BERKSHIRE DIVIDEND STRATEGY

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Berkshire Dividend Strategy — Detailed Portfolio Construction Narrative

To narrow the universe of candidates, Berkshire uses various screens to identify potential stocks for addition to the portfolio. Berkshire then employs a two-step bottom-up process focusing on high, sustainable return on equity and risk adjusted intrinsic value. As we evaluate profitability, financial strength and growth of dividends, we highlight how these factors are deeply intertwined with our valuation process.

Berkshire's Screening Philosophy

- Screening is used as a tool for idea generation, but overly rigorous rules can limit a team's opportunity set
- We believe the narrow focus (both overall firm and research process) of Berkshire allows portfolio managers and analysts to generate ideas outside the scope of a stringent screening process
- This latitude may allow Berkshire analysts to identify future value before it's fully recognized by the market
- Screening is a fluid process as are market conditions

Berkshire's Screening Process

Berkshire screens through various sources to identify companies fitting our discipline:

- Russell 1000 w/ current dividend
- ROE, P/E, dividend growth and earnings growth measurements as compared to the market and respective industries
- Dividend initiation, increases, or cuts
- Company price action
- Special Themes the analyst believes could create an idea: low bank payout ratios, recent dividend initiators, high cash on balance sheet, etc.

Higher than average profitability

- Process goal: How does the company generate higher than average ROE and is it sustainable?
- DuPont formula: Inspires unique, probing questions about each business
- Resulting companies: high margin cash generators with low capital requirements

Once candidates are presented to the committee, our evaluation process begins by identifying companies demonstrating high and sustainable profitability as measured by return on shareholder's equity (ROE). ROE is our financial yardstick to help understand the company's future cash flow potential and to quantify how effective management is at employing capital. ROE helps us decompose profitability and dividend growth potential. Profitability is evaluated by analyzing competitive advantages, pricing power, health of end markets, company management, cash flow diversification, industry advantages, intellectual property, and other factors.

Next, analysis of the company's duPont formula helps us answer the question: HOW does the company generate profit? Is it generated through high profit margins, efficient use of assets, management of taxes or use of financial leverage? Investment committee discussions lead to a cascade of questions about the factors relevant to each individual business. Overall, Berkshire company selections tend to enjoy above average profit margins, low capital intensity, wide moats, consistent and abundant cash flow and high incremental returns on capital.

Stronger than average financial strength

- Focus on quality, established companies with abundant free cash flow and self-funding balance sheets
- Dividends well covered by free cash flow
- Low to modest leverage comparatively
- Discern organic growth vs. financial engineering

As bottom-up fundamental investors focused on quality, balance sheet and income statement analysis play major roles in our process. We seek companies with established business models, low capital intensity, and self-funding balance sheets that do not need to access capital markets to fund operations or expansions. Financial strength can lead to attractive dividend growth and allow management to remain flexible and opportunistic as it weighs capital allocation decisions.

While dividend growth is a positive factor, we do not take a history of growing the dividend at face value. Many companies have used various financial engineering techniques to increase distributions to shareholders. Eventually, these techniques fail. Our process is specifically designed to identify companies with dividends well covered by free cash flow and will likely uncover companies employing various forms of financial engineering.

Since shareholders are the last providers of capital to get distributions, we seek companies with appropriate leverage. Some companies with exceptionally stable businesses and highly regular cash flows can be leveraged more fully to optimize shareholder returns (by lowering average cost of capital). If the company has very erratic revenue and cash flow, leverage should be avoided unless management is extremely adroit at predicting their unique business cycle.

Above average growth

- Dividend growth demonstrates company health, vitality and offers an important component of total return
- Wall Street orientation: near term rate of growth
- Berkshire focus: duration and sustainability of growth, capitalizing on short sightedness of others

We believe companies having the ability to compound dividends and grow cash flow at above average growth rates have provided significant value over time. Dividend growth is a sign of company health and vitality.

We dig deeply into each company's potential for future cash flow and dividend growth. Among other factors, we examine the health of their brands, intellectual property, network effects, long run pricing power, financial strength/flexibility and the ability to maintain high incremental returns on capital. In

conjunction we use ROE analysis to model long run earnings power and optimal capital structure to assess future dividend growth.

We find Wall Street may have a short-sighted obsession with near term earnings and the rate of growth. If our investors are to enjoy the significant benefits of compounding dividends, our focus remains on the duration and sustainability of dividend growth over a 3, 5 and even 10-year period of time. Many of our most successful opportunities developed as a result of Wall Street indiscriminately selling due a near term earnings miss or temporary problems having little to do with Berkshire long term thesis.

Below average valuation

- Buy decision: greater than 20% discount to intrinsic value
- Statistical cheapness vs. overall business value
- True valuation work requires intimate knowledge of fundamentals
- Sell discipline: 95-100% intrinsic value, change in fundamentals, better idea
- Quality growth + value = good upside, lower volatility

While we seek quality businesses that will grow future dividends, valuation plays a major role in our process. The price an investor pays for an investment ultimately determines the rate of return. We seek to add names to the portfolio if there is a significant discount (greater than 20%) on measured intrinsic value versus current price.

To us, value is not defined merely by screening static measures of statistical cheapness (low p/e, low p/b, etc.). These measurements only capture a certain price metric vs a certain fundamental data series at a static point in time. Alternatively, we believe a discounted cash flow model is the most comprehensive tool to synthesize relevant data about valuation.

A discounted cash flow model allows the portfolio manager to make a forward-looking assessment of fundamental measures across three dimensions: the current cash flow, the estimated growth of cash flow, and the risks to the cash flow. We estimate the future cash flows and discount them using a risk-free rate, an equity risk premium and the firm's 'opinion beta'. Traditional beta calculations measure a stock's price volatility vs. an index. We find this as an ineffective way to accurately measure the risk of a given business. Alternatively, our 'opinion beta' allows the analyst to measure and express the perceived riskiness of the underlying business: volatility of operating margins, balance sheet leverage, and liquidity of stock. We believe this is most consistent with the approach an entrepreneur would take if they were to acquire the whole company.

Valuation inputs (current cash flow, growth and risk) require probing questions about the business and inspire exhaustive insight into companies. For example, when valuing a company in our model, you cannot compare the discount rate used to capitalize a stream of cash flows for biotech and pharma firms without evaluating the unique risks to each model. Most mature pharma companies have a diverse range of products with well-established revenue streams, while biotech companies may be reliant on a single product. This can and must be expressed through varying discount rates (the opinion beta) to account for consistency of cash flow. This exercise is paramount to the process as each individual portfolio manager must defend their inputs to the committee.

Our sell discipline is 95-100% of intrinsic value, or a meaningful deterioration in fundamentals (i.e. change in operating margins, loss of competitive advantage, structural change in business model, poor acquisition)

We believe the combination of quality and not overpaying for a company provides good upside and also protects capital in down markets.

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Definitions: The S & P 500 Index is a market capitalization weighted index of the largest 500 U.S. stocks. It is a market-value weighted index (stock price times # of shares outstanding), with each stock's weight in the index proportionate to its market value. The index is designed to measure changes in the economy and is representative of most major industries. Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992. You cannot invest directly in an index. BEst (Bloomberg Estimates) Earnings Per Share (EPS Adjusted) estimate returns Earnings Per Share from Continuing Operations, which may exclude the effects of one-time and extraordinary gains/losses. Beta is a measure of volatility vs. an index. Upside/Downside capture ratios refer to a portfolios performance as a percentage of either positive returns (upside) or negative returns (downside) vs. an index. Standard Deviation is a measure of total risk. Alpha, Beta and capture ratios are represented as calculated by Morningstar.

Risks: Past performance does not guarantee future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will either be suitable or profitable for an individual's investment portfolio. Dividends are subject to change, are not guaranteed, and may be cut. Investing based on dividends alone may not be favorable as it does not include all material risks. There is no guarantee any stated (or implied) portfolio or performance objective mentioned by Berkshire can be met. Berkshire's equity style may focus its investments in certain sectors or industries, thereby increasing potential volatility relative to other strategies or indices. The dividend strategy may include bundled services also known as a "wrap fee program". Because there is typically a low turnover in the strategy, this may be more costly for some investors. No one should assume that any information presented serves as the receipt of, or a substitute for, personalized individual advice from a qualified advisor or any other investment professional.

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