

Equity Investment Approach

At year-end, it is our standard practice to review our Equity Investment Philosophy. Below is our explanation of the process we use to evaluate companies for investment.

We search for companies earning a *high and sustainable* return on shareholders' equity. In our opinion, return on equity (ROE) is the best financial yardstick to identify, evaluate and compare the desirability of investments. Through a comprehensive and careful analysis of a business's ROE, we strive to understand the dynamics of that business's profitability. This evaluation helps us determine a company's ability to generate future growth in profits and free cash flow, which is what we believe, ultimately determines future stock prices.

While our analysis of ROE is predominant in our research, other characteristics we look for are as follows:

- Simple businesses that are easy to understand and operate.
- Stable sales and earnings growth.
- Abundant free cash flow and a self-funding balance sheet.
- A company with a low cost of production. A low cost producer in an industry puts a company in an enviable position to expand its business during periods of economic difficulties.
- A management team that has demonstrated the ability to increase shareholder value over the years. In general, we view management with a meaningful equity ownership of the common shares as a significant positive. Through a substantial equity ownership, management has further incentive to create value for shareholders since their financial interests are aligned with shareholders. In addition, we evaluate management's allocation of capital, i.e., acquisitions, dividend policies and stock buybacks.
- Businesses that possess an enduring competitive advantage. Our notion of competitive advantage includes:
 - a. Significant bargaining power relative to customers and suppliers.
 - b. A high barrier of entry.
 - c. A small number of product substitution opportunities.
 - d. Little competition.

Importantly, we apply a five-year time horizon in evaluating a company's fundamental prospects. This long-term view is a key to understanding our equity discipline and demonstrates how we differ from our competitors. We do not feel anyone can consistently predict short-term results for a company and profit from it. We will resist selling a superior business because of an external event outside the company's control such as a poor macro-economic environment or change in stock market sentiment. Also, we will look beyond the occasional short-term solvable problem such as a quarter of poor earnings. We view these lapses and the inevitable stock price decline as opportunities to buy. Our focus is on the prospective earnings and free cash flow capability of the company.

Once an excellent company is identified and we have confidence in its future prospects, we will attempt to appraise the company's intrinsic business value. This estimate is based on the present value of the company's expected future free cash flow. As analysts, we determine the value of a business while the equity market, with

all its idiosyncrasies and quirks, determines the daily market quotation of the stock. The best description of this notion is captured in the Benjamin Graham classic, the *Intelligent Investor*, first published in 1949. To quote:

“Let us close this section with something in the nature of a parable. Imagine that you own a small share of a private company that cost you \$1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects, as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.”

“If you are a prudent investor or a sensible businessman, will you let Mr. Market’s daily communication determine your view of the value of \$1,000 interest in the enterprise? Only in case you agree with him, or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.”

Therefore, if the stock trades in the market at a wide enough discount to our estimate of a company’s intrinsic business value, we will purchase the shares. We view this discount as a margin of safety. Obviously: the wider the margin—the greater the opportunity. We do not view price volatility as risk. We view the size of the margin of safety as our measure of risk. Our constant focus on company fundamentals and intrinsic value, coupled with an extended time horizon, provides us with an opportunity to generate superior rates of return over time.

A significant component of our equity management approach is our policy of limiting our portfolio’s stock holdings to 25 to 35 companies. Many other investment management firms and mutual funds may keep as many as 50, 100 or more stocks in a portfolio at one time. Our focus is to perform meaningful research on a limited amount of issues, to gain an adequate understanding of each business, while maintaining reasonable diversification. This knowledge increases our comfort level and allows for a meaningful ownership position in the company. However, by concentrating our holdings, our quarterly results will often be unlike the return of market indices. We believe our method is more likely to secure higher long-term rates of return, and that excess diversification serves to limit returns.

In summary, we look for quality businesses that are easy to understand. We buy their shares at a discount to our estimate of intrinsic value with the intention of long-term ownership. We limit the number of issues in the portfolio to a manageable number and sell only when the stock price exceeds the company’s intrinsic value or when we feel we erred in our judgment. We accept the fact that our approach will from time-to-time underperform market indices measured over shorter time periods. However, we think our approach to investing keeps portfolio turnover low and will provide higher returns to our clients over the long-term.

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