Sprott | Gold Report
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Gold Shows Up at the Berkshire Hathaway Shareholder Meeting

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Woodstock for Capitalists

A Review of the Berkshire Hathaway 2018 Annual Meeting through Gold Tinted Lenses

An annual highlight of the financial calendar is the Berkshire Hathaway shareholder meeting. The Berkshire meeting has evolved into a high holiday of American capitalism, uniting 40,000 crusading attendees with millions of global investors in collective celebration of the joys and rewards of investing.

Over the long history of financial markets, Warren Buffett is generally regarded as the greatest investor of all time. What makes Mr. Buffett's story so compelling is the popular belief that his virtuoso performance relies on simple and patient faith in iconic American brands. To this end, Mr. Buffett has long cultivated a public persona as an indefatigable cheerleader for American entrepreneurial spirit.

Buffett and the Formidable Power of Float

While Mr. Buffett's everyman affinity for cherry Coke and See's candy delights crowds, Berkshire aficionados are keenly aware that the company is actually a highly geared financial behemoth. As a supremely calculating financial architect, Mr. Buffett has mastered, more than any American CEO save Jeff Bezos, **the formidable power of float**. Charming gecko aside, the massive, negative-cost float of Geico and Berkshire's reinsurance group have underwritten Berkshire's long-term growth. This critical aspect of Berkshire's success, especially at the company's current half-trillion-dollar market capitalization, ties the company's fortunes far closer to Fed liquidity-provision than is commonly appreciated.

Figure 1: Chairman Warren Buffett and Vice Chairman Charlie Munger at the 2018 Annual Shareholder Meeting (5/5/18)

Source: Yahoo Finance.

In this report, we present a three-part consideration of the 2018 Berkshire shareholder meeting **through a gold investor's lens**. First, we update Mr. Buffett's trademark dismissal of gold through his narrative from the stage of CenturyLink Center Omaha. Second, we present our hypothetical assessment that gold's unique investment merits are perfectly suited to Berkshire's portfolio in 2018. Finally, we develop our contention that few U.S. corporations have benefited more from central bank liquidity-provision than Berkshire Hathaway. While a bit of a buzzkill during Berkshire revival week, we believe our final section lends interesting perspective to the value of a portfolio allocation to gold in the context of post-ZIRP corporate America.

Gold as Brick

When you have reached 87 years of age, with a net worth approximating $1 billion for every year of your life, you have earned the right to address an arena of your constituents with whatever narrative you wish. Given Mr. Buffett's legacy derision of gold's investment merits, however, we found it somewhat curious that he dedicated his opening monologue at Berkshire's 2018 shareholder meeting almost entirely to a comparison of the performances of gold versus U.S. stocks since 1942. The theme of Mr. Buffett's bullion soliloquy was that gold is a non-productive asset which can never produce anything, and therefore constitutes a terrible investment. To prove his point, Mr. Buffett cited statistics that, since he purchased his first stock (at age 11) in March 1942, U.S. stocks have outperformed gold by a factor of 128-to-1! Case closed, right?

Well, setting aside the fact that Berkshire's investment odyssey kicked off around 1965, one must assume Mr. Buffett selected 1942 as the starting point for his gold-to-stocks comparison because April 1942 marked the ultimate World War II stock market low from which modern U.S. equity markets were born. Mr. Buffett observed:

> "Investing $10,000 in an index fund in 1942 to own a piece of American business would now be worth $51 million, and you wouldn't have had to do anything…If you had taken $10,000 and listened to the prophets of doom and gloom and bought 300 ounces of gold instead, today that still would be 300 ounces of gold. You could go down to the safety deposit box and look at it and fondle it, and it wouldn't produce anything. That gold would be worth $400,000 today…**Every dollar earned in investing in American business was matched by less than a penny gained by investing in a 'store of value' like gold over the same period**." [Our emphasis]

Buying Gold in 1942?

We are willing to concede that measuring from the WWII low is a logical yardstick for Mr. Buffett to employ in his fanciful demonstration of what 75 years of continuous, broad market ownership might have accomplished, but comparing these returns to the performance of gold bullion over the same time frame strikes us as a bit disingenuous. First of all, during the 41 years between 1933 and 1974, any U.S. investor attempting to purchase the 300 ounces of gold in Mr. Buffett's illustration would have been committing a federal crime punishable by a $10,000 fine or ten years in prison.

Further, should any U.S. investor have ignored federal law and successfully acquired $10,000 worth of bullion on the black market, their motivation could hardly have been to compete with U.S. stock market appreciation, because **the gold price was fixed at a set U.S. dollar price not only in 1942 but for the next three decades thereafter**! Obviously, no investor in 1942 would have selected gold as a live horse to compete with a booming post-war stock market, so we are not quite sure what significance Mr. Buffett perceives in contrasting the two performances, looking back from the CenturyLink stage in 2018.

As if his 75-year performance comparison were not sufficient in prosecuting gold's non-productive nature, Mr. Buffett returned to his gold-as-brick reasoning in answering Question # 40 posed at his 2018 shareholder meeting. While the proffered query related specifically to the topic of cryptocurrencies, Mr. Buffett veered back to gold in answering:

> "Non-productive assets remain that way. Gold at the time of Christ to now has a compound rate of [return of] a couple tenths of a percent. These assets won't deliver anything other than supposed scarcity, but so what, what does it produce itself?"

Gold has Stood the Test of Time, Like Few Other Assets

At the risk of talking our own book, we would note that other than bread, fish and olives, few worldly items have even survived along with gold since the crucifixion, much less in their original tangible form. For us, Mr. Buffett's biblical reference crystalizes two aspects of his gold-versus-stocks comparison we find self-impeaching.

First, the relevant time horizon for any investor is **significantly shorter** than 2,000 or even 75 years. Especially in the contemporary environment of monetary experimentation, even **75 weeks** is now a time frame with potentially transformational implications for any investment corpus. By way of illustration, we would offer in counterpoint to Mr. Buffett's 1942-to-the-present narrative the far more sobering performance of equities versus gold during the past two decades.

Specifically, an investor committing **$10,000** to the S&P 500[1] in **March 2000** would have **$25,114** today (including reinvestment of dividends through 4/30/18), but if she had used the same **$10,000** to purchase 36 ounces of gold (35.83 ounces to be exact), today she would still have only 36 ounces of gold. She could go down to the safety deposit box and look at it and fondle it, and it wouldn't produce anything. She would, of course, be absolutely thrilled by the knowledge that the **value** of her 36 ounces had almost quintupled to **$47,132**!

This means that during the past eighteen years, every dollar earned by investing in a store-of-value like gold was matched by only fifty-three cents gained by investing in American business.

Figure 2: Cumulative Percentage Performance of Spot Gold versus S&P 500 Total Return Index
(3/31/2000-4/30/18)

Source: Bloomberg.

Time Frame and Entry Point Matter

As shown in Figure 2, eighteen years is an awfully long time for fully-invested March 2000 investors to remain significantly under-compensated for having born the incrementally higher risks of holding equities over gold. Looking forward, our assessment of both market fundamentals and mathematical probabilities suggests risk-adjusted prospects for holding equities over gold are even more challenging today than they were eighteen years ago.

In short, time frame and entry point DO matter, especially when financial asset valuations are as elevated as they are today.

Second, bullion's fixed price through August 1971, and domestic illegality through December 1974, demonstrate why Mr. Buffett's portrayal of gold and equities as competing **investments** is a bit off the mark. President Roosevelt criminalized private gold ownership in May 1933 because U.S. citizens and corporations were hoarding gold over U.S. dollars as preferred **money**. To halt the developing bank run on U.S. gold reserves, FDR's Proclamation 2039 (3/6/33) declared a one-week banking holiday and decreed "no such banking institution or branch shall pay out…any gold or silver coin or bullion." FDR's Executive Order 6102 (4/6/33) then confiscated all gold held by U.S. citizens at $20.67 per ounce, about nine months before the Gold Reserve Act of 1934 (1/30/34) devalued the U.S. dollar 69% versus the gold which FDR had just confiscated.

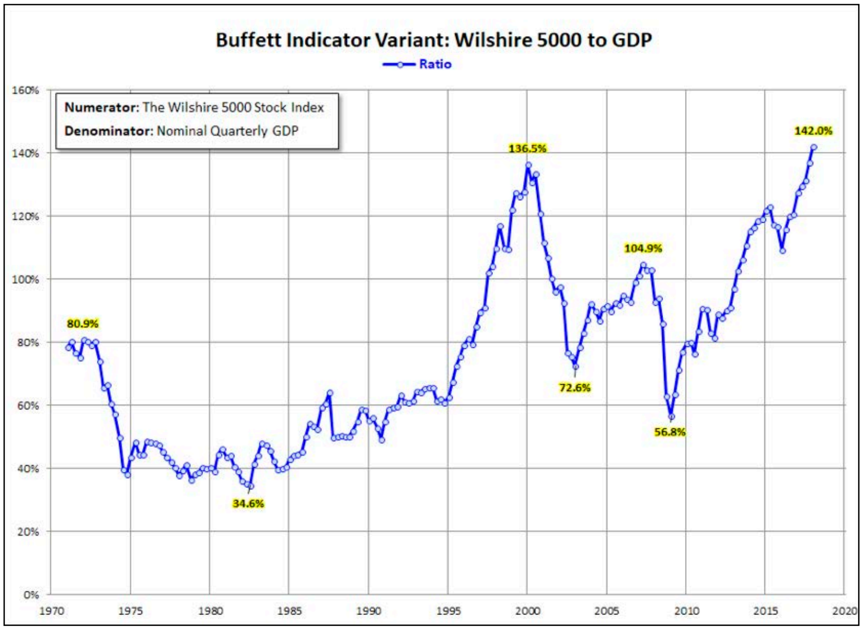
As with gold's outperformance of stocks since 2000, gold's timeless function is to protect wealth when currency is failing its role as a stable unit of account.

Gold at Berkshire?

Ironically, Mr. Buffett's harping about gold being a **non-productive asset** may be distracting him from the appreciation of gold's portfolio utility as a **non-correlating asset**. For example, many of Mr. Buffett's billionaire brethren, such as Messrs. Dalio, Soros, and Singer, are less hung up on gold's lack of cash flow, while coveting gold's unique ability to remove virtually unlimited amounts of investment capital from the vagaries of treacherous market conditions or a shaky financial system. Mr. Buffett's gold-as-brick narrative shortchanges gold's formidable capability as a portfolio diversifier. Because bullion is uniquely uncorrelated to traditional asset classes, gold provides empirical protection against portfolio drawdowns, without onerous fees or lockups. As perhaps the world's most sophisticated purveyor of reinsurance, we would think Mr. Buffett might at least concede gold's proven utility as **portfolio insurance**.

By most historical standards, current bull markets for U.S. financial assets are substantially long in the tooth. In a 2001 Fortune Magazine interview, Mr. Buffett cited the ratio of U.S. equity market-cap to GDP as "probably the best single measure of where valuations stand at any given moment." Since then, the Buffett Indicator has become a popular tool in evaluating where equity indices stand versus historic valuation cycles. Perhaps the most straightforward variant of the Buffett Indicator is the simple ratio of the Wilshire 5000 market-cap to U.S. nominal GDP.

Figure 3: Buffett Indicator: Ratio of Wilshire 5000 Market-Cap to GDP (1971-Q1 2018)



Source: Advisor Perspectives.

As shown in Figure 3, above, the Buffett Indicator now stands at a fresh all-time high of 142.0% of GDP. With stock valuations this stretched, many money managers are wrestling over whether prudence dictates reducing equity exposures. As blasphemous as the concept might first appear, we would suggest that at this point in the market cycle, a gold allocation could improve risk-adjusted returns **even for Berkshire Hathaway!** At year-end 2017, Berkshire's balance sheet was dominated by three investment categories: $182 billion of public equities, $84 billion of short-term Treasury bills, and $32 billion in cash. Messrs. Buffett and Munger have long telegraphed the opportunistic utility of maintaining Berkshire's $116 billion short-term hoard. In our estimation, however, redeployment to gold of just 50% of Berkshire's $32 billion cash balance would help to insulate Berkshire's portfolio from potential equity-market disturbances, whenever they might occur.

For perspective, gold is negatively correlated to Berkshire's two main portfolio components. Trailing 2-year correlations between spot gold and the S&P 500 Index now stand at **negative 13.7%**, and between gold and 4-week T bills at **negative 24.7%**. While total freight to Berkshire (of foregone interest and bullion carrying costs) might approximate 1.5%, we view these costs as eminently reasonable in today's uncertain investment landscape. Additionally, the timing involved in hedging a portfolio with bullion is more forgiving than employing futures, options or derivatives because bullion eliminates time-decay premiums.

Gold as a Portfolio Hedge...Even for Berkshire Hathaway

As strong as Mr. Buffett's capital allocation and equity selection have been over the years, there have certainly been instances in which deteriorating market conditions signaled the prudence of active risk reduction. At these junctures, a portfolio allocation to gold could have added to Berkshire's portfolio the stabilizing influence of a non-correlating asset.

For example, once the dust settled on Mr. Buffett's $5 billion preferred bailout of Goldman Sachs in September 2008, Berkshire shares proceeded to tumble 31.9% in the four months through February 2009. During the same four-month span, spot gold surged 30.1%. While we are not implying gold's contra-performance in early 2009 could have been effectively timed, we are suggesting that the financial crisis was a compelling backdrop for a sustained bullion commitment. **Indeed,**

a consistent portfolio allocation to gold would have added considerable value to Berkshire's balance sheet throughout the first two years of the financial crisis, during which gold rallied 75.2% (from $673.40 on 8/31/07 to $1,179.60 on 11/30/09).

While we recognize Mr. Buffett's philosophical principals relegate probabilities of Berkshire employing a gold hedge fairly close to zero. On the other hand, individual investors employing gold as a portfolio hedge, in complement to their Berkshire holdings, makes inordinate sense to us.

It's Bigger than Jewelry, It's the Story of Your Life

Beyond simple portfolio mechanics, we cannot resist mentioning that Mr. Buffett's chiding of bullion as a non-productive asset gives short-shrift to gold's everyday function as jewelry. Indeed, in its popular form as coveted personal adornment, gold is a natural fit with Berkshire's high standards for consumer preference and customer experience. Gold products from Berkshire's Borsheim's franchise certainly reflect Mr. Buffett's business principles to "surprise and delight customers."

Figure 4: Borsheim's Box

Source: Berkshire Hathaway.

One of Mr. Buffett's favorite vignettes about See's Candy (a Berkshire holding for over 40 years) is that men don't mind paying See's premium price because the **See's box** earns them a delighted kiss from their partner. "See's Candy means getting kissed," Mr. Buffett loves to say. With all due respect to peanut brittle, we would suggest the **Borsheim's box** (Figure 4, above) inspires responses which might make candy-lovers blush! In defense of the yellow metal's productive attributes, the love trade is the oldest and most recession-resistant business on earth, and a timeless franchise like Borsheim's serves Berkshire's portfolio well as a luxurious complement to workhorses such as Jell-O and Velveeta.

Fat Pitch or Blindfold?

A central tenet of our gold investment thesis is the progressive decoupling of paper claims (stocks and bonds) from underlying productive output. The Fed's Q1 2018 Z.1 Report discloses that U.S. household net worth has now climbed $43.9 trillion during the past nine years (from $54.8 T to $98.7 T) during a span in which GDP has expanded only $5.6 trillion (from $14.1 T to $19.7 T). We are quite certain no society can increase wealth eight times faster than output forever. Further, the Buffett Indicator suggests the direct ratio of U.S. stock prices-to-GDP is overdue for significant downward adjustment.

Especially in a post-QE world, gold remains a productive portfolio holding whenever probabilities favor a downward recalibration of enthusiasm for U.S. financial assets.

Pay Attention to What Buffett Does, Not What He Say

In his opening monologue at Berkshire's annual meeting, Mr. Buffett preached the wisdom of long-term equity ownership. "There's no comparison to trying to jump in and out of stocks," he warned his shareholders. In following the careers of Messrs. Buffett and Munger, however, we have generally found it constructive to pay more attention to what Berkshire is doing, and less attention to what its executives may be saying in public. In recent quarters, Mr. Buffett appears to be following a distinctly different path with Berkshire's cash than that which he advocated to his CenturyLink audience. What could be motivating Mr. Buffett to maintain such enormous short-term liquidity ($116 billion, now growing $500 million per week)? Well, if his eponymous market indicator holds much personal significance, it is likely Mr. Buffett recognizes that probabilities for a significant market correction continue to climb.

Berkshire's balance sheet now commands $702 billion of assets with tangible book of $271 billion. No matter how high quality the assets, nor how understated the book, Berkshire is no longer immune from the contemporary math of market shocks. It is one thing for us to suggest that the size of Berkshire's book, coupled with eight years of asset inflation fueled by QE and ZIRP, have combined to link Berkshire's prospects more closely to Fed liquidity programs than ever before. It is quite another for Messrs. Buffett and Munger to acknowledge this connection from the CenturyLink stage, which is precisely what Mr. Munger did in addressing Question # 21 (related to Treasury issuance):

> "It was unfair [for the Fed] to reduce savings rates as much as they did, but they had to do it to fight the Great Recession appropriately. It was weird, and in my lifetime it only happened once, but it benefited all the people in this room with the rise in asset prices including Berkshire stock. We are all a bunch of undeserving people and hope to continue to be so."

More than anything else, Berkshire's business model has always been based on the **rational deployment of capital**. Mr. Buffett popularized the notion of the fat pitch—letting the vast majority of investment opportunities pass by, awaiting only the perfect combination of valuation and business conditions before taking a swing. Unfortunately, eight years of ZIRP and QE have clouded visibility even for batters with eyes as good as Mr. Buffett. Zero percent interest rates destroy time preferences and jam the synapses of capitalism so completely that rational capital deployment becomes nearly impossible. Today, no one can properly evaluate what true demand is for anything. **Through no fault of their own, Messrs. Buffett and Munger have been stripped of their comparative advantage in recognizing the fat pitch**. In the absence of a touchstone of stable unit of account (hard money), all investment decisions are more akin to swinging blindfolded.

When time preferences are extinguished, corporate behavior and decision-making begin to trend toward average. There is no longer sufficient payoff to reward excellence because marginal returns compress towards the marginal costs of ZIRP. **Corporate focus becomes today over tomorrow**. For the vast majority of businesses, the trend to mediocrity can be masked—plummeting capex and productivity are dressed up by mechanical share repurchase and deceptive "strength" in per-share earnings. But for truly exceptional American businesses, the only option is involuntary acceptance of relaxed standards.

Throughout his career, Mr. Buffett has always been known to champion integrity with inspirational quotes such as:

> "It takes 20 years to build a reputation and five minutes to ruin it."
>
> "We can afford to lose money—even a lot of money. But we can't afford to lose reputation—even a shred of reputation."
>
> "Lose money for the firm, and I will be understanding. Lose a shred of reputation for the firm and I will be ruthless."

No event epitomizes the erosion of ZIRP-era corporate standards more poignantly than the Wells Fargo fake-account scandal. We are certain that Messers. Buffett and Munger are disheartened that one of America's iconic financial institutions succumbed to pressure to create profits in the ZIRP world of compressed returns. Their exasperation was evident in answering Question # 7 (relating to the Wells Fargo new-account fraud):

> Mr. Buffett: "We can't have 387,000 employees and think everyone is behaving like Ben Franklin…All the big banks have had troubles, and I see no reason why Wells Fargo, from an investment or moral standpoint, is inferior."
>
> Mr. Munger: "Wells Fargo will be better going forward. Harvey Weinstein has done a lot for improving behavior too."

Truth be told, we believe the quality of Berkshire's business is unparalleled, the acumen of Berkshire management is second to none, and the strength of Berkshire's balance sheet is formidable. Nonetheless, for great investors like Warren Buffett and Charlie Munger to be forced to rationalize morally bereft behavior at our nation's third largest bank speaks volumes about how much effort it will require to rekindle American exceptionalism across the full spectrum of corporate America. We expect the process of revitalizing functional time preferences and rational capital allocation, after so many years of textbook malinvestment, will prove both long and arduous.

On 5/7/18, Mr. Buffett and Mr. Munger joined the inimitable Becky Quick on a CNBC set to field questions about their recent, less-than-flattering characterizations of bitcoin as, "rat poison squared," and "turds." After a few minutes, Mr. Buffett interrupted the conversation by observing in exasperated tone:

> "If people react when you criticize their investment — if they get mad — they're gambling. If somebody criticizes Apple or Berkshire, we like it. I mean, if the stock goes down we'll buy more of it because we don't care—we don't feel it has anything to do with it. But if we criticize something that they own because they only want it to go up tomorrow, they feel we are hurting them and therefore they get very upset about it. If they really liked what they own, what difference would it make?"

We agree completely with Mr. Buffett's sentiments. During the past 17 calendar years, we have encountered countless arguments against gold's investment relevance, yet gold is the only global asset to have increased in 14 of those 17 years. Luckily, our tensile strength remains high, and our analysis continues to suggest that gold remains a productive portfolio asset.

We thoroughly enjoyed our review of the 2018 Berkshire Hathaway shareholder meeting and we look forward to comparing notes again with Mr. Buffett and Mr. Munger next May.

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[1]The S&P 500® Index represents 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion; it is viewed as a leading indicator of U.S. equities and a reflection of the performance of the large-cap universe.

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