For the full year 2014 URI Capital Partners returned 14.4% after all fees and expenses compared to a total return including dividends of 13.7% for the S&P 500 and 9.9% for the Dow. That brings the fund's return to 50.8% after all fees and expenses since its opening in early August 2012. While those may be considered good results, recognize that we are investing for the long term and any short term measurement carries many caveats, not the least of which is that future market volatility could reverse some or all of those gains. With that in mind however, I believe the companies we own are very well positioned for the long term. They are above average companies and we own them at below average valuations. In short, I remain optimistic about our long term performance but cannot and will not attempt to prognosticate how we will perform in the short term.

Seeking Understanding Through the Noise

Today, there are a tremendous number of news sources that dispense information 24 hours a day, seven days a week. We have so much available at our fingertips that we can be fooled into believing all this information leads to understanding. In a recent talk I gave in New York which I will touch on later, I used the byline "Seeking Understanding Through the Noise" as a guide to making better investment decisions.

The increasing amount of noise that we are fed day by day can lead to a false belief that we are gaining understanding. We can actually know more but understand less. We can have an almost trivial awareness of an incomplete picture of the truth. True understanding requires a deep dive, it cannot be found in a headline or a post, but is found through deep analysis with a perspective that moves beyond that particular moment towards a perspective years into the future.

Noise masquerading as knowledge makes it difficult to make sound, long term decisions. This holds particular sway when it comes to investing in publicly traded companies. There are untold snippets of information that traverse CNBC and other news sources on a daily basis in addition to the second by second "news" of how a stock price is moving. We can be fooled into giving too much value to these snippets of information. Does the true value of a company tick around second by second every trading day of the year? No. You would never think your privately held business' value moves around in that fashion so why would another company do so? Just because a stock price says so?

So how does this apply to your investment in the fund? We create a distinct advantage by taking a long term perspective and seeking a deep understanding of businesses. By taking this longer term perspective and having a foundational understanding of a business that surpasses the noise of the day, we find opportunity. We can see a negative headline and with a longer term perspective recognize a temporary issue that does not have an effect on the long term intrinsic value of a business. And when the market overreacts to the noise of the day, we strike in opposition with the goal of garnering outsized returns over the long term.

A Strong Foundation

I have often heard in the car with our kids the song with a chorus saying “The wise man builds his house upon the rock.” The more complete version of that story says the rain came down, the streams rose, and the winds blew and beat against the house; yet that house did not fall because it had its foundation on the rock. But for the house built on sand, when the rain came down, the streams rose, and the winds blew and beat against the house; it fell with a great crash.

Even as the true value of a company does not change that much on a day to day or month to month basis, the market and thus stock prices do change, and sometimes dramatically. So what do we as a fund have to hold on to in the inevitable storms of the market? What is the foundation of our investment decisions?

We strive to provide a firm foundation by owning good companies that are well positioned for the future at good valuations which can lead to superior longer term investment returns. As the markets return to more normal volatility, we can use that volatility to our advantage. If we like owning a company whose stock price drops then our opportunity to succeed in the long term becomes even more pronounced as we are able to buy that same company at an even lower valuation. We all like when gas prices go down and we should feel the same way when we can buy the same company at a lower price since our perspective comes from wanting this investment to perform for many years to come.

So, we seek first to know and understand a range of companies. We dive deep to understand the value drivers, the risks and the opportunities in a business. It may take years of studying a company before there is sufficient comfort to invest but it is critical to build a foundation of understanding before investing. Beyond understanding the business, we then need to assess what the entirety of that business is worth. Excitement builds when a very good business can be bought at a significant discount to our assessment of what that business is worth. The combination of a very good business at a very good valuation then serves as our foundation to move forward.

As for the fund today, I believe we own good companies at good valuations. We have built a strong foundation for the long term to withstand the ups and downs of the more short term thinking, often myopic stock market.

It is also important to put our investments in their proper place. Successful investing is but one small part of a successful life which requires its own, more complete foundation on a rock. I place great importance in my stewardship of your dollars through URI Capital Partners in part so you can focus on the more important aspects of your own life enabling us all to make this world and our lives meaningfully better.

Companies

As you have come to expect, there has not been dramatic change in the fund’s holdings. Berkshire Hathaway remains the top holding of the fund as it has been since day one. For your reference I wrote an update to Berkshire in March of 2014 and have included it at the end of this letter. Given its importance to the fund, I recommend taking the time to read through it and better understand what I find to be so unique about the business. Last year I said we would continue to focus on our best ideas and I have strived to do so. Our top ten holdings comprise over 85% of the fund and I expect that level of focus investing to continue.

The large banks including JP Morgan, Bank of America and Wells Fargo continue to dominate our top five holdings. In many ways, the dynamics for the large banks are very similar to last year. I have copied the short update on JP Morgan from last year's annual letter immediately below and frankly not much has changed.

> JP Morgan, like many of the large banks, had a difficult year when measured by negative headlines. Absent the large litigation related expenses however, JP Morgan had an incredibly profitable year. It is hard to talk about normalized earnings power with the combination of elevated litigation costs and very low interest rates but JPM continues to trade at historically low valuation levels even against a very challenging operating environment. A return to even some level of normalized interest rates will greatly increase the earnings power of their franchise. In effect, the very low cost deposit funding base that is endemic to and a huge advantage to JP Morgan (and Wells Fargo and Bank of America) is undervalued and in some ways "unseen" in today's low rate environment. Importantly, few financial institutions have truly low cost and sticky deposit franchises. Once rates return to a more normal level their earnings power will surge and the unique value of these low cost deposit franchises will be more accurately seen (the fund also owns Well Fargo and Bank of America and did at year end 2012 as well). JP Morgan remains at very reasonable valuations today in a subpar earnings environment and will be even more attractive in a more robust operating environment with higher rates.

What has changed is these banks have continued to build much higher levels of capital and liquidity which serve to protect their incredibly valuable franchises. While the increases in capital and liquidity have served to slow down their return to higher rates of return, they provide a tremendous foundation for the longer term. By way of example, JP Morgan has roughly doubled the capital in its business since before the financial crisis and currently holds over $600 billion in liquidity, which is substantially more than pre-crisis levels. So, these banks are currently generating very strong underlying earnings, have dramatically bolstered the safety and soundness of their businesses and remain at very attractive valuations before even taking into account the possibility of a more normalized banking environment. As a group, I believe the large banks stand alone as our best longer term opportunity.

As mentioned earlier, I was given the opportunity to speak at an event at Bloomberg in New York this past November and I shared my interest in the convertible TARP warrants of JP Morgan. During the past year, we have started a small position in these JP convertible warrants to supplement our core JP Morgan position. The warrants allow for conversion into regular shares of JP Morgan in October of 2018 and have the potential to amplify the return potential of JP Morgan returning to normalized earnings and normalized valuations. A four minute video from the talk I gave is found at the link below. I have also included at the end of this letter a written summary that was distributed at the event which discusses the opportunity with the warrants and importantly talks about the business, earnings power and attractive valuation of JP Morgan. As JP Morgan is a top holding in the fund, I recommend taking a few minutes to read through the summary to better understand our investment rationale.

Link to four minute video: http://www.institutionalinvestor.com/Article/3399598/InvestPitch-Brian-Pitkin-JPMWSUS.html#.VJGRyNE5CP8

Last year we talked about Comcast as a new position for 2013. We continue to appreciate their combination of NBC Universal content assets and distribution assets which grant them competitive control over the pipes coming into many homes enabling it to provide entertainment through the more traditional TV bundle or increasingly through their high speed broadband offering. Comcast is the scale provider in the US in a business where scale is critically important in enabling high returns on capital and high levels of free cash flow. We continue to place a higher value on the cash flow potential of Comcast than the market does.

Sticking to the cable theme, Liberty Global was the only new company added to the fund in 2014. Liberty Global is the dominant cable provider in Europe and controlled by the US cable industry leader John Malone. Malone pioneered not only the business of cable TV but also a unique financial model with extreme focus on generating high returns on invested capital while generating significant free cash flow and pairing those high returns and free cash flow with accretive acquisitions and substantial share buybacks. This model allows for strong long term investment returns and we are pleased to have joined the ride with Malone and Liberty.

Finally and most importantly, thank you all for your belief in what we are working to accomplish. I take the responsibility of stewarding your investment very seriously. To paraphrase from the Book of Luke 12:48: “To Whom Much is Given, Much Is Expected”. That should hold true for all of us both personally and professionally and it certainly does for me.

Warmest Regards,
Brian Pitkin
URI Capital Management, LLC

URI | Capital Management

Important Disclaimers:

The net rate of return is calculated using a time-weighted methodology. Returns are unaudited. The performance listed above is being provided to you for informational and discussion purposes only. Actual returns are specific to each investor.

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URI | Capital Partners

JP Morgan TARP Warrants – October 2014

To set the perspective of our approach to investing, our aim is to acquire stakes in world class companies at a discount to an increasing intrinsic value, allowing for strong future returns with limited risk of permanent capital loss.

JP Morgan is one of the leading global financial services firms with businesses including consumer and community banking, corporate and investment banking, commercial banking, and asset management. JP Morgan has been a large holding since URI Capital Partners opened in August 2012 and continues to be a large holding today.

JP Morgan has risen in price from around $37 at our initial purchase to roughly $56 today. While we continue to view the common shares of JP Morgan as compelling enough to warrant a top position in the fund, I want to talk about an opportunity that further amplifies the return potential of investing in JP Morgan.

This summary of the JP Morgan TARP warrants (Ticker: JPM/WS) necessarily contains a full discussion of JP Morgan itself including the business, valuation and return potential of investing in JP Morgan at today's prices along with a discussion of how its long term value is protected with substantially bolstered capital and liquidity. As covered in detail below, the broader summary of JP Morgan describes a path to $9.75 per share in annual earnings for 2018 which, at a reasonably conservative 12x multiple, would yield a stock price of $117.

From a different perspective, the broader summary also describes tangible book value per share growing to $65 by 2018 (roughly 10% annualized growth which is below the 12% annualized growth since 2005). It is not out of line with historic norms for a bank to trade at or above 2x tangible book value which would imply $130 per share.

With those metrics in mind, let's use $120 as our 2018 target valuation. With the stock recently trading around $56, a medium term valuation of $120 allows for strong return potential in the coming years. Most of the major banks, including JP Morgan, remain much maligned by the investing public thus allowing for the possibility of these strong future returns.

Much of the disdain felt for the banking sector came from the 2008-2009 financial crisis but that same crisis created a unique investment opportunity in the form of TARP warrants. These warrants were issued for many of the institutions that took TARP dollars, including JP Morgan. ***The JP Morgan TARP warrants are long dated with dividend protection allowing for magnified returns to the underlying thesis of JP Morgan returning to normalized earnings and valuations.***

The general terms of the JPM warrants are as follows:

- Original Strike Price: $42.42 (currently $42.405)
- Warrant Price (recent): $18
- Maturity: October 28, 2018
- Original Conversion Factor: One Share per Warrant

What is the Potential?

If we assume that our above estimate of the 2018 per share intrinsic value for JP Morgan is $120, it becomes immediately obvious the return potential with the warrants is quite high. Using a recent warrant price of roughly $18 and assuming a slightly declining strike price moving down from the original strike price of $42.42 (potential changes to the strike price and conversion factor to be discussed later), the warrants should move in value towards $78 as maturity approaches in 2018 (roughly four years from today).

Each dollar invested in a warrant today has the potential to become roughly $4 in four years equating to an IRR over the four years exceeding 40%.

The dividend protection is not a straightforward calculation and is covered in detail in the full summary of the warrants. There are two components to changes associated with dividend payments: (1) a change to the strike price and (2) a change to the conversion factor. The dividend adjustments will not occur until the quarterly dividend exceeds $0.38 per share.

Beyond that $0.38 quarterly amount, the strike price will lower and the conversion factor will increase by amounts dependent upon the stock price at the time. The general direction allows that higher stock prices yield lesser changes and lower stock prices yield greater changes.

The actual formula and related terms for any changes to the strike price and conversion are summarized below from the Investor Relations site of JP Morgan. These and other terms related to the warrants are also covered in the prospectus of the warrants which should also be read before considering any investment.

> *Under the terms of the warrants, the Exercise Price of the warrants (as defined in the warrants) may be reduced as of the record date for each quarterly dividend declared in an amount above $0.38 per share. The new Exercise Price will be calculated by multiplying the current Exercise Price by the quotient of:*
>
> - *the last reported sale price of the Firm's common stock on the New York Stock*
>
>   *Exchange on a determination date (which is expected to be three business days before the record date), minus the difference between the amount of the declared dividend and $0.38 per share; divided by*
> - *the same last reported sale price of the Firm's common stock.*
>
> *In addition, the Warrant Share Number of each warrant (as defined in the warrants) may be increased as of the record date for each quarterly dividend declared in an amount above $0.38 per share. The new Warrant Share Number will be calculated by multiplying the current Warrant Share Number by the quotient of:*
>
> - *the current Exercise Price of the warrants; divided by*
> - *the new Exercise Price determined as described above.*
>
> *The above calculations will be made with respect to the Exercise Price and the Warrant Share*

Number for each quarter for which a quarterly dividend is declared in an amount above $0.38 per share. The calculations will be made to the nearest 1/10th of a cent or to the nearest 1/100th of a share. No adjustment of less than $0.01 will be made to the Exercise Price, and no adjustment of less than 1/10th of a share will be made to the Warrant Share Number, but certain amounts below these adjustment thresholds will be carried forward into any subsequent adjustments, or upon the exercise of a warrant if that occurs earlier.

The dividend with a record date of July 3, 2014 and payable July 31, 2014 was the first dividend above $0.38 per quarter and thus can provide an example of how the changes will occur. The dividend for the quarter was $0.40 per share, $0.02 higher than the threshold amount. The stock price of JP Morgan three days before the record date was $57.62.

The new Exercise Price (strike price) was calculated as follows:

$$\frac{\$57.62 - \$0.02}{\$57.62} \times \$42.42 = \$42.405 = \text{new Exercise (strike) price}$$

The calculation for a change in the conversion factor is as follows:

$$\frac{\$42.42}{\$42.405} \times 1 = 1.00035 = \text{no change in conversion factor}$$

Since the change in the conversion factor is less than $1/10^{th}$ of a share, the conversion factor remains at 1.

So, as a result of the $0.40 quarterly dividend, the strike price was lowered by $0.015 per share while the conversion factor did not change.

From a broader perspective beyond just this one quarterly example, while there is some level of dividend protection, the warrants fully give up the value of quarterly dividends up to $0.38 per share and are likely to give up some portion of the dividends above that amount with the exact amount depending on the stock price. As detailed above however, the warrants offer substantial return potential even without full dividend protection.

Where is the Margin of Safety?

The large margin of safety in the common shares of JP Morgan (described more fully in the longer summary) and the lack of any significant premium in the warrant pricing allow the warrants to share most of JP Morgan's margin of safety. However, the fixed maturity of the warrants reduces the margin of safety in the warrants as the normalization of the earnings and valuation of JP Morgan has to play out in a specified period of time (in this case by October 2018). While this period of time is over four years, it is an important consideration.

Most importantly, the foundation of this investment lies in the business of JP Morgan. With that in mind, I strongly encourage you to read the below summary of JP Morgan, its underlying businesses, the earnings power of its franchise and how that translates to the valuation of its common shares. It is both necessary and well worth the time to understand the underlying business of JP Morgan to fully assess the opportunity that exists with the warrants.

What are the Predominant Risks?

There are two predominant sources of risk associated with the JPM warrants: (1) risks inherent in JP Morgan and (2) timing risk. The risks inherent in JP Morgan are discussed throughout their SEC filings and also discussed below in the common shares summary which serve as the foundation to an investment in the warrants. There is however an added risk with the warrants. As described above, the warrants mature in October of 2018. So, the underlying thesis on the company JP Morgan must be correct but importantly the growth and revaluation must come to fruition before maturity or the warrants will not capture the return potential described above and could in fact impart permanent losses at maturity. In effect, the dynamics described pertaining to the common shares of JPM could end up being correct but if the revaluation does not occur until after the warrant maturity, the warrants will expire and an investment in those warrants will be lost. By way of example, if JPM trades at or near $42 per share through 2018 only to rocket higher in early 2019 well above $100 per share, the warrants could expire worthless (while the thesis of an undervalued JP Morgan would hold true assuming common shares are held through this theoretical 2019 move).

JP Morgan Common Shares – April 2014

JP Morgan is one of the leading global financial services firms with businesses including consumer and community banking, corporate and investment banking, commercial banking, and asset management.

How is Value Created?

There are two primary sources of revenue for JP Morgan: fee income and net interest income. Fee income includes lending and deposit related fees, investment banking fees, asset management fees, card fees and market making fees, amongst others. Net interest income is simply the spread revenue generated from lending money at higher rates than what JPM pays for that money (largely in the form of deposits but also short and longer term borrowings and equity capital).

While this description may be overly simplistic for some, I believe many tend to view JPM as an investment banking and trading business largely different from a traditional banking franchise. The numbers would tell you otherwise.

Net interest income (traditional banking) comprised roughly 45% of total revenue in 2013 while fee income represented the other 55% (by way of comparison, in Q4 2013, Wells Fargo's net interest income was 52% of revenue while fee income was 48% of revenue). As described above, there are many components to the fee income many of which are not the volatile trading and investment banking related fees that drive the perception of JP Morgan. In fact, principal transaction fees (mostly market making) and investment banking fees comprise roughly 17% of total revenue. On the other hand, asset management fees alone comprise roughly 16% of total revenue.

Why does that matter? For good reason, investment banking and market making fees are valued differently than asset management fees. Asset management fees tend to recur on a consistent basis over time and thus allow for greater visibility and ultimately higher valuations per dollar of earnings. In short, asset managers are valued more highly than the more volatile investment banks. This distinction, along with the distinction between more traditional consumer and commercial banking, will become more important as we talk later about value.

One minor note on the principal transaction fees: the fee revenue attributable to that category was reduced in 2013 by DVA losses so the revenue figure excluding DVA attributable to principal transactions (arguably a more accurate measure) would be somewhat higher but that same DVA exclusion would also have shown higher total revenue mitigating its impact.

As above, net interest income (traditional banking) comprises roughly 45% of revenue. Net interest income is a function of the amount of interest earnings assets multiplied by the net interest margin (NIM) which is simply the spread between the bank's lending and investing rates less the costs of its funding. From 2005 to 2010, JPM's NIM averaged 2.95%. In 2013 its NIM was 2.23%, a historically low rate reflective of the current low interest rate environment.

JP Morgan is positively levered to a rising rate environment. Put another way, JPM has positioned its balance sheet in such a way that it is purposely making less money today to not take undue rising rate risk. To frame the magnitude of a return to more normalized rates, if JPM's NIM increases from the roughly 2.2% to 2.7%, net interest income and profits would increase by roughly $6 billion after tax.

There will be more discussion about growth in later sections but it is important to note the future opportunity set that exists for the financial services broadly and JP Morgan as well. The financial needs of countries, companies and individuals will continue to expand and those expanding needs will need to be served by the financial system. World trade will expand, infrastructure needs will increase, new large companies will be developed, existing companies will expand, and financial assets will grow. This global growth will serve as a long term tailwind enabling JP Morgan and others to grow over time, although not in a straight line. As just one example, total global financial assets of consumers and businesses are expected to grow nearly 7% per year from $248 trillion in 2013 to $453 trillion in 2023.

And in our increasingly global economy, scale will matter. Size has become a four letter word in the banking world. The large banks are targets based on size alone and they have been demonized by the public, politicians and regulators in addition to investors. In reality however, banking is a scale business and scale will be increasingly important as the same politicians and regulators create added complexity to the business of banking.

The costs of being a bank are going higher on a consistent basis and it is likely that scale will be an increasingly differentiating factor as more cost burdens need to be spread across a bigger base of business to remain competitive. Additionally, large, global customers increasingly demand a full suite of services across geographies. In short, the scale that JP Morgan brings to bear can make them more cost efficient while also enabling them to better serve large, global customers.

The cost and regulatory burdens in banking are higher than ever, their customers demand a larger and broader presence and it is now harder to become a larger presence in the banking world all of which serve to enhance the moat around large and existing banking franchises.

How is Value Protected?

Beyond an ability to generate earnings, a bank must protect its franchise from unforeseen events. Strong capital and liquidity serve to protect a bank in difficult times.

The capital levels of the broader banking system certainly did not allow for prudent risk management leading up to the recent financial crisis. The relative short term rearview mirror of many investors have caused that pain to be an ever present dynamic in their views on financial institutions and their value as productive long term investments.

The reality of today however paints a very different picture than those days leading up to the financial crisis. The banking system is better capitalized and more liquid than it has been in the past 60 years. Relating to capital levels, the average amount of equity to assets was 11.1% at yearend 2013 which is the highest amount since 1950.

In addition to historically strong capital levels, the banking system is also incredibly liquid. At the end of 2007, the banking system had $6.7 trillion of deposits, $6.8 trillion of loans and roughly $21 billion on deposit at the Fed. Today, the banking system has $10 trillion of deposits, $7.6 trillion of loans and $2.6 *trillion* on deposit at the Fed. Bank balance sheets are incredibly liquid and in many ways underutilized.

While the above figures paint a strong story in regards to the capital levels and liquidity of the banking system, this summary is specifically about JP Morgan. The broader banking system remains important however as weaknesses can transmit through the banking system from the bad apples to the good apples in certain adverse circumstances.

JP Morgan itself has experienced dramatic growth in its capital levels and liquidity in recent years just as with the banking system broadly. By way of example, JP Morgan's risk weighted capital levels as calculated by the new Basel III standards have increased from 5% in 2007 to 9.5% at year-end 2013. There are countless nuances when calculating Basel III capital but looking at comparably calculated levels gives a sense for the dramatic buildup in capital levels in recent years (a near doubling in the Basel III figures described).

In addition to having much higher levels of capital, JP Morgan is full of liquidity. The company had $356 billion in cash at year-end mostly on deposit at the Fed. JP Morgan had another $244 billion in High Quality Liquid Assets (those that count for liquid assets under the regulators' definition of liquidity). This *$600 billion* comprises safe and highly liquid assets should the company need cash in a crisis situation. That is an incredibly large amount of liquidity relative to the total size of the balance sheet and, when combined with the higher capital levels of the company, bolsters the fortress balance sheet to withstand times of great financial stress. Beyond the $600 billion, JP Morgan has another $141 billion in unencumbered marketable securities with an average duration of 2.2 years and a AA+ rating.

While this topic will be covered in greater detail when talking about the earnings power of the business, part of this liquidity is in place to manage the asset sensitivity of the company. The asset base of the company is short in duration so as to not take undue interest rate risk. In fact, the company is positively levered to rising rates and has purposely not taken on as many longer term assets as it would in a more normalized rate environment. Another way of saying the same thing is JP Morgan is purposely making less money today so as not to be exposed to the risk of higher rates.

In short, JP Morgan has substantially more capital per dollar of assets and substantially more amounts of short available liquidity. All of this enhanced capital and liquidity has caused many to believe that the large banks including JP Morgan are now too safe to grow in any material way. They would argue they have regulated into utility-like businesses. Such an argument about the enhanced levels of risk management that pervade these companies including JP Morgan is entirely correct. The enhanced risk management does not in and of itself preclude growth however. And valuations questions are raised if the large banks are truly becoming more "utility" like. Both of these issues will be addressed in later sections.

How Much Can JPM Earn Per Share?

The earnings of JP Morgan and most other large banks have been a mess for several years. There has been a litany of charges negatively impacting net income along with the effects of a subpar banking environment as low interest rates have served to drag down net income.

In the medium term, JP Morgan has expressed a belief they can earn roughly 15% through the cycle returns on tangible common equity. Tangible book value per share at the end of 2013 was $40.81 implying through the cycle earnings power at that time of $6.12 per share.

What actually happened in 2013? As above, the earnings picture at JP Morgan and other banks has been muddy at best. JP Morgan's reported 2013 earnings per share was $4.35. Those earnings however were subject to several unusual items, some negative and some positive. By JP Morgan's assessment, the net of all those items yielded adjusted earnings per share of $5.70, or just over $23 billion in total.

To arrive at the $5.70 number, JP Morgan subtracted gains on the sale of VISA shares and the One Chase Manhattan Plaza building along with reserve releases in the real estate and credit card businesses. In essence, they viewed those as non-recurring gains. Reserves for bad loans cannot be released indefinitely but more reserves remain that will get released over time, partly a reflection of over reserving in prior years for losses that did not materialize. Selling the Plaza certainly feels like a onetime gain (there is only one after all). Like reserve releases, there will be more gains on the sale of assets (likely to include gains on the sale of VISA shares) going forward but those sales and their related gains are lumpy and episodic. Allowing some portion of these gains to be viewed as recurring would further increase the $5.70 per share figure.

The company added back heightened legal expenses largely the result of litigation that still surrounds JP Morgan and the other large banks from the financial crisis. Heightened legal expenses are clearly an issue for JP Morgan and the other large banks and the costs of controls (not added back to the EPS number) and other regulatory costs will continue to remain elevated. I do find it reasonable that legal expenses from the financial crisis will subside over time (I cannot say when) and thus are reasonable to exclude when thinking about longer term earnings power. The company also added back charges to net income associated with changes in FVA and DVA which is quite reasonable to me.

In short, there are countless iterations to how 2013 should be viewed from an earnings perspective. Adding back just the heightened legal costs (but keeping added controls and regulatory costs) and adding the FVA and DVA charges would bring 2013 earnings to $6.85 per share. I would characterize that as the high end of the reasonable range of 2013 earnings with reported earnings of $4.35 being the low end.

As you can see, we are talking EPS from $4.35 to $6.85, a pretty wide range. With my view that there were unusually large legal costs and settlements in 2013 I am comfortable assessing 2013 earnings around $5.70 per share as described by management. So with that as a backdrop, where does JP Morgan go from here? Are those earnings normalized?

One important consideration is the banking environment and what backdrop did it provide in 2013. In effect, is this a normal banking environment? I believe the answer to that is clearly no. We talked earlier about the impact of low rates on the portion of income generation (about half) known as net interest income. Low rates have in effect caused roughly half of the bank's earnings power to significantly underperform. As above, returning net interest margins to roughly 2.7% which is below the average of 2005 through 2010 (a period reflecting different rate environments but all reasonably low by historic standards) would yield another roughly $6 billion after tax which is about $1.60 per share at yearend current share count. Put another way, the increased net interest income would move 2013 EPS from $5.70 to $7.30.

> *Before moving on to fee income, I want to talk briefly about the value of strong deposit franchises. Banks funded by low cost deposits have a distinct cost advantage to those institutions funded by other means. Deposits tend to be low cost and very sticky in relation to other short and long term sources of funding. In today's low rate environment however, this funding advantage is masked by the relative low cost of funding across the spectrum. As rates rise however, the real value of a low cost deposit franchise will shine through. In effect, the most important advantage of successful deposit gathering franchises is covered up or not seen in today's environment. The enduring long term competitive advantage of a strong deposit franchise still exists however, even if it cannot be "seen" as well today.*

Net interest income does not impact JP Morgan in isolation. There are numerous factors affecting the earnings power of the franchise. As mentioned, fee income comprises the other major driver of earnings. We can reasonably expect that fee income to grow over time although not in a straight line. As discussed above, the need for financial services will continue to grow and JP Morgan can be expected to maintain a share of that growth. Judging the pace of that growth is challenging based on the lumpiness of many of the fee drivers (investment banking being maybe the most obvious sources of lumpiness). Fee income growth would add to any net interest income growth but for the moment we will avoid pegging a number or growth target. I do believe it is fair to say that many of the drivers of fee income are operating below normal given the subdued economic environment.

How else can we think about growth and earnings? As previously discussed, the bank has set for itself targets for return of tangible common equity (which we can translate to tangible book value per share) of 15%. Is that target reasonable? Looking back over 2010, 2011, 2012 and 2013 the company did indeed post roughly 15% returns on tangible common equity, and again, in a suboptimal banking and lending environment. (It is important to note that the 2012 and 2013 results were adjusted for litigation, one-time gains, CVA/DVA, etc. as we have discussed above. For a complete rundown of those adjustments you can refer to the Investor Day presentations from February of this year.)

How has book value changed over the years? Both book value and tangible book value have grown consistently through the years. Focusing on tangible book value per share, from 2005 to 2013 tangible book value per share grew roughly 12% annualized and, over a more recent period of time, growth from 2009 to 2013 was 11% annualized.

Putting those pieces together and looking out to the end of 2018 assuming tangible book per share grows at the lesser rate of 10% annualized would yield tangible book value per share of roughly $65. A 15% return on tangible equity would equate to earnings per share of $9.75. Assuming 8% annualized growth would bring tangible book value per share of roughly $60 yield earnings per share of $9 at a 15% return on tangible common equity.

To put someone else's perspective on the earnings power of JP Morgan, a sell side research analyst put forth a case for 2018 normalized earnings power of $29 billion which would equate to roughly $7.75 per share at today's share count. However, that earnings per share number could increase to $9 per share assuming there is a 15% reduction in share count between now and 2018 which is not at all unrealistic given the likely dramatic capital build that will occur through those years given JP Morgan's earnings power. It is not likely they will be allowed to dividend the majority of that earnings/capital build based on the Fed's desire to keep dividend payouts low relative to historic norms. That capital must however go somewhere and it will either stay on the balance sheet or more likely be returned at least in part through share repurchases. Beyond the share repurchase assumptions, the business growth assumptions leading to $29 billion detailed in the report are not at all unrealistic. In fact, you could pick apart the assumptions leading to $29 billion and argue they are conservative.

Thought of in a different but related way, you could take the $23 billion in 2013 net income and simply add the previously discussed $6 billion in after tax net interest income with NIM moving up from 2.2% to 2.7% and get to $29 billion. This is without any other aspect of the business growing (no growth in card, no growth in asset management, etc.).

So, we can reasonably discuss earnings today for JP Morgan in the neighborhood of $6 per share going to $9 or potentially higher on the assumption that rates return to more normalized levels and general economic conditions continue to improve.

All of this is not to say the path to reaching the higher normalized earnings power of the business is easy and straightforward. Rather, attaining these higher levels of normalized earnings power are possible and arguably probable. There are most certainly risks with any large financial institution. And many of these risks (trading books, derivative exposures, etc.) can be hard to grasp, but there comes a time when the downside risks are priced in without much appreciation for what can go right. JP Morgan trades for less than 10x current earnings in an environment where they are under earning, arguably significantly, their potential.

There are risks in the business but they also have tremendous liquidity to mitigate such risks. They also have a breadth of businesses that are not all investment banking risk profiles. They have a steady asset management and private wealth management business which should carry higher valuations. They have a largely consumer bank in Chase. You could value the business on a sum of the parts basis to a much higher value because today the entire business is being valued as a trading parlor.

You will notice we have not discussed a singular number for normalized EPS. That level of precision is not realistic when assessing any business let alone a large financial institution. We should however recognize that most large banks are under earning their potential largely due to the low rate environment. The low rate environment obscures the true earnings power of their assets while also obscuring the enormous value embedded in those banks with strong deposit franchises at great scale.

If we can pay a low to reasonable price on today's lowered earnings with the potential for greater earnings in a normalized scenario, then our risk reward dynamic is strong enough to warrant investment.

How Should JPM Be Valued?

Part of the challenge in valuing and in some ways understanding JP Morgan stems from its breadth of businesses. Is JP Morgan a traditional bank? An investment bank? An asset manager? The short answer is all of the above and therein lies part of the complication.

As above, JP Morgan earned an adjusted $5.70 per share in 2013. Tangible book value at the end of 2013 was $40.81 and if we assume it can earn 15% on that tangible equity it would earn roughly $6.12 per share this year. Recent quarterly earnings support annualized earnings in the neighborhood of $6 per share. JP Morgan trades in the neighborhood of $56 as of this writing.

What is a fair multiple or earnings to pay? The multitude of businesses inside JP Morgan makes this already difficult question even more difficult than usual. To paint the extremes of its business from a valuation perspective, we should be willing to pay a much higher multiple of earnings for the recurring and reasonably steady earnings from asset management when compared to the more volatile investment banking business. We must start somewhere however so ascribing a 12x multiple to the entire franchise seems a reasonable start and a discount to historic norms. Ascribing that 12x multiple to a $6 per share earnings figure implies value of ***$72*** per share. If we assume the business is now boring and "utility" like then a fair multiple would be much higher. I do not share that opinion but you cannot call a business boring and utility like and then value it at 10x or 12x earnings, particularly when large plants and equipment are not required for growth.

While $72 seems reasonable for the earnings being generated today, I still believe it misses some of the underlying value that exists in the business. As discussed several times above, JP Morgan is not earning to its potential today largely due to the current low rate environment. Net interest margin moving from 2.2% to 2.7% (still below historic averages) alone brings earnings to about $7.60 on today's share count. That net interest margin potential is on the balance sheet today but again is largely obscured by low rates. A 12x multiple of $7.60 brings value to over $90. Interest rates will not rise to make that possible in the short term however, so some discount to that value is warranted to determine value today.

So, how can we think about growth and value going forward? As above, tangible book value per share has grown around 12% on average per year since 2005. Growing by a lesser 10% per year would bring tangible book value per share to roughly $65 in 2018. A return of 15% on tangible common equity would thus yield earnings of roughly $9.75 for 2018. If during 2018 that $9.75 is valued at 12x it would bring a share price of roughly $117.

How should we discount that price back to today? Assuming that $117 is four years from now (assuming 12x current year 2018 earnings roughly midway through 2018) we can ascribe different discount rates to bring us back to today. At a 10% discount rate, a today value would be around ***$80***. At a 7.5% discount rate, a today value would be about ***$88***.

Thinking of value another way, what is a fair multiple of tangible book value to pay? Tangible book value was $40.81 at the end of 2013 and increased to $44.13 in the third quarter of 2014. With returns on tangible equity of 15%, to earn a 7.5% return today (a return that will grow relative to original cost as tangible book value and thus dollar returns grow over time) you could pay up to 2.0x tangible book value, or ***$88***. Investors are obviously not inclined today to pay 2.0x tangible book for a large bank but through history there has been strong willingness to do so.

During Investor Day, JP Morgan's CFO Marianne Lake seemed to imply the company was good value up to 2.0x tangible book. The weight of this must be small given the lack of depth behind the statement but it does serve as a small dose of support for the other values discussed above.

As can be seen, there are many paths to determining a fair price for JP Morgan and none can be done with perfect precision so that is why we have spoken of a number of different methods and outcomes. With that in mind however, all of the above valuation scenarios allow for a wide margin of safety with significant upside given today's $56 price.

And while JP Morgan has significant earnings power, those earnings will be lumpy and thus difficult for more short sighted investors. For those with a long term perspective however, the opportunity to buy JP Morgan at today's prices remains unique.

Questions and Risks:

The questions and risks with a large money center bank can be miles long. In that regard, I would point you to their filings which detail and capture many of the risks inherent in their business (importantly, you should not invest without fully studying their business and SEC filings including Risk Factors, footnotes, etc.). Interestingly, you can also capture some of the risks in the banks simply by reading the paper as they are often in the headlines for legal issues, regulatory issues, trading losses, and on and on. My more substantive point is that a bank is a highly leveraged business (even if less so today than in recent memory) and thus is much more prone to blow up risk than buying a stable cash generator like a Coca Cola or Proctor and Gamble. Banks require a truly deep dive and a larger margin of safety before investing.

Beyond what is generally discussed above, I did want to point out risks not generally discussed in regards to the large money center banks including JP Morgan.

Cybersecurity Risk: It is hard to imagine what would happen if we collectively and the banking system in particular could not access all the information that is stored electronically. A truly disruptive cyber-attack that would stop banks, companies and individuals from getting their money would create real panic and it is hard to imagine the knock on effects from such an event. We "see" our assets electronically and not being able to "see" them would affect the psyche of the world in untold and unknown ways. Most banks have systems and backups in place but the risk remains. This risk would not be isolated to the banking industry but the long term effects could be enormous.

Master Netting Agreements: A master netting agreement is an agreement between two counterparties who have multiple derivative contracts with each that provides for the net settlements of all contracts, as well as cash collateral, through single payment, in a single currency, in the event of default or termination of any one contract. JP Morgan has trillions of dollars of notional derivatives outstanding which get netted down through master netting agreements and collateral agreements. The netting and collateral agreements help manage the notional derivative exposure in a significant manner but such agreements have not been materially tested in times of great market turmoil.

Conclusion:

Many investors have continued to avoid the large money center banks and their valuations reflect such avoidance and JP Morgan even more so than the others. Do these low valuations reflect the turbulences of yesterday, or tomorrow? I would argue rear view mirror assessment on the headline inducing challenges facing JP Morgan is too prevalent and does not properly account for the earnings power of the franchise.

JP Morgan currently generates a tremendous level of earnings set against a heavily discounted valuation all with significant upside earnings potential as the lending environment normalizes. JP Morgan is great value today and even greater as we look forward.

World class company. World class management. Discounted valuation.

URI | *Capital Partners*

Berkshire Hathaway – March 2014

I wrote an investment thesis on the opportunity to purchase shares of Berkshire Hathaway in the summer of 2012 at a discount to a conservative estimate of its intrinsic value. Since that time the price of Berkshire has increased alongside increases in the broader market. Importantly, the *value* of Berkshire has increased during that time as well. This updated investment thesis is meant to recalibrate the relation of price and value as it stands in March of 2014 for Berkshire.

You will note when comparing this thesis to the last that not much has changed in how value is created at Berkshire. The lack of dramatic change in how value is created remains a key tenet to Berkshire. It is much easier to assess and invest in a business model that is enduring and not subject to dramatic change.

To set the perspective of our approach to investing, our goal is to acquire stakes in world class companies at a discount to a consistently increasing intrinsic value, allowing for strong future returns with limited risk of permanent capital loss.

Our ideal investment would entail buying a (1) great business run by (2) superb management at a (3) low valuation. The business should also be timeless, understandable and it should retain an ability to compound returns for years into decades with minimal tax drag. When we can invest in a great business run by world class managers at low valuations, we invest aggressively.

Berkshire Hathaway is a collection of great businesses held both as fully owned operating businesses and as investments in publicly traded companies. The management at Berkshire carries a superb reputation for honest, reliably consistent and shareholder focused actions. The Company has the broadest of mandates that allows Warren Buffett, Charlie Munger and the rest of the management team the flexibility to invest wherever the best returns exist, irrespective of industry or asset class. Most importantly, Berkshire remains available for investment today at attractive valuations.

How is Value Created?

The collection of investments and operating businesses of Berkshire are wrapped inside an insurance business that provides the predominant funding mechanism to continually and consistently grow the base of investments and operating companies' earnings. Berkshire is truly a wonderful business with three distinct but related drivers: (1) investments, (2) controlled operating businesses and (3) insurance.

The internal driver of value creation largely rests with Berkshire's insurance operations. The vast collection of insurance businesses creates large amounts of float that can then be invested in both investments and controlled operating businesses which then in turn are consistently and reliably creating their own value which also reverts back to Berkshire.

The insurance businesses create cash flow which is then used to grow the balance of investments and operating businesses. The investments and operating businesses themselves create cash flow which reverts back to Berkshire and is used to further enhance the amount of investments and operating businesses. There is in effect a virtuous cycle of existing assets (insurance, investments and businesses) that spin out increasing amounts of cash which are used to further bolster the amount of assets (investments and businesses) which then create more cash to invest, and on and on.

One critical attribute in the assessment of a company's investment potential is how the cash generated is treated. Such free cash can either be distributed to owners or reinvested at high rates or low rates of return. Berkshire's business model is particularly unique in that all free cash is sent to corporate where reinvestment decisions are made based on the best available return possibilities regardless of where the cash was generated. In most businesses the retained capital is only going to be invested back into its existing business, regardless of whether there are better places to invest those dollars. Berkshire is an open canvas and free cash is constantly seeking the best long term returns.

The total freedom of where to invest coupled with unusual expertise in determining how to allocate capital allows Berkshire to reinvest with unusual long term success.

The virtuous cycle of cash generated from insurance, operating businesses and investments being reinvested by world class capital allocators constantly on the prowl for the best use of capital. Importantly, Berkshire grants relative autonomy to the operators of those assets to grow and build their cash generating capabilities creating a unique model that has served to create significant value over time. This bolting of cash generating businesses (particularly the float from insurance underwriting) to an open platform of investing and capital allocation is what truly differentiates Berkshire from other businesses.

In effect, there is a myriad of businesses serving to independently create value for Berkshire while also generating cash that is used by the capital allocation team at corporate to further grow the number of businesses and investments that will then add yet again to the virtuous cycle.

Investments:

Berkshire's investments comprise cash and cash equivalents, bonds, equities and other hybrid investments.

The historical foundation of Berkshire Hathaway has been its equity investments. Berkshire's top four holdings are Wells Fargo, Coca Cola, America Express and IBM and the company has smaller positions in a host of other companies some of which have been chosen by Berkshire's two new investment managers, Todd Combs and Ted Weschler.

Wells Fargo is one of, if not the most, well respected and well run banking franchises in the world. Berkshire has been consistently adding to its Wells Fargo stake as the continued overhang from the recent financial crisis weighs on bank valuations thereby allowing for opportunistic long term investments in the company. Berkshire's stake in Wells should continue to grow in value as Wells trades at reasonably low valuations even against currently depressed earnings from a subpar economic environment, current low net interest margins and generally weak trading and capital markets environments. Wells' earnings should increase as these aspects of their business normalize allowing them to capitalize on their best in class low cost deposit funding base leading to enhanced profitability and a return to more normal valuations. Wells has resumed stock buybacks and a more normalized level of dividends both of which should increase as they attain and move beyond the higher capital levels being mandated by new regulatory standards.

Coca Cola consistently posts high returns on capital and carries a strong combination of world class brand value and an enduring, high return, cash generating business model. Coca Cola has been a strong foundational ownership stake for Berkshire and continues to grow its global business while returning significant amounts of cash to its shareholders including Berkshire.

American Express is the largest closed loop credit card company in the world. It has a global and highly trusted brand that engenders strong customer loyalty with a client base geared towards wealthy consumers and corporations. Typifying its historic and future growth potential, American Express' billed business has grown from $124 billion in 1993 to $888 billion in 2012. The majority of its revenues are fee based and the company has an asset light business model generating high returns on capital. As payment processing moves away from cash and more and more towards credit cards, its business should continue to grow years into the future.

IBM is a global technology company increasingly built upon a strong and recurring services business that now represents over 50% of annual revenue. IBM has also emphasized software which has eclipsed hardware as the second largest revenue source, followed by hardware and financing. The global combination of having software, hardware and related services available under one roof allows IBM to fully differentiate itself with large global customers. As with most of Berkshire's companies and investments, IBM has consistently grown its earnings while also returning significant amounts of its free cash flow to shareholders. As an indication to its ability to generate high amounts of free cash flow without having to heavily reinvest for future growth, IBM consistently posts extremely high returns on capital and equity and does so with a conservative balance sheet.

One should note the commonalities of the investments above: industry leaders, high returns on capital, conservative balance sheets, strong free cash flow generation, strong management adherence to shareholder value with the stakes being acquired at attractive valuations. These dynamics ensure the long term viability of the businesses which in turn supports the long term viability of the Berkshire business model and investment portfolio. The balance of the investments in the equity portfolio share these same dynamics including the recent additions by new investment team members.

Beyond core equity investments, Berkshire's reputation, financial prowess and ability to make quick decisions allows for unique investment opportunities most currently represented by a series of hybrid investments made in the throes of the recent financial crisis. Examples include current pay debt and preferred equity investments in Bank of America, GE, Goldman Sachs, Dow Chemical and The Wrigley Company, often with attractively priced long term warrants.

To highlight one example of an investment unique to Berkshire, in the fall of 2011, Berkshire invested $5 million in a Bank of America 6% Cumulative Preferred Stock position which also included warrants to purchase 700 million shares of BAC expiring in 2021 with an exercise price of roughly $7.14 per share. So, between now and 2021, Berkshire has the right to buy Bank of America stock at $7.14 per share. Current book value for BAC is $20.71 and current tangible book value for BAC is $13.79. Tangible book value has consistently increased in recent years through a highly challenging environment for banks in general and Bank of America in particular. There is tremendous upside potential in this particular investment along with the other hybrid investments that Berkshire invested in through the recent financial crisis.

With today's historically low interest rates, bonds (particularly those of long duration) carry heightened risk with an unfortunate corresponding low yield and return profile. With that in mind, Berkshire's bond portfolio is of relative short duration and also of high quality. To highlight its short duration, over 2/3 of the highly rated portfolio matures in five years or less allowing for those investment dollars to be redeployed at likely higher rates and/or into future business acquisition and equity investment opportunities.

Berkshire also consistently carries significant cash balances positioning the company for unknown events and opportunistic investments.

Operating Businesses:

Through time, Berkshire has preferred to focus increasing amounts of its capital on controlled operating businesses. This grants Berkshire more control over capital allocation from the cash generated by such businesses.

While the foundation of Berkshire has historically been its investment portfolio and insurance businesses, Berkshire has become increasingly reliant on the success of its growing portfolio of operating businesses. These businesses include large, well known and valuable companies such as: Burlington Northern, Heinz, MidAmerican Energy Holdings, Lubrizol, The Marmon Group, See's Candy, NetJets and McLane, amongst many others.

As can be seen in the valuation section below, the pre-tax earnings of these operating businesses has increased dramatically in even just the last ten years. Berkshire's increased emphasis on owned businesses makes them an increasingly important piece of the company's value. The combined businesses posted strong growth in 2013 and are likely to continue to do so in 2014 and beyond. The addition of strong companies like Heinz in the summer of 2013 and NV Energy in December of 2013 imply that more and more of Berkshire's value will reside in fully owned and controlled businesses.

One note on the summary per share pretax operating earnings below: the figure for 2013 understates actual earnings power even at year end 2013 (to say nothing of the general expected growth in 2014). As just one example of the many acquisitions made during the year, Heinz was acquired in June. Its full year results were dragged down by one time acquisition related expenses as well as significant restructuring charges. Coupling those effects with only owning the business for part of the year meant that Heinz contributed little in the way of 2013 earnings even though its 2014 earnings power for Berkshire will be significant. Thus, our 2013 figures already understate today's earnings power.

Insurance:

To understand the underlying value of Berkshire is to first understand a more commonly run insurance company and then understand how Berkshire differs.

Most insurance companies take in premiums and invest such premiums hoping and planning for their investment returns to outpace the traditionally recurring underwriting losses prevalent with most insurance companies. They in essence price policies to incur annualized losses that are an offset to the investment income the management of such premium income allows.

In contrast, Berkshire historically operates with reasonably consistent underwriting profits (on average over extended periods of time). There are some years with underwriting losses but those have tended to be the exception rather than the rule. To support such a claim, the insurance operations have shown an underwriting profit for eleven consecutive years with pretax profit over those years totaling $22 billion.

As described earlier, the collective insurance businesses are the fundamental driver behind the virtuous cycle of cash generation and value creation that sets Berkshire apart from other businesses.

Simple Investment Thesis: Berkshire Hathaway is a consistently growing amalgamation of businesses and investments augmented by consistent cash generation from profitable insurance operations. The additional cash generation from those same investments and businesses further add to the base of businesses and investments in an perpetual cycle of value creation. As important, the business can be acquired today at materially less than a conservative estimate of its intrinsic value.

Understandable: Berkshire Hathaway is a collection of investments and businesses that are enduring in value while being run by a Chairman and management team who articulates and presents the company in a straightforward and understandable manner.

Key Elements of Value:

1. High quality investment portfolio
2. Stable of owned businesses that continue to generate cash and grow in value
3. Insurance businesses that have a long history of profitable operations and generate significant cash flow for new investments
4. Corporate capital allocation from consistent cash generation deployed to most optimal uses by first class capital allocators: Warren Buffett, Charlie Munger and the investment team they have assembled
5. Consistently increasing intrinsic value through the acquisition and ownership of world class companies

Discounted Valuation:

Warren Buffett is reasonably transparent in how he thinks about the value of his own company (read pages 109 and 110 in the 2013 annual report as an example). In other words, one of the best investors of all time nearly walks us through how to arrive at his company's intrinsic value. A conservative current estimate of intrinsic value comprises the combined value of Berkshire's investments and operating businesses.

- Berkshire has roughly $129,253 of per share investments at the end of 2013
- Berkshire had per share earnings from its operating businesses of $9,116
- As more fully discussed above, the 2013 per share earnings from operating businesses does not full reflect today's earnings power. Already, the 2014 run rate of such earnings is higher.
- I have used a 10x multiple to further the conservative nature of the calculation ascribing roughly $91,160 per share for the operating businesses
- I have conservatively ascribed no value to the insurance profits even though the combined insurance businesses have a long record of consistent profitability. The rationale being the insurance businesses are the engines that create the means to build underlying value. While they clearly have value in and of themselves their predominant contribution is as a contributor of capital so we can be conservative and peg this value at zero.

➢ ***Current estimate of intrinsic value is $220,413 per share which should continue to increase over time***

  - Cash levels continue to build quarter to quarter increasing the base of investments and/or dollars available for future full business acquisitions
  - Existing businesses and investments continue to grow in value

	Per Share Value of Investments		Per Share Pre Tax Earnings
1990	$7,798		$102
2000	$50,229		$918
2010	$94,730		$5,926
2013	$129,953		$9,116
		10x	$91,160
Estimate of Intrinsic Value Year End 2013			***$220,413***

The current conservatively estimated intrinsic value of Berkshire Hathaway is significantly less than where Berkshire is available for investment today (roughly $187,000 per A share). In addition to the current significant value gap, intrinsic value will continue to increase as time progresses. The insurance businesses will continue to add freely available cash to grow the base of investments and fully owned operating businesses. The existing investments and businesses will continue to grow in value.

To put valuation in another perspective, let's assume the investments are valued on a dollar for dollar basis. So, of the roughly $187,000 in today's Class A share price, there is $129,253 in per share investments. The remaining operating businesses can then be acquired for less than 6.5x pretax earnings (paying $58,000 for roughly $9,116 in per share pretax operating earnings).

An investment is available today to sit alongside one of the greatest investors of all time at a value well below intrinsic value in a company with a growing base of strong value investments and operating businesses.

World class company. World class management. Discounted valuation.

To show how value has been created since my first writing in the summer of 2012, I have included the summary valuation section from that writing below:

Low Valuation (from Summer 2012):

Warren Buffett is transparent in how he thinks about the value of his own company. In other words, one of the best investors of all time nearly walks us through how to arrive at his company's intrinsic value.

A conservative current estimate of intrinsic value comprises the combined value of Berkshire's investments and operating businesses per the playbook laid out by Buffett himself.

- Berkshire has roughly $107,000 of per share investments at the end of Q2 2012
- Berkshire has a per share earnings run rate from its operating businesses of roughly $7,600 and this run rate is increasing on a year to year basis including in 2012
- Buffet has historically implied (through discussions and annual reports) a fair value multiple for such earnings of 11x to 13x
- I have used a 10x multiple to further the conservative nature of the calculation ascribing roughly $76,000 per share for the operating businesses
- I have conservatively ascribed no value to the insurance business even though it historically averages profitable operations

➢ ***Current estimate of intrinsic value is $183,000 per share which should continue to increase over time***

- Cash levels continue to build quarter to quarter increasing the base of investments and/or dollars available for future full business acquisitions

- Existing businesses continue to grow in value

	Per Share Value of Investments		Per Share Pre Tax Earnings
1990	$7,798		$102
2000	$50,229		$918
2010	$94,730		$5,926
2011	$98,366		$6,990
Q2 2012	$107,000		$7,600
		10x	$76,000
Estimate of Current Instrinsic Value			**$183,000**

Note: The Q2 numbers are my estimates from the 10Q and the pre tax earnings reflect a current run rate that includes full year ownership of Lubrizol.

The current conservatively estimated intrinsic value of Berkshire Hathaway is significantly less than where Berkshire is available for investment today (roughly $127,000 per A share). In addition to the current significant value gap, intrinsic value will continue to increase as time progresses. The insurance businesses will continue to add cash available to grow the base of investments and fully owned operating businesses. The existing investments and businesses will continue to grow in value.

To put valuation in another perspective, let's assume the investments are valued on a dollar for dollar basis. So, of the roughly $127,000 in today's Class A share price, there is $107,000 in per share investments. The remaining operating businesses can then be acquired for well under 3x earnings (paying $20,000 for roughly $7,600 in per share pre tax operating earnings).

An investment is available today to sit alongside one of the greatest investors of all time at a value well below intrinsic value in a company with a growing base of strong value investments and operating businesses.

Questions and Risks:

Warren Buffet: Let's assume for a moment Warren Buffett is hit by the proverbial bus tomorrow. Coca Cola will still be the leading carbonated beverage company in the world. Wells Fargo will still be banking its customers. Burlington Northern's trains will keep running. In short, the show will go on. I do understand and appreciate there is some concern regarding future capital allocation. Charlie Munger would still have his hands on the capital wheel in my hit by the bus scenario. The Board will have appointed leaders for oversight of both the operating businesses and of the investment portfolio.

The beauty of Berkshire is in its enduring management structure. The businesses largely are left to be run by their own management. There is little control from Omaha. The company has in place a stable of managers that have been ably managing the operating companies for decades. The investment portfolio is in place. So, we are largely talking about what will happen with new investments. A team has being assembled to address those concerns. They are being tested as we speak. The cash generating insurance businesses (arguably the most important component to future value as they generate the cash to fund future investments) are run by some of the best insurance managers in the world. Maybe the investment growth profile diminishes to some degree. In our dire scenario there remains a world class collection of investments and companies that are growing at an admirable pace. And, most importantly, they can be acquired for a significant discount today.

Boring: Berkshire may be boring but that is fine with me.

No Discernible Catalyst: I don't know what singular catalyst, if any, there will be to prompt a share price move closer towards fair value. However, my long term horizon does not require such a move in any narrowly defined period of time. In fact, a continued divergence from fair value only allows me time to build a larger position leading to enhanced long term profitability.

No Growth: Some associate the old economy nature of the Berkshire businesses with a slow growth model. I don't find that to be true. The data above points to significant growth over time and more growth is expected given the business model's unique ability to add to its growing breadth of investments and businesses. Berkshire may no longer grow its book value at the pace of years and decades past but it can still grow. And it can be bought at a significant discount to intrinsic value thereby augmenting the growth for current shareholders from today's valuations.

Industry Confusion: Berkshire is hard to place in any one particular industry. Is it an insurance company? A diversified conglomerate? A financial services company? This industry confusion can create valuation confusion, amongst other perceptual challenges. What Berkshire remains however is a collection of wonderful of business, run by highly competent managers all working to grow per share intrinsic value over time.

Insurance Risk: Berkshire is subject to large catastrophic risk through its super cat and reinsurance businesses as well as more traditional risks in their various insurance businesses. This is the predominant reason for retaining a very significant cash balance at all times (in excess of $20 billion). This business risk is mitigated by Berkshire's incredibly strong balance sheet and the strong management teams in place including Ajit Jain.

All of this is not to say there are no risks associated with an investment in Berkshire Hathaway. There are many risks (significant insurance losses, economic contractions, market volatility, unforeseen natural or geopolitical events, amongst many others) but those risks are managed through the ownership of great businesses, a strong, liquid and stable balance sheet and a corporate philosophy with a unwavering eye towards thoughtful capital allocation. There will certainly be bumps in the road but Berkshire should have the assets to withstand the bumps over the long term. The businesses are resilient so while short term pain will certainly occur, the overall business is well positioned for long term success.

Conclusion:

Have people ever talked about this idea? Absolutely. Is it heroic? Not even close. Is there real value in this investment? Without a doubt.

Buying Berkshire Hathaway today may seem too easy. It may not seem “smart” enough.

But those are bad reasons to look past the opportunity in search of a more heroic investment. Berkshire Hathaway should be bought today. And it can and should be held for years.

World class company. World class management. Discounted valuation.