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Feb. 27, 2017

OBSERVATIONS ON THE MARKET

No. 308

By Greg Denewiler, CFA

The Berkshire Hathaway annual letter to shareholders came out on Saturday and it is always worth reading what Warren Buffett writes, since he is one of the most successful investors of our time. Here are a few observations from this year's letter.

First, he is optimist about our economy's future. He doesn't make a prediction about next year, but does make a prediction about the future. "*American business – and consequently a basket of stocks – is virtually certain to be worth far more in the years ahead. Innovation, productivity gains, entrepreneurial spirit and an abundance of capital will see to that. Ever-present naysayers may prosper by marketing their gloomy forecasts. But heaven help them if they act on the nonsense they peddle*."

Second, Buffett has a great sense of taking advantage of opportunity. If you have followed what investments he has made in the past, to his credit, he did step in and become an aggressive buyer in the recession of 2009. So, when he says: "*During such scary periods, you should never forget two things: First, widespread fear is your friend as an investor, because it serves up bargain purchases. Second, personal fear is your enemy. It will also be unwarranted. Investors who avoid high and unnecessary costs and simply sit for an extended period with a collection of large, conservatively-financed American businesses will almost certainly do well.*" He means it. "*Every decade or so, dark clouds will fill the economic skies, and they will briefly rain gold. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons. And that we will do*." His attitude regarding major market downturns, as a credit card marketing slogan states, is priceless.

Some other points taken from the letter are his comments regarding the insurance business, which are a major part of Berkshire Hathaway's revenue. Insurers should know the risk they are taking, conservatively asses the cost of those risks, set premiums to earn a reasonable profit, and walk away when a reasonable profit cannot be earned. The final point is what he states gets most insurance companies in trouble. They think they need to be doing something all the time. That seems to be the state of investors currently, every body wants to be doing something after the stock market has moved up over 100%.

Some of his investments in this year's letter seem out of place. However, there are two managers that now run some of his investment portfolio. In previous shareholder letters, he has stated that airlines are one of the worst places to invest, because the industry long-term struggles to make money. He experienced a substantial loss in US Airways 10 or more years earlier. Berkshire Hathaway now has $4.6 billion invested in two airlines. The point is not that he contradicts himself, but that what any great investor writes or says should be used as food for thought, not taken as absolute truth.

Expectations are running high. The stock market is now trading at 18 times this year's estimates, and 16 times next year's estimates. Currently, the market is at 22 times earnings. The issue we now face is that as investors, we are not getting paid for any execution risk. It is as if the projected tax cuts, regulation rollbacks, and perceived better business climate will all happen without any setbacks. Future earnings estimates are almost always revised downward as we move closer to the actual date. With current earnings at $106, and estimates for the S&P 500 companies to earn $147 next year, that is an expectation of 40% growth by the end of next year. It may happen, but it sure leaves a lot of room for disappoint. If you were an insurance company, this is probably the time to be walking away from any new insurance business. But that doesn't mean you sell what you have.