Epsilon Theory

In the Flow
It's the Multiple, Stupid

February 25, 2019

A couple of observations before I get into the meat of today's *In the Flow* note …

1) Attached is a PDF for a long-form note I wrote this weekend, the third in a series on pricing power in the financial services biz. This series started as an idea for a couple of Briefs (#1 in the series is really short), but it's evolved into something bigger. Today's note is about the failure of active investment management over the past ten years, and why I don't think that the next ten years will be any different. That doesn't mean that you have to abandon the active management ship, but it does mean (I think) that you have to go back to first principles in order to survive in the business of active management. As always, I'd be interested in your thoughts on all this!
2) We've **posted the video recording** of last week's ET Live, and I think it's worth your time. It's long (about an hour), but the subject matter kinda requires it – everything you wanted to know about MMT, but were afraid to ask. If you're a podcast rather than a video person, there's nothing lost by just listening to this episode rather than watching (we'll start with more true video elements next month AND begin a true podcast series).
3) Speaking of MMT, this article from the weekend NYT, "**How America Learned to Stop Worrying and Love Deficits and Debt",** is a reminder that the core shift in the political and economic Zeitgeist – deflation, lower rates and wealth concentration becomes inflation, higher rates and wealth distribution – continues unabated. As discussed in **recent *In the Flow* notes**, this is the long-term social narrative shift that means everything to your portfolio. Also, it's a reminder that imitation is the sincerest form of flattery, since Neil Irwin is clearly copying **my ET note** and Dr. Strangelove reference with his title here (JK … although maybe).

The meat of today's note is something a little different. I wanted to walk through a bit of Warren Buffett's annual Berkshire Hathaway letter, not as some genuflection to a received truth and not as some gotcha exercise, but as an example of how to read texts for their narrative impact and why identifying narrative shifts is so useful for understanding corporate (and national) policy.

The particular text in the letter that I found so interesting is how Buffett opens the letter, immediately after his summary introduction:

> Long-time readers of our annual reports will have spotted the different way in which I opened this letter. For nearly three decades, the initial paragraph featured the percentage change in Berkshire's per-share book value. It's now time to abandon that practice.

> The fact is that the annual change in Berkshire's book value – which makes its farewell appearance on page 2 – is a metric that has lost the relevance it once had. Three circumstances have made that so. First, Berkshire has gradually morphed from a company whose assets are concentrated in marketable stocks into one whose major value resides in operating businesses. Charlie and I expect that reshaping to continue in an irregular manner. Second, while our *equity holdings* are valued at market prices, accounting rules require our collection of *operating companies* to be included in book value at an amount far below their current value, a mismark that has grown in recent years. Third, it is likely that – over time – Berkshire will be a significant repurchase of its shares, transactions that will take place at prices about book value but below our estimate of intrinsic value. The math of such purchases is simple: Each transaction makes per-share intrinsic value go up, while per-share book value goes down. That combination causes the book-value scorecard to become increasingly out of touch with economic reality.

The direct statement and rationale here is pretty straightforward: **Buffett will no longer report Berkshire's per-share book value, because he wants to buy back the stock and that will make the per-share book value look bad.** Rather than maintain his 30-year tradition of reporting per-share book value and every year going forward be forced to explain why it's not a bad thing for this metric to have gone down (after spending 30 years saying why it IS a bad thing for this metric to have gone down), he's going to bite the bullet now and drop the measure entirely.

So now let's dig a little deeper. Why did Buffett report per-share book value in the first place? I mean, who does that these days?

Answer: pretty much no one, *outside of banks and similar financial institutions*.

Which leads us to the indirect statement and rationale here: **Buffett no longer wants to be thought of (*and valued as*) an investment firm, but wants to be thought of (*and valued as*) an industrial conglomerate.** It's something that he's been writing about for years, that the mix of Berkshire's investments is moving away from public company stakes and moving towards outright ownership of operating companies. But that mix shift doesn't make Berkshire an operating company itself … it makes them more of a private equity investment firm rather than a public equity investment firm. No, Buffett is doing more here than just call attention to the mix shift in investment assets. He is trying to change the narrative about what Berkshire IS.

Which leads to the next question: Why does Buffett care whether the market sees Berkshire as an operating company itself, and not as a private equity investment firm? I mean, he's not doing anything different. Why all the concern about the optics and the narrative around Berkshire?

Answer: to paraphrase James Carville and his famous line about the 1992 presidential election, *it's the multiple, stupid.*

Here's a ten-year price chart of Berkshire Hathaway's stock price versus the S&P 500. It doesn't include last week's Kraft Heinz debacle, because I didn't want to warp the longer term picture here.

That's S&P 500 total return (so including dividends) in blue and BRK/B in orange. For all practical purposes, Berkshire Hathaway is a S&P 500 tracking stock with egregiously high fees. This has been true for a DECADE. And Buffett knows that this is all Berkshire will ever be, so long as the company is seen as – and valued as – an investment firm that buys S&P 500 companies, whether those purchases are in a public equity portfolio or a private equity portfolio.

Buffett wants a better multiple on his stock, and he's going to do both financial engineering (buy back stock hand over fist) and *narrative engineering* (change the common knowledge about BRK) to get there.

Buying back stock as an investment firm drives a narrative of failure. "I'm sorry, Mr. Shareholder, but it turns out I can't invest your $115 billion in cash any better than you can." You're not going to get a higher multiple with this sad story.

Buying back stock as an industrial conglomerate, on the other hand, drives a narrative of success. "See, Mr. Shareholder, everyone knows that everyone knows that this is what makes an operating company's stock really shine." This is how you get a higher multiple.

It's all eerily familiar to anyone who has watched GE over the past 15 years, because this combination of financial engineering and narrative engineering IS the Jeff Immelt playbook. The only difference is that Immelt ran an industrial conglomerate and wanted a financial services multiple, and Buffett runs an financial services firm and wants an industrial conglomerate multiple. Funny world, innit?

And maybe I'm picking a pejorative example with GE and Jeff Immelt. Someone on Twitter mentioned Teledyne and Henry Singleton as a more positive example of conglomerate engineering, and that's fair. Although if we're going back to ancient history, I'll call your Henry Singleton and raise you with Hal Geneen.

The larger point, though, and the thread that runs through all of these examples, from ITT to Teledyne to GE to Berkshire Hathaway, is that at some point these companies get too big to continue growing through acquisition. There's no more step-function P/E growth to be had on the E side of the equation. **So they ALWAYS start focusing on the P side – the multiple – which is entirely a creature of narrative.**

I wouldn't bet against Buffett in his effort to reshape the narrative around Berkshire and win a higher multiple. He's the best player of what I call "**the metagame**" that I've ever seen in corporate management. But it is a very different narrative than the Buffett true-believers are used to hearing, and it may require a painful shift in the investor base for Buffett to pull this off. I just don't know if he has enough time.

DISCLOSURES

This commentary is being provided to you as general information only and should not be taken as investment advice. The opinions expressed in these materials represent the personal views of the author(s). It is not investment research or a research recommendation, as it does not constitute substantive research or analysis. Any action that you take as a result of information contained in this document is ultimately your responsibility. Epsilon Theory will not accept liability for any loss or damage, including without limitation to any loss of profit, which may arise directly or indirectly from use of or reliance on such information. Consult your investment advisor before making any investment decisions. It must be noted, that no one can accurately predict the future of the market with certainty or guarantee future investment performance. Past performance is not a guarantee of future results.

Statements in this communication are forward-looking statements.

The forward-looking statements and other views expressed herein are as of the date of this publication. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements, and there is no guarantee that any predictions will come to pass. The views expressed herein are subject to change at any time, due to numerous market and other factors. Epsilon Theory disclaims any obligation to update publicly or revise any forward-looking statements or views expressed herein.

This information is neither an offer to sell nor a solicitation of any offer to buy any securities.

This commentary has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. Epsilon Theory recommends that investors independently evaluate particular investments and strategies, and encourages investors to seek the advice of a financial advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.