

QUANTUM ADVISORS, L.L.C.

Investment Management

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*“Nobody goes there anymore;
it’s too crowded”*

—Yogi Berra

Old Dogs, New Tricks and Why We Own Berkshire Hathaway

I recently attended the Grant’s semi-annual investment conference which is sponsored by the *Grant’s Interest Rate Observer*. The conference is attended by some of the finest (and most skeptical) investment minds in the country. The speakers are leaders in their respective fields of expertise and range from well known titans of industry to lesser known presenters of thoughtful and provocative ideas. In deference to the speakers, but primarily for the sake of our money, I take a lot of notes.

A theme seems to be developing and it is complex, yet it is as loud and clear as a bell. The messages that seem to resonate with increasing frequency are that, we are at an inflection point economically, that in the markets there is a widening gap between perception and reality and most importantly, the smart money has left the building. For the sake of brevity, let me explain the last point. I hope to follow up with more technical economic comments in the coming weeks.

I had the good fortune to attend two noteworthy presentations. The first was by T. Boone Pickens, oil man, champion of shareholder rights, and most recently, natural gas speculator. The second was by Martin Whitman, Chairman and CIO of Third Avenue Management and widely recognized deep value investor.

There is a clarity of message when it is delivered by a 74 year old billionaire who has nothing to prove. Those who ignore the message, do so at their own peril. When asked why the rig count was so low as a segue to why oil service stocks were apparently undervalued, Boone Pickens replied succinctly, “Cause you can’t make money drillin’ anymore.” Refreshing candor was once again served by Martin “Marty” Whitman, who at 78 years old, with an affable nature that would belie the fact that he is one of the world’s most brilliant financial minds, started his lecture with the simply eloquent, “Let me tell you how I got rich.” It seems as though Mr. Whitman has a special affinity for distressed debt these days. With a twinkle in his eye he described the joys of acquiring the debt of distressed companies at pennies on the dollar and then proceeded to give an MBA level lecture on the underlying traits of distress investing. This apparent fascination with asset classes other than US equities at the supposed end of a three year bear market made me

think of another “adult” investor who has steered clear of “the asset class of choice” for some time now.

Why We Own Berkshire Hathaway

Most of you are aware that we hold shares of Berkshire Hathaway in our *Quantum Diversified* and *Quantum Balanced* portfolios. Many of you are also aware of the fact that I have read practically everything written by and about Warren Buffett. His approach to investing has shaped my investment philosophy profoundly. Given Mr. Buffett’s visibility in the news of late, you will please forgive any redundancy.

Warren Buffett got rich investing in US equities, but in recent years the Chairman of Berkshire Hathaway has found the domestic equity markets to be overpriced and has searched for more fertile ground in the way of private equity, distressed debt, natural gas infrastructure and more recently, food distribution through the newly acquired McLane Co. and oil and gas production in China. The essence of today’s message is as follows... *If the likes of Boone Pickens, Martin Whitman and Warren Buffett, those with the investment acumen and resources necessary to exploit the best ideas, are searching for returns in places other than the US equity markets, why is everyone else getting so excited about them?*

Irrespective of our less than lukewarm view of domestic equity market valuations (which we have mentioned on occasion), we have tried to allocate assets in our underweighted large cap domestic equity position to those companies where we feel the management has the resources and the ability to deploy capital efficiently and profitably. In the case of Berkshire we believe the Chairman has exhibited the consistent ability to seek out the inefficiencies in the market place and exploit them through swift action. In these days of daily reports of corporate malfeasance, Berkshire meets our prerequisites of conservatism in financial accounting and transparency in financial reporting. Given the decline in the value of the dollar recently there may be an argument that multinational companies like Gillette and Coca Cola will benefit from currency exchange gains as well as enhanced competitiveness. Berkshire has major stakes in both companies.

One risk inherent in the ownership of Berkshire however, is that the Chairman is 72 years old and from what I understand, his diet is not what one would call macrobiotic. Another is the subject of derivatives and how they may impact the insurance industry. Berkshire Hathaway enjoyed record earnings last quarter in no small part due to improvement in its insurance businesses which make up in excess of forty five percent of gross revenues. While a detailed discussion of derivatives is not a topic within the scope of this letter, generally speaking, derivative contracts are financial instruments designed to reduce risk at a cost or assume risk at a profit. The size and type of the contracts are limited only by the imagination of the creator and the needs of the contractees or counterparties to these instruments. The repercussion of unforeseen and thus unhedged derivative risk is a matter that may be faced by some insurance/financial companies in the future. Derivatives are considered “financial weapons of mass destruction” by Buffett and “an increasingly important vehicle for unbundling risks” by Federal Reserve Chairman, Alan Greenspan. Whichever definition you subscribe to, it is not unfair to say that some counterparties to these instruments have PhDs in mathematics and the strike of a cobra, while others have, well, low golf handicaps and a history of not sweating the details. Yet again, there are

counterparties with excellent risk management skills but really bad luck. Any combination of the aforementioned parties can lead to chains of events that have in the past and may in the future, leave someone “holding the bag”, if you will. Some very smart people believe the effects of said bag holding will show up on the financials of companies in the insurance industry. Berkshire has taken material charges related to derivative contracts inherited as a result of the acquisition of General Re Securities, and Buffett believes that he has significantly reduced Berkshire’s exposure. Berkshire is in the process of unwinding its derivative contracts and will eventually exit a business that Buffett likens to Hell, “*Easy to enter but almost impossible to exit.*” However, Buffett believes that those who buy insurance will pay a premium to those insurers that will actually have the ability to pay on the claims they are paid to insure. He eschews the idea of capturing market share at the expense of profitability and his philosophy of a “no called-strike ball game” is more a product of his Midwestern principles than his business school education and ensures that Berkshire will only entertain business where it can receive an acceptable return on capital. Berkshire had \$19.4 billion in available cash on its balance sheet as of March 31.

Given the uncertainty in the world and the world markets, we think it is shortsighted to pay high multiples on opaque earnings just because interest rates are currently at historic lows. We believe that it is a better long term trade to invest in a company that increases its intrinsic value at more than twice the rate of the annual percentage change in the price of the S&P500. Berkshire has increased its book value at an annual rate of better than 22% over the last 38 years.

Our view is that, in the future, price earnings multiples will contract. There is too much of a premium being paid to companies listed on Wall Street relative to those that operate on Main Street. As hard as it seems to believe today, at some point, momentum investing will die a certain death as more money managers treat their equity investments as ownership interests rather than lottery tickets. The equity markets will not remain stuck in a trading range forever. Companies that increase their intrinsic value at a rate faster than the market will attract capital.

In today’s environment, if one must have some exposure to domestic large cap equities, it is best to hitch the wagon to an asset class agnostic, who is both an effective and nimble allocator of capital. We can’t think of a better choice.

Best Regards,

John J. Hughes

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