation.
- (2) We remain curious and if the facts change we will therefore change accordingly our assumptions and understanding; and
- (3) Once purchasing, we want to ensure weather the investment is delivering on expectations and that we do not step in the way of compounding.

Tom Millner, Will Culbert and Rodney Forrest  
Contact Asset Management  
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