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THE GREATEST GROWTH COMPANY WALL STREET NEVER HEARD OF:

BERKSHIRE HATHAWAY

Warren Buffett and Berkshire Hathaway have had a considerable impact on our client portfolios, directly and indirectly, measurably and immeasurably, over the years. We first invested in the shares of Berkshire Hathaway in December of 1998. With the stock near all-time highs, we can proudly state that all but the newest of our clients have a profit in their shares. Those clients who have been with us for more than a few years are fully aware that Berkshire Hathaway has been our best-performing stock since the stock market bubble burst in the spring of 2000. The stock continues to be one of our better performers thus far in 2004. We still think that the stock is cheap. (More on that later.)

As for the immeasurable impact of being students of Warren Buffett's investment and business philosophies, it is difficult to quantify, much less overestimate, the impact on our investment philosophy, and in turn, the performance of your portfolio, other than to say it has been large and significant. We have been students of Buffett's since at least 1984. (A fair question – or complaint – would be why did it take us 15 years to buy our first shares?)

The philosophical precepts expounded by Buffett were first taught to him by his Columbia University professor Benjamin Graham. Of course, Graham is the author of the seminal investment textbook Security Analysis (1934) and arguably the best lay investment book The Intelligent Investor (1949). Graham taught a generation of investors from his Columbia perch from 1929 to 1954. Buffett was the only student to receive an A+ from Graham.

The Graham-Buffett investment philosophy is founded on three timeless ideas: invest as an owner of a business rather than speculate in prices of stock certificate paper; stocks should be purchased cheap enough from the value of the underlying worth of the business to allow for the inevitable error in judgment (a margin of safety); and, finally, an investor must understand that stock market prices are often based on popularity, fashion and emotion, rather than sober logic, and many times fluctuate wildly from true underlying business value. That's it.

Any investment management firm worth their salt adheres to some rational investment philosophy and process. Same goes for successful individual investors. To be a successful investor one needs only to check their ego and stand on the shoulders of investment giants. Tony, Dana and I have chosen this path. We apply these timeless investment tenets differently than other firms, but we believe that we stay well ahead of many investors in that we do not believe we need to reinvent the investment philosophy wheel to be successful.

Even casual students of Buffett have long since learned that Berkshire Hathaway is quite a different entity than it was only ten years ago. Where once Berkshire was not much more than Buffett's personal investment portfolio, the company is now a conglomerate of mutually inexclusive businesses, dominated by a core of insurance companies. Wall Street is not casual about anything. When it comes to Berkshire and Buffett, Wall Street has finally caught on to the reality that the company is mainly a conglomerate of businesses. Wall Street does not slavishly follow every Buffett buy and sell as Holy Grail secrets any more.

That said, we still think Wall Street once again remains behind Buffett's learning curve. We believe that the Street fails to realize that Buffett has slowly built Berkshire Hathaway into a true growth company. In fact, not only is Berkshire a growth company, but a remarkably rapid one considering its enormous asset base ($180 billion) and equity base ($78 billion). Would anyone believe that a conglomerate the size of Berkshire Hathaway could grow operating earnings per share by 28%, compounded, over the past five years? The key here is the term *per share*. Wall Street worships the mantra of "growth". Too many corporate executives are compensated far too largely for any type of growth – good growth or bad growth. Make no mistake about it: not every type of growth is good for shareholders.

Growth via acquisition and mergers is the most prominent means of growth, and often the most fraught with abuse (Enron, Tyco, WorldCom, etc.) Investors must also be aware of managements' claims of "record" growth. Buffett reminds us that even a simple passbook savings account generates "record" growth every year.

This matter underscores a most underappreciated aspect of Berkshire: *non-dilutive* growth by acquisition. Buffett has a growing reputation, particularly among large family-owned private businesses, that Berkshire is a terrific home for them since Buffett will not dismantle what these families have built over the years. More to the point, mediocre businesses become good businesses under the Berkshire umbrella. Moreover, good businesses become great businesses. We cannot stress this point enough.

The simple but powerful reason for this is that Buffett dramatically and radically changes the reinvestment equation for Berkshire's wholly-owned companies. Consider the capital reinvestment plight of a good-sized carpet or brick manufacturer. Now such a business may be considered a "good" business by measures such as profitability and market share, but unless the respective CEO can reinvest retained cash earnings accumulated in owner's equity to earn *future* high returns, such businesses fail to be true "growth" companies. Of course, the carpet CEO or brick CEO can pay out all net earnings as dividends, but this is unlikely; since most CEOs are paid in part (in too many cases, in large part) on the size of the firm, Then the reinvestment of earnings becomes the paramount job of a CEO. So, what is the CEO to do if reinvestment opportunities *back into the business* are lackluster? Not much. This "lack of sustainable growth" is the simple reality facing the majority of Corporate America. Most businesses, by economic reality, cannot achieve growth much better than their underlying industry growth, or faster than the overall economy. We have stated for years that true growth companies are rare.

Consider now the capital reinvestment options if our carpet/brick company is wholly-owned under the conglomerate of Berkshire. Buffett solves the reinvestment conundrum unlike almost any other business we know of. Sure, Buffett can allow CEOs to reinvest in carpets or bricks – but only if the CEO can convince Buffett that these reinvestment opportunities are superior to Buffett's exceptionally wide canvas of reinvestment opportunities. This is highly unlikely since Buffett can invest in any asset, stock or bond, private or public company, or do nothing at all and just sit on wads of cash. Rare is the CEO who sits on stacks of idle cash. Too many CEOs view any and all activity as progress.

This is why businesses become better as a wholly-owned subsidiary of Berkshire. Buffett solves the ever-present capital reinvestment dilemma: this is the unique essence that too many investors fail to appreciate about Buffett and Berkshire Hathaway.

Now back to that pesky matter of "per share" growth. Berkshire's growth has been driven in large part by acquisition. However, Buffett – unlike most companies – rarely uses Berkshire stock to pay or fund an acquisition. Therefore, as Buffett reinvests Berkshire's many billions of cash into seemingly boring but profitable businesses, revenues grow, earnings grow, and cash flow grows. But since outstanding shares do not grow, *per share* growth at Berkshire explodes. Per-share earnings have compounded at 28% for the past five years and 24% for the past ten years.

So, make no mistake about it – Buffett has masterfully built Berkshire Hathaway into an outstanding growth company.

As we stated earlier, we have been fortunate to sit on Buffett's philosophical shoulders. We have read every Chairman's Letter Buffett has penned, including those from the Buffett Partnership days of the late 1950's. Without a doubt, we have found that Buffett chooses his words very carefully. He is a serial under-promiser/over-deliverer. When he does report good news you should assume that such news is understated, and if you are a Berkshire shareholder you had better pay close attention. Buffett could not have been clear enough, at least to us, in his last two Chairman's Letters regarding the fundamental health of Berkshire's insurance businesses (2002) and that Berkshire is indeed a terrific growth company (2003).

Berkshire has three main insurance businesses: Berkshire Reinsurance, General Reinsurance and GEICO. Berkshire Re and GEICO have been outstanding operators for years. The third, General Re, acquired in 1998, has had trouble changing their underwriting philosophy to be more profitability oriented rather than market share oriented. Buffett now states unequivocally that General Re is fixed. In this era of grand jury-indicted CEOs, we believe Buffett. So should you.

Insurance companies are usually mediocre businesses at best. Few have competitive advantages. Most sell a commodity product. Selling a price-sensitive, undifferentiated product is nobody's ideal business proposition. Furthermore, the long-tail nature of paying insurance liability claims of most insurance products lends itself – human nature being what it is – to poor future loss assumptions. As Buffett has stated countless times, *"most surprises in the insurance business are not pleasant."*

On the other hand, under the right operating environment and operating philosophy and with just a touch of a non-commodity aspect or attribute to the insurance product, an insurance business can be a great business. The effectiveness of an insurance company is measured largely in two ways: the profitability of the underlying insurance underwriting activities and the investment profit generated on the insurance float. Most insurance companies operate at an underwriting loss. The price competition of most insurance products is so intense that it yields the business of collecting premiums and paying out claims (underwriting) a net loser. Insurance companies usually make up for underwriting losses with gains on investing the float.

A simplistic definition of float is the collected premiums an insurance company holds, but does not own. Float accumulates since losses often take years to be paid. Float, by accounting definition, is a liability. All insurance companies incur a cost of float. If an insurance company can consistently generate low cost float then the inherent liability of float starts to have attributes of an asset. Perhaps even a very valuable asset.

In his 2002 Chairman's Letter Buffett offered a rare forecast of multiyear underwriting profitability for Berkshire's insurance subsidiaries. This was (and is) a hugely bullish development. To clarify this point: When an insurance company operates at an underwriting profit it is as if the policyholders are "paying" the insurance company to invest the float. In 2003, Berkshire's insurance companies generated a collective cost of float of negative 4%. In layman's terms, policyholders "paid" Berkshire 4% to invest over $45 billion dollars of float. What does a mere "4%" underwriting gain mean for shareholders? How about $1.7 billion! You decide if low-cost float is an asset. With Buffett at the helm investing Berkshire's billions of float and nearly $40 billion more in cash at the holding company, Berkshire's shareholders (including yours truly) do sleep well at night these days. Berkshire's insurance businesses will not necessarily be the main driver of growth, but will be the leading driver of cash-flow generation over the next few years. Berkshire's Fort Knox-like balance sheet driven claims paying ability has earned it the enviable reputation of "insurer of last resort."

In summary, Berkshire Hathaway is a true growth company. We expect Berkshire to grow at rates in excess of 15% for the next several years. Such rates of growth are rare for a company the size of Berkshire. If the market offers up more than a few opportunities to invest the billions currently invested in very low yielding investments into businesses that produce 8% to 10% cash flow yields (think of a "mediocre" Acme brick or Shaw carpet company), then our earnings assumption will once again be too low.

Much has been written about Buffett and Berkshire Hathaway. One could build a decent-sized investment library with just Buffett related books. This letter is far too brief to convey Buffett's superb transformation of Berkshire into a perpetual cash flow machine. In 2003 Berkshire posted net earnings of $8.2 billion - that's almost $160 million crossing Buffett's desk every week.

The most important point we can make is that even with the stock near all-time highs, we believe the stock is still cheap. Perhaps very cheap. In his recent 2003 Chairman's Letter, Buffett wrote at length about the growth of Berkshire's operating earnings – not his personal investment prowess. The stock is currently valued at 1.8X shareholders equity (book value). Berkshire's 7-year growth in revenues and earnings are 38% and 27%, respectively. American International Group has grown revenues and earnings over the same period by 16% and 12%. General Electric: 12% and 9%. AIG is valued at 2.8X book value, while GE sells at 3.7X book. Now, both AIG and GE are overvalued, relative to Berkshire, or Berkshire is still cheap. We think it is the latter. Just valuing Berkshire at 3.0X book renders the stock 50% higher.

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