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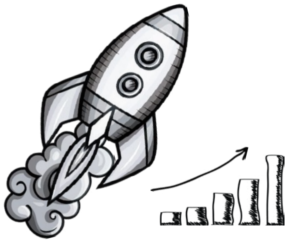


THE BERKSHIRE MODEL
Quality Shareholders

Prepared by:

AVENEL FINANCIAL GROUP

President: Mike Pruitt
Analyst: Adam Allen
Analyst: Sam DiFiore
Intern: Lauryn Unger

"Managers get the shareholders they deserve."
- Lawrence A. Cunningham

The Berkshire Hathaway cohort of investors is an unusual one. This investor group denies the temptations of selling and retains their shares for the long term with 98% of shares failing to change hands year over year. Further, Berkshire shareholders are highly concentrated with 90% having Berkshire as their largest holding. This affords Berkshire many opportunities not available to other companies. Of particular importance is Berkshire's radical focus on capital allocation for long term growth. This assembly of long-term, concentrated shareholders is not a coincidence, it is the product of decades of conscious effort to develop and communicate a company culture that keeps the interests of shareholders in mind. Through this, shareholders have both taken notice and come to appreciate this effort.

Berkshire has accumulated a high concentration of quality shareholders through three key practices. First is the commitment to the creation of shareholder value over the long-term through intelligent capital allocation. Second is the conscious communication of this corporate culture through the now celebrated annual shareholder letters and meetings which work to demonstrate the values and philosophy of the company. The shareholders can then evaluate their commitment relative to the company's mission. Over time this has produced a tremendous alignment of interests between the company and its shareholders. The third factor in this cultivation of Quality Shareholders is Berkshire's disinterest in share dilution or splits. Berkshire famously has the highest share price on the stock market in its BRK.A shares, which currently trade above $300,000 a share. This price is not just due to a small number of shares in circulation, but an unwillingness to split the stock which serves to decrease liquidity and in turn trading volume which decreases the number of non-quality transients. Berkshire serves as a playbook for the development of a durable base of concentrated and committed shareholders.

What is a Quality Shareholder?

Quality Shareholders (QSs for short) are a coalition of shareholders that are informed on a company, invested in a company and work to support a company's long-term success. To better understand QSs we need to understand the alternate types of shareholders and what their impact and incentives are. Indexers, Transients, and Activists make up the rest of the shareholders outside of the quality group companies wish to accumulate.

The first type of investor we will evaluate is Indexers. Indexers tend to subscribe to the idea of perfectly efficient markets; therefore, they buy into the broad market, low-cost indexes that have gained massive popularity in the past few decades. Indexers are exemplified by longer holding periods and lower average stakes. This type of passive investing will deliver low-cost market returns but has the side effect of poor voting heuristics and minimal interest in individual companies. Indexers currently represent approximately 40% of holdings in the market.

A smaller but equally influential group of shareholders are Activists. Activists buy large stakes in a company to influence board elections, implement managerial changes that benefit their short-term interests, and then sell those positions for a profit. Activists possess the smallest portion of market capitalization at 5% but pose potentially the largest threat to long-term oriented management. An effective activist could negatively alter the direction of the organization for long after they have sold their position. Activists are characterized by their higher average concentration but shorter holding periods.

Finally, we need to understand Quality Shareholders. QSs view themselves as owners of a company. This requires a sense of conviction and self-discipline to make effective decisions. QSs tend to think about investments as a business, not just securities, positions, or cash flows. A common characteristic of QSs is patience, holding companies for extended periods with an eye towards their economic advantages and long-term prospects. Owning companies for long periods not only limits transaction and tax risk but also extenuates the gains of compounding. An essential part of QSs is growing investments through the conscious and consistent application of patient capital. The only way to do this is to be aware of, and promote, the long-term interest of the company. Quality Shareholders tend to represent only 15% of market capitalization.

Advantages of QSs

“It’s all about the long-term” as Jeff Bezos famously stated in his 1997 letter to shareholders that serves as the cornerstone of his business philosophy and a lighthouse for one of the strongest groups of Quality Shareholders. The essential advantage of a strong cohort of Quality Shareholders is their commitment to the long-term health and growth of the company. Management needs time, capital, and strategy to grow a company. Corporate strategy acts out over years instead of periods, QSs understand this and engage in discussions and make informed decisions to assist management towards this goal of long-term growth. Additionally, QSs afford the advantage of managerial flexibility. QSs allow managers to work on long term goals with room for maneuvering and support them by supplying a consistent ownership group. QS also dissuade large market moves or activists from derailing long term corporate strategy. These shareholders are not focused on short-term results, which alleviates executives of time pressures and allows them to execute their long-term missions to improve company performance. As Lawrence Cunningham, author of the book on Quality Shareholders, says: “Proof of corporate strategy usually manifests itself over years not quarters.”

The trouble indexers pose generally manifests in shareholder voting. Indexers usually vote in accordance with preexisting guidelines, whereas QSs take time to analyze the correspondence given to them by a firm, dissect it, and vote for what they believe is beneficial to the corporation. Indexers are primarily concerned with their portfolio overall, so they may only interact in voting when a decision could affect their whole portfolio. Indexers are found everywhere and have holdings in “more than eleven thousand companies worldwide” and “three thousand in the US alone.” Their votes are cast at thousands of meetings which add up to “more than 30 thousand proposals.” The average person may believe indexers are doing everything they can to learn more about a specific company by reading annual reports, proxy statements, and learning more about strategic planning and management teams, but “evidence indicates that even the big indexers access only 29 percent of governance-related public filings of their investees.” This paucity of corporate knowledge leads to suboptimal voting on many occasions. Further, according to notable QS Howard Marks, the indexers lack of due diligence on individual companies provides opportunities for those investors who take the time to quantitatively and qualitatively analyze companies in order to form investment theses.

Activists view the ownership structure of targets and are deterred from companies with substantial shareholders that are likely to oppose their strategies. This is because activists usually own no more than 5% of a company therefore their voting influence is limited in situations where a cohort of QSs will insulate elections from well-organized Activist campaigns. Activist investors usually “urge razor-sharp focus, criticize diverse operations, and oppose conglomerates.” This approach can disrupt companies with especially strong management teams that are growing for the long term.

Quality shareholders also supply a valuable and durable economic moat that is not immediately obvious to the outside observer. QSs allow managers to maintain a flexible leadership style within the pursuit of long-term objectives. The advantages of solid ownership of a company are obvious in sports as well. If we observe the NFL Owners who micro-manage, control, and change the organizations' management we will see many of the consistently failing franchises. The Browns, The Jaguars, The Cowboys, and the Washington Football Team all have notoriously intrusive management groups, and this has produced ailing franchises. This principle can be extrapolated to public companies as well. If an ownership group is disinterested or unsupportive of management, the company's performance will likely suffer as a result. A strong cohort of QSs function the same way a good NFL owner would. They ensure they place the proper people in positions of power then monitor performance with minimal interference.

How to Attract QSs

Management who understand the value and importance of attracting a strong base of QSs will consciously modify their behavior and practices in such a way to attract them. There are several crucial factors to attracting this enticing set of shareholders, but the essential function that QSs appreciate is a commitment to the creation of shareholder value over time. We will discuss a few ways to practice and communicate this function below.

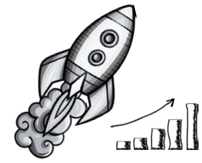
QSs understand the importance of growing a business for the long term, therefore management that shows a commitment to this through the prioritization of high returning capital allocation decisions will attract a cohort of dedicated shareholders. Most companies that attract this QSs cohort are extraordinarily strong capital allocators with ROIC's and ROE's above 15% and, most often, over 20%. This strong reinvestment of capital from cash-producing assets is the key to healthy growth. Annual shareholder letters and meetings serve as the primary means of communication and affirmation for QSs. Annual letters allow companies to reaffirm their managerial principles and capital allocation strategy while simultaneously allowing shareholders to reevaluate their commitment to the company. Over time this will produce a shareholder base that is aligned and supportive of management's decision-making. This tool has been used to great effect by almost every company that has successfully cultivated a cohort of QSs including Amazon, Berkshire, Constellation Software, and Coca-Cola. Another tactic that has proven effective for firms is the issuance of a shareholder owner's manual, or something equivalent, such as Amazon's 1997 letter to shareholders (which is referenced in every annual letter and outlines their corporate principles).

QSs appreciate those who appreciate them. Management that demonstrates a disinterest in equity dilution through new stock issuances or stock splits will be attractive to QSs. This is a sign of a commitment towards shareholder value and equity preservation. Further, Companies that attract QSs rarely issue quarterly earnings guidance and reduce their quarterly communications. These practices incentivize managers to hit specific short-term targets and often choose substandard practices to achieve these predetermined goals. Managers should instead be incentivized to make decisions that lie with the firm's long-term interests. Further, Quarterly earnings calls are often utilized by transient traders to inform short-term market maneuvering which increases volatility and dissuades QSs who prefer companies with reasonable valuations.

Several companies have created an environment where Quality Shareholders thrive and assemble. This effort towards the conscious cultivation of QSs has afforded them meaningful strategic advantages that has led to outsized growth and effective capital allocation over the long term. These companies include the ones previously mentioned as well as 3M, Netflix, Graham Holdings (formerly the Washington Post), PepsiCo, and Walmart.

How to be a QS

QSs Traditionally hold large positions in a fewer number of companies, often 20 or less. This fact allows QSs to remain involved and knowledgeable about the decision making of management and the long-term outlook of the company. This commitment to the company through concentrated positions allows for focus in the investing process and more informed decision making about investments. QSs rightfully see themselves as acquirers and owners of a business.



This mindset incentivizes them to conduct appropriate due diligence when researching an investment opportunity. This research process includes the evaluation of financials, the review of managerial correspondence, a general understanding of the industry, and legitimate effort placed towards uncovering management's strategy and capital allocation record. Ruane Cunniff & Goldfarb, a noted Quality Shareholder, exemplifies this saying "We take pride and pleasure in investigating a company from all angles, doing the kind of on-the-ground primary research that an enterprising journalist might do." QSs tend to have well-formed and durable theses regarding their investments, time spent on developing sound reasoning in companies allows a QS to have conviction in the company they are invested in.

QSs are separated from their counterparts largely through their engagement with the firm. While other shareholders may all together ignore management's communications or the voting process, QSs are consistently involved. These events present the QS cohort an opportunity to reevaluate and reaffirm their investment yearly, which in turn works to align their values with the values of management. Over time this committed process of QSs will help create an owner group and a management group who mutually support and reaffirm the actions of the other, which leads to a healthier company. This is particularly important around shareholder voting where QS owners must involve themselves in the process of annual votes to stave off the efforts of the activists and indexers who may not be voting for the long-term interests of the company.

QS hold their positions over the long term. Due to their deliberate research process, durable theses, and commitment to the company, QSs are afforded the peace of mind needed to endure the randomness of short-term market movements. This effort towards the cultivation of patient positions and sound temperament is a key catalyst to the outsize returns available to long term owners of a business.

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