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Dear Berkshire Hathaway Shareholder:

Warren Buffett's letter to Berkshire Hathaway shareholders was published last Saturday. The letter to shareholders is always much anticipated by investors, as Buffett usually provides well-written insights into a number of topics that investors consider relevant. This year's letter may have been more eagerly awaited than some, given the choppy start for the stock market in early 2016, and given Berkshire's disappointing 2015 stock price performance (down 12%, versus a 1% gain for the S&P 500).

Below are my notes from the letter.

For those that don't want to wade through the details, the bottom line is that we believe Berkshire remains attractive for long-term investors, and Buffett noted that he would strongly consider buying Berkshire shares at or below 1.2x book value. The stock currently trades just slightly above that level.

Berkshire Hathaway 2015 Shareholder Letter Notes

Here are what I believe are some salient highlights from the 2015 Berkshire Hathaway shareholders letter.

The first page of the letter has several significant points for investors that have a long-term horizon:

1) Buffett views BRK as attractive for purchase at 120% of book value. At present, "total equity" is $255 billion, market cap is $325 billion, so current valuation is very close to where Buffett would presumably buy back BRK stock.
2) Presumably, the "Buffett put" would extend beyond Buffett's tenure at the helm, which would eventually alleviate concerns that at Buffett's death or disability, BRK shares would trade down (and remain depressed) significantly.
3) Buffett notes that "book value", because of accounting conventions, significantly understates the true intrinsic value of the company – so, at 120% of book value, a purchase of BRK shares would be attractive long-term because a) the shares are cheap (book value is understated relative to actual "worth") on their face, b) the underlying business is likely to grow at solid rates over time, and c) management would view any lower valuation as an excellent opportunity to make accretive share repurchases.

Summary of 2015

1) BNSF improved its operating efficiencies and outperformed U.S. railroads in a tough environment, primarily due to $5.8 billion of capital expenditures (that said, revenues for BNSF were DOWN, but net income was up because expenses were down more than revenues during the year).

2) BRK's "Powerhouse 5" – BNSF, BH Energy, Marmon, Lubrizol, and IMC – earned $13.1 billion in 2015, up 5% from 2014.
3) Small, non-insurance businesses did better: they earned $5.7 billion, up 12% from $5.1 billion in 2014.
4) Insurance operated at an underwriting profit in 2015 for the 13th straight year (hard to do in insurance). Insurance "float" grew $4 billion to $88 billion, but Buffett noted that future increases in float would be difficult to come by. That said, float remains one of BRK's most valuable "assets" (although, technically, it is a liability on the balance sheet), because it allows BRK to have effectively a very large, no interest revolving loan on which it keeps any returns it can earn during the time it holds the float.
5) Buffett discussed the Kraft – Heinz merger, and drew a distinction between 3G's approach and BRK's approach to investing in large companies. Buffett notes that many corporations have significant excess costs; 3G invests and then slashes costs; Berkshire avoids companies that have excess costs and focuses on investing in companies run by efficient, shareholder-friendly management teams.
6) BRK added to two of its largest publicly-traded holdings: IBM and Wells Fargo. BRK also saw its percentage ownership in American Express and Coca-Cola increase due to share buybacks at those companies. Buffett did NOT specifically address disappointing operating performances in 2015 at American Express and IBM; instead he noted that the "Big Four" publicly-traded holdings were "excellent businesses" run by managers that he considers to be both talented and shareholder friendly. Buffett reiterated that he views the publicly-traded holdings of BRK as sources of "substantial" return over time through their growth in business value and free cash flow, which will lead to share repurchases and dividend increases (BRK's dividends from the "Big Four" totaled $1.8 billion last year).
7) Buffett noted that BRK retains capital allocation flexibility that will allow it to benefit from both purchases of entire operating companies, and investments in strong public companies, as opportunities to invest in either area arise.

Buffett's view of the U.S. economy

Buffett points out that 2% GDP growth, while disappointing to some commentators (especially in an election year), is actually reasonably strong, and he considers the U.S. economy in good shape to continue to generate solid aggregate economic growth (with a concomitant rising standard of living for all Americans) for decades. While he does touch on the issue of "income inequality", and notes that a market based economy inherently will create "winners" and "losers", he notes that it has historically been wrong to bet against the American economy, and he expects that it will continue to generate significant growth in the future (and enough growth to meet, and possibly increase, its social entitlement "promises" (without specifying who exactly will pay for increasing social "entitlements")).

Intrinsic Business Value

Buffett revisits the topic of intrinsic value again this year, and notes that, while an inherently imprecise metric, intrinsic value allows him to estimate what BRK is worth. In addition to using 1) per share cash and investments and 2) earnings from operating companies, Buffett is now including insurance underwriting income in the business earnings calculation, because BRK's mix of insurance operating earnings has changed significantly over time, such that mega-catastrophe insurance is a smaller percentage of the mix, and more stable insurance products are a larger component. Buffett re-emphasizes that while growth from investments (+19% compounded annually since 1970) and growth in operating company earnings (+24% annually, including insurance underwriting results) has been great, BRK's focus remains on building operating earnings over time.

Operating Business Review

Insurance – Buffett notes that while float has grown significantly over the past several decades, future growth in float may be difficult to achieve. Float will remain an important element in driving return for BRK shareholders, but Buffett's comment here is material.

While Buffett comments on the strengths of BRK's insurance operations (financial strength, float, disciplined underwriting, strong, experienced managers), the four insurance divisions, in the aggregate, saw underwriting profit decline from $2.7 billion in 2014 to $1.8 billion in 2015, while float increased from $84 billion to $88 billion.

Regulated, Capital-Intensive Businesses--This segment includes BNSF and Berkshire Hathaway Energy, and it accounts for 37% of BRK's after-tax operating earnings. Buffett noted significant capital expenditures made in both companies. BHE saw net earnings rise from $2.1 billion to $2.3 billion, and BNSF (on the strength of lower operating costs) had a net income increase from $3.9 billion to $4.2 billion.

Manufacturing, Service, and Retail Operations--This segment is a catch-all of many diverse operating companies, which overall account for $57 billion in equity on BRK's balance sheet, and which last year generated $4.7 billion in earnings, up from $4.5 billion in 2014. Buffett notes that the results are affected by a multitude of accounting conventions required by GAAP, only 20% of which Buffett defines as "real" in a true, economic sense.

Viewed in the aggregate, Buffett notes that in 2015, this group is "an excellent business", deploying $25.6 billion of capital to earn 18.4% after-tax on that capital; this segment should see material growth going forward as the Precision Castparts and Duracell acquisitions come online.

Finance and Financial Products—Buffett spends considerable time discussing Clayton Homes, which is a leading producer of "manufactured homes." He notes that BRK retains the mortgages on most of the homes Clayton sells, and while it finances those mortgages by lending long and borrowing short, the risk of this approach is more than offset by BRK's large corporate cash position: BRK is highly asset-sensitive, and would benefit (more) from rising interest rates (i.e., BRK would earn more on its excess cash than the increased costs associated with higher rates in the Clayton financing portion of the business). Overall, BRK's various financial products businesses earned $2.1 billion in 2015, up from $1.8 billion in 2014.

Investments

BRK's 15 largest investments in public companies ended 2015 with a cost of $48.3 billion, and a market value of $95.9 billion; total investment at cost in common stocks was $58.6 billion with market value totaling $112.3 billion (equivalent to about one-third of BRK's market capitalization, 40% of its net equity of $255 billion, and about 20% of its total assets of $552 billion). American Express, Coca-Cola, IBM, and Wells Fargo comprised about 60% of the total common stock holdings.

Buffett did not specifically address sub-par 2015 performances by American Express (-24%) and IBM (-11%), but rather noted that the Big Four were excellent businesses managed by strong, shareholder friendly management teams.

He also did not address general underperformance of many of the core common stock holdings in recent years.

BRK's common stocks to have several key themes: 1) they are relatively low business risk companies, that have a relatively well-defined range of future returns, likely mid-to-high single digit growth; 2) Buffett is willing to add to core holdings when their prices weaken and their valuations improve; and 3) the proportion of equities managed by Ted Weschler and Todd Combs is increasing (now around $18 billion, up from several billion a few years ago). Weschler and Combs appear to be willing to invest in companies that may have somewhat higher long-term growth profiles (with a wider range of possible outcomes) than Buffett's long-term core positions.

Float remains a key element in the strategy: Buffett continues to own very high quality, steady growth companies that increase their dividends over time in line, or a bit faster than underlying earnings growth, while also repurchasing their shares. Float in essence can drive total returns on these companies from mid-to-high single digits to high-single to low-double digit levels.

Productivity and Prosperity

Buffett writes about the relationship between economic productivity gains in the U.S. economy, and increases in economic prosperity over time.

He cites several historical examples: farming, railroads, utilities, and auto insurance. Generally, over time, improved productivity, through the application of "better ideas and approaches" and "better technology", have resulted in significant gains in economic prosperity that have benefitted American society over the decades.

Buffett also notes two other bi-products of productivity gains on society: unequal wealth impact, and disruption for workers who lose jobs that are displaced by technology. He notes that these realities do not call for restraining actions that improve productivity, but they do call for maintaining, or even increasing, social safety nets to protect workers who are unable to adapt their skills to an ever-changing economic landscape.

Important Risks

After the bulk of the letter paints a generally optimistic long-term outlook the U.S. economy, and a generally positive outlook for BRK's operating and public company investments, Buffett closes with a segment on "risks", and notes that Berkshire, along with all corporations, constantly faces the risk of a significant terrorist event (in the form of nuclear, cyber, chemical, or biological attack), which could "decimate" the value of "all equity investments." While it is impossible to predict when such an attack might occur, or determine what the probabilities of such an attack might be, Buffett notes that, over the long-run, such an event "approaches certainty."

Conclusion

Overall, the 2015 BRK shareholder letter reaffirms Buffett's approach to valuing the company, and indicates that he will buy back shares when they reach 1.2x book value. Buffett will continue to focus on building BRK's operating earnings, which generate significant excess cash over time. Insurance float growth is likely to slow or flatten out, but the insurance business is also moving toward an overall lower risk profile. While Buffett notes that the world is a risky place, he reiterates that the U.S. economy has immense core strengths, and that over the long run, those strengths should lead to continued GDP growth and a higher standard of living for U.S. citizens.

I believe that BRK should remain a core holding in portfolios because:

1) Valuation is at the low end of the long-term range
2) Buffett continues to provide a "put" by indicating the BRK will buy back shares at 120% of book value
3) Risk is moderate to low: BRK has a strong balance sheet, a diverse group of strong operating companies, and an investment portfolio comprised primarily of high quality companies that have low valuations and steady, low-risk business operations
4) Float should act to enhance BRK's underlying returns – from mid to high single digits ex-float, to high single digits to low double digits with float
5) Buffett remains a supremely talented capital allocator, and Weschler and Combs build on that expertise

BRK is not without risks:

1) BRK's growing size becomes an obstacle to future growth
2) BRK's exposure to mega-cat, while declining relative to its other insurance businesses, is still large
3) BRK's core investment portfolio has a number of "cheap" companies, but performance has been declining in recent years
4) BRK has little exposure to technology and health care (by design) – two areas of significant unit growth

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