

## Second Quarter 2009 Commentary

### MID YEAR UPDATE

Global capital markets continued their recovery in the second quarter of 2009 as the Dow, S&P 500 and NASDAQ all rose 15 to 20 percent during the quarter.

For the year, the S&P 500 has risen by 3.26% and we are happy to report Berkshire equity portfolios have eclipsed that return by a fairly-wide margin. We attribute our out-performance to ownership of consumer cyclical, technology, financial and telecommunications stocks as well as the avoidance of commodity and energy stocks which had a big run in the middle of the quarter, but retreated sharply in June.

Market participants have surmised that the absolute worst of the crisis is over and the depression-free fall scenario for the world markets is now off the table. We share this view but, more importantly, believe that stocks were simply too cheap to ignore at 10 times earnings and 1.5 times book values in the lows set in March. This rally, also fueled by copious global liquidity, has started to fatigue of late, as the so-called "green shoots" crowd begins to realize how nascent this recovery really is and that it will be a long way back to peak economic activity.

But there have been enough real events to justify the rise in stock prices and continued optimism.

The first large market positive happened as the market was generally satisfied with the results of the bank "stress tests." A few institutions needed to raise capital but fears of bank nationalization quickly subsided.

The market has also displayed a genuine appetite for risky assets. Credit markets showed signs of life, junk bonds have had one of their best quarters ever and banks and companies were even able to capitalize on higher prices by selling equity capital, something which would have been virtually impossible in the early parts of the first quarter 2009. Some banks are also paying back TARP funds early.

Emerging markets, also a good proxy for risk appetite rose sharply off extremely low levels. Remember, these markets declined nearly 70% in 2008. They have risen roughly 70% in 2009,

yet still leave the investor with roughly fifty cents on the dollar.

Even home sales have picked up as record affordability has helped generate an up tick in real estate activity, putting markets closer to settling at equilibrium levels.

As for the manufacturing sector, proliferation of the terms "less bad" or "second derivative" (meaning the rate of descent has slowed) encouraged investors. In some cases, we have seen outright up ticks in the data as some companies begin to rebuild inventories. It remains less clear how sustainable this rebuild is, or how the durable the ensuring demand will be.

On the negative side, the dismal employment report released just before the end of the quarter seemed to mark a meaningful change in sentiment and markets have been on the retreat since.

It will be difficult for housing to stabilize if the economy keeps losing 450,000 jobs a month. Foreclosure and delinquency rates continue to flash warning signs as prime mortgages, Alt-A mortgages and even mortgages which were modified show more deterioration.

The treasury market also endured large gyrations during the quarter. In late May, yields on U.S. Treasuries began to surge from nearly 3.30% to 4%. Mortgage rates followed suit which threatened to intensify an already disastrous housing market. Some attributed the rise in rates to a healthy flight away from safe havens and into stocks, but the surge started around the time the government announced large increases in government debt, jeopardizing the U.S. AAA rating.

But, despite fears that foreign investors such as the Chinese would turn sour on treasuries and seek other investments, the auctions went extremely well, particularly as poor economic data rolled in. Investors once again concluded the economy was still too weak to generate any meaningful inflation - at least for now.

As of early July, direction and sector leadership remain erratic as investors calibrate their view and no clear trend or consensus has been formed. However, the aforementioned em-

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 20 years, we have successfully implemented highly focused equity, fixed income and balanced portfolios. Our guiding principle is a belief that success is achieved by combining rigorous, well crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference...Diligence, Integrity and Focus.

### IN THIS REPORT

- Global capital markets continue recovery
- Berkshire equity portfolios enjoy strong second quarter, year to date performance
- Economic positives include: improving financial sector, increased risk appetite, up-tick in housing transactions, manufacturing/inventories
- Economic negatives include: unemployment, strained consumer balance sheets, continued mortgage delinquencies, high government spending and a stricter regulatory environment
- Inflation analysis: structural forces at work counteract inflationary bias in some monetary aggregates
- Fundamental valuation work indicates 900 on S&P should prove durable floor; fair value closer to 1050

**Financial planning note:** mortgage rates nationwide have fallen below 5%, making it economically profitable for many property owners to refinance. Feel free to call us if you need help assessing if it is feasible for you.

ployment released in late June has clearly knocked the wind out of the sales of the green shoots and reflation crowd, as some of the most cyclical stocks in the economy (materials, energy, consumer discretionary) have retreated sharply.

## THE OUTLOOK FOR INFLATION

One of the most important factors that will shape the investment climate for years to come is the direction and rate of inflation. We believe that it is generally a consensus view that inflation is likely to be a problem going forward.

On the surface, it appears valid – the government is running large deficits, the dollar is weakening and the Fed is pursuing an ultra easy monetary policy by printing money. Of course, we are concerned by this and all of its ramifications: falling P/Es, loss of purchasing power, the effect on bond portfolios, etc.

However, the argument is not nearly as one sided and more analysis is required, as the rate of inflation is driven by a host of factors.

On the broadest level, it is hard to surmise there will be much inflation when there is so much slack in the economy and activity is so moribund.

The cost of labor is one of the most important determinants of the overall price level. The unemployment rate continues to rise, approaching double digits, and the bargaining power of workers to raise wages is extremely low. Wages are falling at an alarming rate.

Capacity utilization indicates how much our economy can produce versus what it is actually producing. Right now, we are running at 68% of our productive capacity (an all-time low) so there is a long runway to any type of shortages which would be inflationary.

The easy credit policies of 2001-2003 led to a structural building boom: homes, condos, casinos, steel plants, office complexes, shopping malls, etc. which were all built on growth assumptions that failed to materialize.

Many of these assets were financed with high levels of debt and, now, as these projects prove unviable, the assets will need to be sold at distressed prices to reduce debt, creating a powerful deflationary force. This is likely to exert itself until enough capacity is taken out and equilibrium is restored.

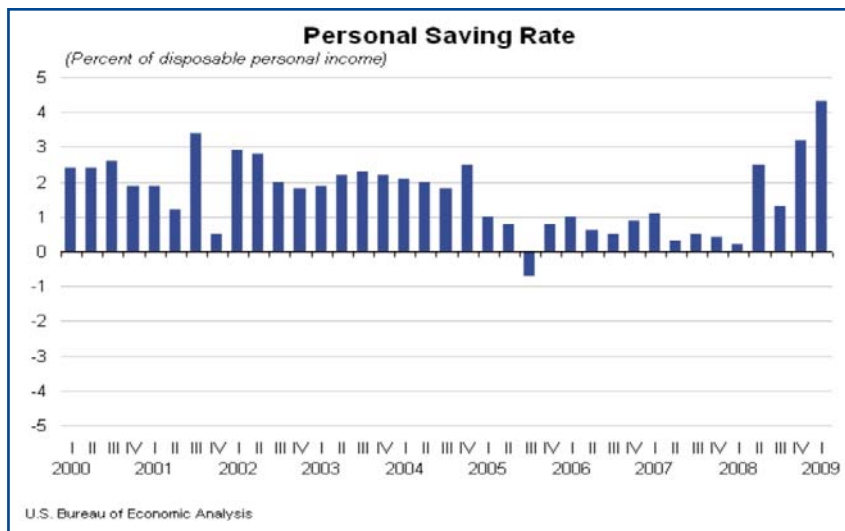
Commodity prices are also an input cost, but are far less important than labor. During the credit boom, commodity producers expanded plant capacity right at the time demand was peaking at artificially high levels. Now, there is excess capacity in the system which will take time to reduce and will, most likely, continue to exert downward pressure on prices.

This excess capacity and deflation is showing up in the latest data. In the fourth quarter 2008 and first quarter 2009, prices as measured by the GDP deflator fell by 3.9% and 1%, the largest two-quarter decline ever recorded.

Seeing this, the Federal Reserve was quoted as saying, “The committee sees some risks that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.” Translation: Dangerous deflation is still a risk.

Seventy percent of our nation’s Gross Domestic Product is driven by the consumer. For years, the growth in consumption outpaced incomes and personal balance sheets exploded with debt. This debt-fueled consumption had an enormous effect on our growth and may have artificially inflated our GDP growth by 100%. Said differently, if we had a normal savings rate, GDP growth would have been 1.5% instead of the 3% reported in 2006.

Now that the stock market has fallen, home prices have dropped precipitously and job loss is feared. U.S. household wealth has declined nearly \$13 trillion in wealth, yet the debt remains and the return of high levels of consumption seems unlikely. The rate of savings is skyrocketing (through debt repayments) of late and it will take years of asset growth, income growth and just outright saving for our system to get back to normal leverage ratios and restore equity in the household balance sheet. For many, this replenishment may only come from permanent changes in spending patterns.



And while it’s bad in the U.S. as now we must “go without,” it’s even worse for the overseas manufacturing and emerging markets who built high capacity for the now-fallen binging U.S. consumer client.

Jeremy Grantham, who runs GMO Partners, in his sardonic, yet spot-on, insight said it best: “We in the U.S. will have to buy two fewer teddy bears for our already spoiled 4-year-olds. The third TV will be postponed as will the second or third car. Woe is us. China, on the other hand, will close teddy bear factories and send its workers back to the marginal or sub-marginal jobs in the countryside. The real world delivers real pain. Even worse in some ways are the Germans and Japanese who make and sell the equipment that builds the teddy bear factories, no more of which will be needed.”

To a large extent, the world is a supply chain to the U.S. consumer as the U.S. consumer alone is nearly three times the size

of China's entire economy. If we aren't consuming, other economies will have difficulty maintaining the rapid growth they have enjoyed in recent years. Faced with high fixed costs, excess capacity and weak demand from its deleveraging U.S. customers, prices for goods from these overseas markets are likely to stay low.

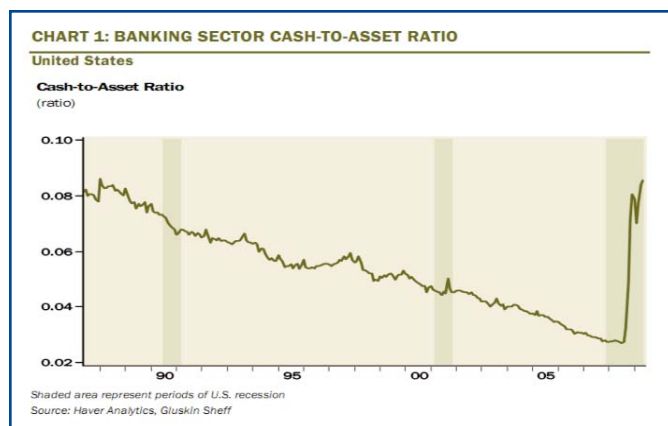
Demographics will also play a part in the new frugality. The large number of retirees who had high-spending rates in the wake of rapidly-declining markets will likely cut back, maybe even sell non essential assets putting more pressure on prices. Those saving to satisfy their own "retirement liability" have been set back years in some cases. Instead of being able to fund this liability with relatively small cash contributions and getting the rest from appreciating assets, investors may need to put in more dollars, which is another negative for an economy dependent on consumption.

No discussion of the inflation would be complete without a discussion on the money supply. The popular consensus view is that our dollar is being assaulted by the Fed simply printing more money out of thin air in an attempt to reflate the economy (which would deflate everyone's debt burdens). This concern is valid. Of course, if you thought you had the last original rookie card of your favorite sports star, the price would go down if another million of them miraculously appeared out of nowhere. So, the monetary purists believe if you print more money, the value of each dollar falls and prices rise.

To battle deflation and economic weakness, the Federal Reserve is flooding the market with liquidity by increasing bank reserves through its various open market facilities and swap lines. The thinking is that injecting this liquidity will spur lending, but some feel the Fed is going overboard, will not be able to reverse the process, and the excess money will create high inflation.

Estimates of the Fed's balance sheet show the monetary base (currency + reserves at the Fed) sheet has expanded to nearly \$2 trillion. That number IS large, but also needs to be put in other context. First, we are seeing that financial institutions are using the excess liquidity to rebuild their balance sheets as opposed to multiplying it into more credit in the system.

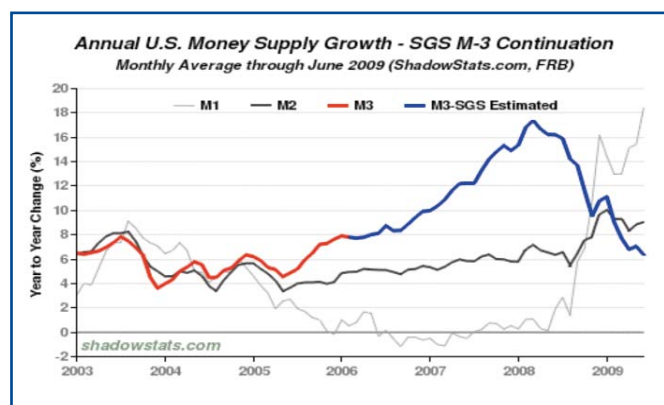
The chart below shows that the cash to asset ratio at banks has risen markedly.



The excess liquidity is only inflationary if banks multiply it into more loans that chase too few worthy projects. So far this hasn't happened and it could quite possibly be that there is no need for loans as we deleverage, shed assets and pay down debt (as opposed to taking on new debt).

But the public sector is only one source of credit in the economy. While the public sector is pumping the system full of money, the much larger private sector, is reducing credit at an even faster rate.

Banks are pulling credit lines, tightening lending standards and requiring higher down payments, all factors that contract total credit. It is estimated that the private sector reduced \$14 trillion in credit over the past year and the government is desperately trying to replace what has been taken out. Broader measures of the money supply such as reconstructed M3 data, show a very different trajectory of the money supply.



The source of the credit also matters greatly as banks are only one component of the private system of credit creation. The securitization market (the process of turning loans into bonds that can be sold so new loans can be created) accounted for nearly \$10 trillion in lending in the last years of the credit bubble. This market has been absolutely decimated at the current time and shows little vibrancy. It makes sense that, as the securitization market was one of the culprits fueling the credit bubble, its decimation would be behind a large contraction. So while the two trillion by the government (and counting) on the surface seems inflationary in relation to the amount of credit being pulled out and the sheer size of our existing debt base (\$25 trillion or so), the increase in money supply by the Fed may not be inflationary.

We find ourselves in a relative minority position on the inflation issue, but are obliged to look beyond the headlines. At the same time, we realize inflation expectations matter greatly and can get baked into asset prices in a hurry. Perception can become reality. But after an expansive analysis of all the factors that affect the rate of inflation, we conclude there are plenty of structural deflationary forces at work that accompany a deleveraging cycle which will keep inflation muted for some time.

### Portfolio Positioning

How does this research affect how we are positioning portfolios?

First, we believe that while a recovery is at hand, it will be very lumpy, muted and erratic. After all, if a record debt binge produced only a 3.0% GDP growth in the so-called good years of 2004-2007, what will growth look like with an equally veracious credit contraction? The government pulling otherwise productive capital out of the private sector (through taxes and borrowing) for social programs and regulatory policies which are not friendly to prosperity also makes the case for below-average growth.

Markets should continue to benefit from the large amounts of liquidity in the system and more stable fundamentals but, most importantly, attractive valuations. Our analysis indicates a minimum value of the S&P around 900. A more likely, but still conservative, estimate of intrinsic value is just north of 1050.

Our inputs account for an already written-down book value, below average margins (as measured by a below average 12% return on equity) and a discount rate that indicates high levels of risk aversion. Stock prices which seemed so washed up in March on total pessimism now have increased to the point where fundamentals will need to deliver.

The indices enjoyed a broad-based rally with low-quality stocks delivering outsized gains, but now the market is likely to get far more discriminating. Investors will likely not have the luxury of broadly rising indices and will need to be selective. That said, the average stock in our portfolio appears to be 50% undervalued but is focused on sectors and names that either avoid the most cyclical areas of the economy (materials, energy, commodities), have a unique secular growth profile (technology, selected health care, growth industrials) or are simply incorrectly undervalued by the market.

We remain fluid in our approach in the wake of changing markets and are constantly evaluating improvements to the portfolio. Our bench of companies under evaluation is quite large, as the declines in the market have created plenty of opportunities that fit our parameters.

Thank you for your continued participation in our strategy.

#### *Commentary Disclosures:*

*Investment Risk: All investments are subject to risk, including possible loss of principal. Because Berkshire Asset Management, LLC's investment style expects to hold a concentrated portfolio of a limited number of securities, a decline in the value of these investments would cause the portfolio's overall value to decline to a greater degree than a less concentrated portfolio. Our equity investment style may focus its investments in certain sectors or industries, thereby increasing the potential vulnerability to market volatility.*

*The views expressed in this commentary reflect those of Berkshire Asset Management, LLC (Berkshire) as of the date of the commentary. Any views are subject to change at any time based on market or other conditions, and Berkshire disclaims any responsibility to update such views. These views are not intended to be a forecast of future events, a guarantee of future results or investment advice. Because investment decisions are based on numerous factors, these views may not be relied upon as an indication of trading intent on behalf of any port-*

*folio. The information contained herein has been prepared from sources believed to be reliable, but is not guaranteed by Berkshire as to its accuracy or completeness. Past Performance is no guarantee of future results.*

*References to particular securities are intended only to explain the rationale for the portfolio manager's action with respect to such securities. Such references do not include all material information about such securities, including risks, and are not intended to be recommendations to take any action with respect to such securities.*