

## Berkshire Hathaway or S&P 500 Index?

I encountered the name Warren Buffett for the first time in 1988 at Madame Tussauds wax museum in London. The figure of him there was labelled “Warren Buffett – Investor”. As a citizen of a communist country, neither his name nor his profession meant anything to me. The only thing that lingered in my head were his big strange glasses, a bit like Elton John’s.

The next year communism fell, the world changed completely, I began to get involved in finance, and sometime in the mid-1990s I bought shares in Berkshire Hathaway for the first time and became a fan of Warren Buffett. During that entire time, from the very beginning up until today, I have repeatedly come across commentaries (usually by more or less unknown commentators) repeating always the same things: Buffett is already old, he doesn’t understand the modern world, he’s not all that successful, Berkshire shares have no great future, and investors would do better to buy an index instead. But as the proverb says, “the dogs may bark but the caravan moves on”. Such has been the case of Berkshire. The critics have come along and then disappeared again, and the price of Berkshire shares rose in the meantime from the original \$22,500 at the end of 1994 to today’s \$278,500, which means by 12.3 times. The S&P 500 Index increased over the same period from 460 to 3,036, which means by only 6.6 times. That’s not bad at all for a person who is not all that successful!

If you think the 1990s are the too-distant past or not so much relevant, then we can take a look at more recent years. We bought Berkshire shares into Vltava Fund at the

beginning of 2012. At that time, they cost \$114,500 apiece and the S&P 500 Index’s value stood at 1,277. Today, Berkshire shares are higher by 143% and the index by 137%. At first glance, then, it seems that the two businesses are doing about the same. Upon closer examination, however, we will find something a bit different.

The collective earnings per share of the companies in the S&P 500 Index were \$86.95 at the end of 2011 according to Standard and Poor’s. At the close of 2020’s first quarter, those earnings came to \$117.01. That means that they surprisingly grew by only 35% during this long period of economic expansion. Earnings growth contributed only about one-quarter to the rise in the index. Three-quarters of the gain in the index was due to expansion of the P/E from the initial 14.7x to the current 26x.

It’s a completely different picture for Berkshire. If in the case of the S&P 500 Index earnings may be regarded as quite a good indicator of fundamental value, then in the case of Berkshire that function is filled by the figure for book value. The fundamental value of Berkshire is of course significantly greater than is its accounting value, but this change in book value over a given period shows quite reliably the change in fundamental value over the same period. (Of course, Berkshire’s profits can also be used to estimate value growth, but they are relatively laborious to calculate. Both results would be similar.)



The book value per Berkshire share had been \$99,860 at the end of 2011. At the close of first quarter 2020, it stood at \$229,361. This is a 130% increase. If we compare this to the price increase for Berkshire shares over the same period, which was 143%, we can see that it corresponds almost exactly to the rise in book value.

It is clear from this data that Berkshire is a far better business than is the index as a whole. Its value is growing far faster, and the only way the index managed to keep pace with the price of the Berkshire share since 2011 is that investors pushed the index's price up four times faster than the rate at which its earnings grew.

Berkshire's balance sheet also shows less risk than do companies in the S&P 500 Index. The index companies' indebtedness expressed as Net debt/EBITDA (ex financials) has roughly doubled since 2011 and is at a historically elevated level. By contrast, Berkshire's cash on the level of the holding company exactly doubled from \$65 billion to \$130 billion and its ratio of total assets to equity remained about the same.

Concerning our expectation for the next decade, we expect the expansion in fundamental value will be similar to that seen in the past decade. Berkshire's book value should continue to grow faster than will the collective earnings of the index. If index holders expect to outperform Berkshire shareholders, their only hope for seeing that happen will be if the P/E of the index will rise somewhere above 30x (nearly to an all-time high) and the Price/Book value (P/BV) of Berkshire will remain just above 1 (nearly at an all-time low). I'll let each individual ponder for himself or herself how probable that is.

If on the other hand there will be something more on the order of reversion to the mean, then it could look like the following at the end of this decade:

**Berkshire Hathaway:**

Book value per share: \$500,000 (that would mean growth slower than in the past 8 years)

P/BV of 1.5 (still substantially below the fundamental value)

Share price: \$750,000

Change from today: +169%

**S&P 500:**

Earnings per share: \$170 (that would mean growth faster than in the past 8 years)

P/E of 20 (still significantly above the long-term average)

Index level: 3400

Change from today: +12% (excluding dividends)

Should you wish to play with these assumptions, you can come to any results you like, but you most likely will find that your assumptions would need to be very aggressively to the advantage of the index and to the disadvantage of Berkshire for the index to have a chance even of keeping up with the Berkshire share price. Berkshire shares are very cheap today, and their price reflects neither their current fundamental value nor their future potential. Moreover, that share price completely overlooks the very low business risk of the conglomerate as a whole. Today's price includes something I call the Buffett discount. Buffett will not be managing Berkshire for too



much longer. This, unfortunately, is a biological inevitability inasmuch as he is 89 years old. It seems that the market is being a bit short-sighted here and undervalues the possibility that the three key people who will manage Berkshire after him (Greg Abel, Ajit Jain and

Todd Combs) may together be even a good bit better than is Buffett himself.

Invest with care !

Daniel Gladiš, May 2020

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\*Footnotes:

1. Data as at 31 December 2018, 2. The MSCI World Index is calculated in local currencies, 3. Information concerning the investment strategy during 2004–2008, returns, and the change to the present investment strategy can be found in letters to shareholders and annual reports.