Conscious Investor® Fund

Annual Letter to Members: 2015 -2016

Your Capital Allocation Team has been busy looking for secure investments for your money. Our role has three parts:

- Identifying great businesses in which we have confidence that earnings will continue to grow
- Ensuring that their management is trustworthy and acting in the best interests of shareholders
- Buying at a price that offers a reasonable return over the long-term with safety

For each company that meets these criteria we set prices that we believe would result in at least a satisfactory return. As investments come into the Fund, we will wait until these prices are met before making any significant purchases.

Performance

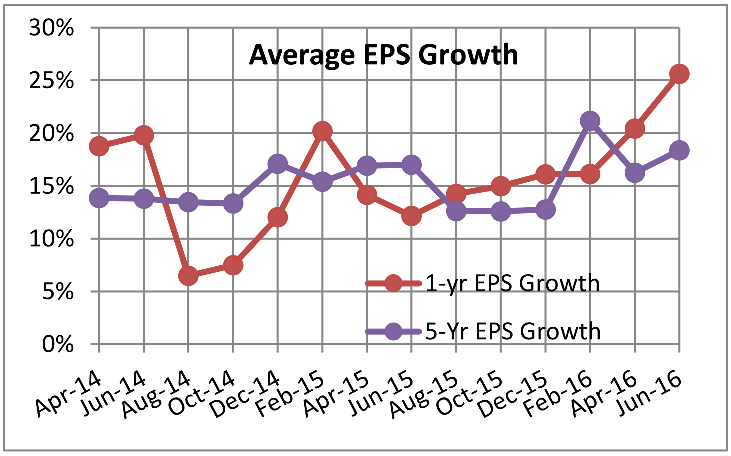
The following table shows the monthly results based on an actual benchmark portfolio started on 22 May 2014. The percentages are calculated from the dollar amounts in the portfolio and so are after fees. In the Last two columns the 12-month performance over each financial year is compared with the 12-month return of the S&P / ASX 200 Accumulation Index.

FY	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	12-month	Accum Index
2015-16	4.74%	-4.11%	0.65%	4.70%	3.22%	5.42%	-3.75%	-1.58%	1.57%	1.98%	3.79%	-2.05%	**14.9%**	**0.6%**
2014-15	4.03%	3.15%	-2.12%	1.11%	-2.16%	2.05%	0.72%	7.07%	2.09%	0.35%	2.89%	-6.16%	**13.1%**	**5.7%**
											0.65%	-3.60%	**-2.97%**	**-1.25%**

Comparison: Comparison of Conscious Investor® Fund and the S&P / ASX 200 Accumulation Index from 22 May 2014 until the end of June 2016.

	Growth of $1,000,000	Total Return	Average Annual Return
Fund	$1,260,709	26.07%	11.63%
Index	$1,049,329	4.93%	2.56%

Earnings Growth: Since share price performance over time depends on the growth of earnings per share (EPS), we track changes in EPS growth. The adjacent chart shows the history of the average annual growth of EPS for the holdings in the Fund over the previous one-year and five-year periods. The growth rates of the individual companies are weighted according to their proportion within the Fund excluding cash.



Everything is recalculated at the end of each two months. Notice that the rates are well above the level of inflation. Our goal is to choose those companies with strong historical growth of earnings per share and with a likelihood of this growth continuing in the future as it has in the past.

Additional Funds

During the year we received $2.7 million in additional funds. This includes funds from three existing members who topped up their investments.

We were able to invest this extra money quite safely, one of the larger investments being a single Class A share of Berkshire Hathaway.

As at the end of June 2016 we held 6.99 percent of our portfolio in cash. While the returns on cash are low, we view this as a war chest we have ready to deploy the moment Mr Market falls out of love with one of our favourite companies – as we can expect to happen from time to time. While this may cause other investors to panic, we're overjoyed when we see great businesses sold down to bargain prices. Your Capital Investment Team stands ready to act quickly to deploy cash when Mr Market obliges. We are also looking for the right opportunities to invest in Teaminvest Private Companies.

The Bias Of Pulling Out The Flowers

I had the good fortune of being given shares when I was around 14 years old. Two of them were BHP and Brambles.

As I recall, BHP would have a capital raising once or twice a year. I would diligently mail in my cheque for another four or five shares. (It was a very small portfolio.) At the time I did not know anything about how capital raisings increased dilution. My memory, though, was that after a capital raising I would see the price go down before slowly creeping back up to its starting point. I also recall that I had printed sheets on which I could record the dividends.

However, it wasn't until I was living in the US from 1990 to 2000 that I started to look at markets in a more serious way. This, as you know, led to the development of Conscious Investor®.

As part of my research, I had also collected years of records of transactions I had made. I thought I would go back over these records to see if there was anything I could learn from what I had done.

The most obvious bias I saw was that I sometimes "pulled out the flowers".

What is "pulling out the flowers"?

Most people recognise this idea as coming from Peter Lynch as described in his book *One Up On Wall Street*. Here is what he wrote:

> *Some people automatically sell the "winners"—stocks that go up—and hold on to their "losers"—stocks that go down—which is about as sensible as pulling out the flowers and watering the weeds.*

By flowers, Lynch means stocks with prices that have risen substantially. I would like to broaden this idea and use it here to refer to great companies, those with all the attributes of being Wealth Winners®.

In the spirit of these ideas, I looked over my early US portfolios and saw that I had owned some genuine flowers, Amazon being one of them. For instance, I purchased Amazon on 19 January 1999 for US$139.82. Currently the shares trade around US$767. Allowing for the split in September of that year, this represents an average return of 15.85% per year.

But I pulled this flower after only owning it for a few months. I made a nice profit, but nothing like what the result would have been if I had kept these shares.

Warren Buffett had a similar experience. In 1951 when he was 21 he started buying shares in the auto-insurance company GEICO. He spent US$10,282. By the end of the year, his holding was worth US$13,125, more than 65% of his worth. But then he sold his entire stake in 1952 for US$15,259, primarily to switch into Western Insurance Securities. Buffett described his actions as follows:

> *This act of infidelity can partially be excused by the fact that Western was selling for slightly more than one times its current earnings, a p/e ratio that for some reason caught my eye. But in the next 20 years, the GEICO stock I sold grew in value to about $1.3 million, which taught me a lesson about the inadvisability of selling a stake in an identifiably-wonderful company.*

When you do the calculations, you see that Buffett passed up a 20-year return of 24.8% per year.

Avoiding pulling out the flowers

Pulling out the flowers simply means selling great companies purely because their prices have gone up. Three common reasons for doing this are that the earnings (or price) were once growing but have now slowed, that the P/E ratio is simply “too high”, or that there is another more attractive flower. Often the accompanying adage is to “sell now, and get back in when it is cheaper”. Or “you can’t go wrong taking a profit”, what I have referred to elsewhere as the behavioural bias of *consolidatus profitus*.

Sometimes it is true that taking money out of a great company and it investing elsewhere can be more profitable. But when I look over my investing record it is the exception. Except on one occasion, every time I sold a “flower” because I thought that perhaps it was past its prime or I could buy back in later for a lower price, I was wrong.

Of course, flowers don’t always remain as attractive blooms. They can wither for a variety of reasons: large foolish acquisitions, new management that does not understand the business, or there is no longer a need for the products and services, to name three. If this happens, and it does not look like the company will recover, then it makes sense to sell.

But so long as the products and services of the company are needed, that sales and earnings are continuing to grow, and that management are not doing anything foolish, my experience plus ample research confirms that it is better to keep with the original investment.[1]

In the short-term it may appear that it is beneficial to pull out the flowers (and the human brain is brilliant at finding reasons to do this). It may even be that not doing so hurts returns in the short term. However, the goal of the Conscious Investor® Fund is to maximise returns over the long term subject to prudence and safety based on proven principles and strategies. This means in the Fund we will not

[1] This bias to “pull out the flowers” is related to what Daniel Kahneman and Amos Tversky dubbed the disposition effect: because of their desire to avoid regret, over time investors lose money because they tend to sell their winners too soon and hold their losing investments too long.

be pulling out any established flowers. Quite the opposite, we will look for opportunities to water them by adding to our holdings whenever Mr Market provides suitable opportunities.

Why We Like Berkshire Hathaway in the Conscious Investor® Fund

When you invest in Berkshire Hathaway a lot happens. First, you buy a share of 100 billion dollars' worth of listed companies, around 47 at last count. Most of these are outstanding businesses such as American Express, AT&T and Wal-Mart. Second, you buy a share of approximately 100 private companies fully owned by Berkshire Hathaway including GEICO Insurance (32,000 employees), BNSF Railway (48,000 employees) and Heinz (24,000 employees). Third, you now own a share of $87 billion of cash and fixed maturity securities.[2]

Fourth, and most importantly of all, you gain the services of the brilliant business and investment minds of Warren Buffett and Charlie Munger. We can also include here Todd Combs and Ted Weschler, exceptionally talented people handling around $9 billion each of the Berkshire Hathaway investment portfolio.

These four people are totally dedicated to give you the highest possible return consistent with care and prudence. Over and above these four people are the managers and founders of the companies in the Berkshire stable. In the case of the private companies, these are typically founders of the actual businesses, their ability being a large part of the reason why Buffett decided to make the acquisitions in the first place. (Later in the report I will also mention the board of Berkshire Hathaway as another source of strength of the company.)

Despite these advantages, when it comes to deciding whether an investment in Berkshire Hathaway Inc (BHI) is likely to be successful or not, we need to know three things: what its track record was, what is its likely performance in the future as a business and what is the likelihood that this business performance will convert into a profitable investment.

The first question is easy. Since 1965 until the end of last year the book value of BHI per share has grown by an extraordinary 19.2% per year. This means a total growth of 798,981%. That is the business side of BHI. What about the share-price side?

Again an easy question. Over the same period the share price has paralleled the book value and returned an average of 20.8% per year for a total return of 1,598,284%.

This clears the way for the remainder of the report. Based on our knowledge of the business including areas such as management, economic moats and future risks, how do we think the business will perform in the future. If we are pleased by what we discover, what is a fair price to pay for this performance. We want to be confident that any investment in BHI will give us a good return on our money. Is it going to be a Wealth Winner®?

Economic Moats of Berkshire Hathaway

Since we are dealing with roughly 150 companies, it is virtually impossible to look at them one by one listing their moats, let alone trying to describe how strong their moats are and their durability. But we can look at the big picture.

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[2] Per-share figures used in this report apply to Berkshire's A shares. Figures for the B shares are 1/1500th of those shown for A. All amounts refer to US dollars.

Moat 1: Warren Buffett is passionate about moats

The first economic moat is that Buffett himself is passionate about moats and this passion means that he impresses the importance of moats on his managers. Consider what Buffett said about GEICO 20 years ago:

> *The difference between GEICO's costs and those of its competitors is a kind of moat that protects a valuable and much- sought-after business castle. No one understands this moat- around-the-castle concept better than Bill Snyder, Chairman of GEICO. He continually widens the moat by driving down costs still more, thereby defending and strengthening the economic franchise.*[3]

There are many interviews showing that the managers of companies in the BHI stable of companies recognize the importance of economic moats. If they didn't, the companies would probably not even have been considered by Buffett in the first place: "In business, I look for economic castles protected by unbreachable 'moats'."[4]

But even if, by some miracle, there was a manager of a BHI company that did not recognize the importance of moats around his or her company, Buffett would certainly let them know:

> *We evaluate their performance by the two methods we apply to the businesses we own. The first test is improvement in earnings, with our making due allowance for industry conditions. The second test, more subjective, is whether their "moats" – a metaphor for the superiorities they possess that make life difficult for their competitors – have widened during the year.*[5]

Moat 2: Buffett picks great managers and companies, then leaves them alone

We know that Buffett does not interfere with the running of businesses in the BHI stable. His skill is making the initial choices and allocating capital to either invest in them, buy them, or provide further capital. "Charlie[Munger] and I have the easy jobs at Berkshire: We do very little except allocate capital… Our managers, however, work very hard -- and it shows."[6]

Moat 3: Berkshire Hathaway is a low-cost provider

Even though BHI is a $350 billion company, apart from Buffett, it runs with only 24 people in head office. When Buffett goes to meetings he goes on his own without an entourage of accountants, advisers and lawyers. The base fees provided to board members is $3,000 per year. Buffett refers to their fees as "paltry". Finally, for the past 25 years, the compensation of Buffett and Munger has been fixed at $100,000 per year.

Moat 4: Managers of BHI companies have access to Buffett

Buffett's business acumen is such that each year, bidders pay millions of dollars (this year it was $3.4 million) for a private lunch with him. He once said: "I am a better investor because I am a businessman, and I am a better businessman because I am an investor."

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[3] Berkshire Hathaway Annual Report 1996
[4] Berkshire Hathaway Annual Report 1995
[5] Berkshire Hathaway Annual Report 2007
[6] Berkshire Hathaway Annual report 1998

The managing directors and CEOs of companies that have been bought by BHI often say that one of the greatest benefits of the sale is that they have access to Buffett's business insights.

Moat 4: Reputation of Warren Buffett and Berkshire Hathaway

Regarding the reputation of Warren Buffett and Berkshire Hathaway, twice a year Buffett sends a memo to the managers of the BHI companies. Recently, it was reported in the New York Times that one of these contained the call:

> *We can't be perfect but we can try to be. As I've said in these memos for more than 25 years: "We can afford to lose money — even a lot of money. But we can't afford to lose reputation — even a shred of reputation.*

This, of course, lowers the likelihood of their being a scandal or legal challenge against any of the BHI companies. But it also gives BHI an edge when considering acquisitions. A founder of a company would be more likely to sell to Buffett, even at a lower price, than to some other private equity firm: they would have more confidence that his or her company would not be damaged or broken up by unscrupulous actions by the new owner.

Moat 5: Ability to make fast decisions

Each year Buffett describes the type of companies he is looking to buy. At the end of the description he writes: "We will not engage in unfriendly transactions. We can promise complete confidentiality and a very fast answer as to possible interest - customarily within five minutes."[7] Billion dollar deals such as the Heinz/Kraft purchase typically are done under four weeks.

Moat 6: Ability to deploy vast amounts of cash

With its enormous cash reserves, Berkshire Hathaway is able to supply vast amounts of cash to the companies it owns to help them grow or make acquisitions in their own right. If a company can put a favourable case to Buffett, then the money will be forthcoming. For example, since purchasing Clayton Homes in 2004, BHI now provides a $13 billion mortgage portfolio for people buying a Clayton Home. This gives CH a huge advantage over its competitors who have to deal with banks to finance sales and the associated charges and uncertainties.

Another example is Burlington Northern Santa Fe (BNSF) Railway: during 2013 BHI spent $6 billion on plant and equipment for the company. According to Buffett: "That sum is nearly 50% more than any other railroad has spent in a single year and is a truly extraordinary amount, whether compared to revenues, earnings or depreciation charges."[8]

Moat 7: Members of the Board of Berkshire Hathaway

Usually we don't talk about the board of a company as a moat. But, in this case, each of them are extremely talented and business savvy, they are successful business people in their own right, and they are personally committed to Berkshire Hathaway. I won't go through each one individually, but two examples are Bill Gates and Stephen Burke.

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[7] Berkshire Hathaway Annual Report 2013

[8] Berkshire Hathaway Annual Report 2013

Bill Gates is the founder and former chair and CEO of Microsoft. Stephen Burke has been the CEO of NBCUniversal and Executive Vice President of Comcast Corporation since January 2011.

We know the directors are committed to BHI from the small board fees they are paid as described earlier. They are not even covered by liability insurance.

Conclusion*:* As a group these moats are very strong as evidenced by the outstanding performance of BHI since Warren Buffett bought his first shares in December 1962. As we will see in the next section, most investors see the age of Buffett and Munger as the main challenges to the moats of BHI. However, we will also see that Warren Buffet and Berkshire Hathaway have put in place structures, procedures and a general philosophy so that these moats will continue to remain strong for many years.

What are the Future Risks of Berkshire Hathaway?

When considering Berkshire Hathaway, most people describe the biggest risk as the age of Warren Buffett (85) and, to a lesser extent because he plays a smaller role, the age of Charlie Munger (92). Putting it bluntly, they may not live much longer and, if they do, they may not be able to continue in their roles. Replacements will need to be found. However, we know that the board of BHI spends a great deal of time talking about succession planning emphasising Buffett's confidence that a suitable plan is in place.[9] "Both the board and I believe we now have the right person to succeed me as CEO – a successor ready to assume the job the day after I die or step down." he wrote. "In certain important respects, this person will do a better job than I am doing."[10]

Perhaps successors will not be as successful as Buffett and Munger. Perhaps fewer opportunities will be presented to the new managers. Because almost all the assets of Berkshire Hathaway are already invested in stable businesses selected for their superior management and built-in longevity, it will be quite a while before these factors will materially damage the bottom line performance of BHI.

Just as for the economic moats in the previous section, the following list of risks are for the overall business rather than for individual businesses within the BHI stable. The reason for approaching risks in this way is that, except for a handful of the largest of BHI businesses, if any one of them would suddenly completely fail, the effect on the overall performance on BHI would be minimal.

Even though this report only looks at the overall risks, it should be pointed out that "at least once a year, the senior management of each of the Corporation's significant businesses reports to the Board of Directors on risks facing their respective businesses."[11] Given the strength, experience and commitment of the board, this is a significant safety bulwark for BHI.

The risks have been adapted from the 10-K report of BHI with three additional columns provided by the Conscious Investor® Fund Capital Allocation Team: Likelihood of the risk occurring in the next

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[9] The formal statement in the proxy says: "Mr. Buffett and the other members of the Board of Directors extensively discuss succession planning at each meeting of the Board. Upon his death or inability to manage Berkshire, no member of the Buffett family will be involved in managing Berkshire but, as very substantial Berkshire shareholders, the Buffett family will assist the Board of Directors in picking and overseeing the CEO selected to succeed Mr. Buffett. At that time, Mr. Buffett believes it would be prudent to have a member of the Buffett family serve as the non-executive Chairman of the Board. Ultimately, however, that decision will be the responsibility of the then Board of Directors."

[10] Berkshire Hathaway Annual report 2013

[11] Berkshire Hathaway Proxy Statement 2015

economic cycle, Damage if it did, and an overall combined Score out of 10. The Likelihood and Damage are based on the scale:

Likelihood of occurring in next economic cycle:

0: Won't occur, 1: Possible, 2: Probable, 3: Virtually certain

Damage Scores: Assuming a risk does occur, the severity of the damage:

0: No damage, 1: Some damage, 2: Severe damage, 3: Capital Killer™ - destroys business

Risk	Likelihood	Damage	Score
Deterioration of general economic conditions may significantly reduce BHI's operating earnings and impair its ability to access capital markets at a reasonable cost	1.5	2.0	6.1
Competition and technology may erode its business franchises and result in lower earnings	1.0	2.0	5.3
Loss of key personnel at head office for the major investment and capital allocation decisions	2.9	1.0	4.8
Terrorist acts against the US could hurt BHI's operating businesses	2.0	1.0	4.2
The degree of error inherent in the process of estimating property and casualty insurance loss reserves may result in significant underwriting losses.	1.5	1.2	4.3
Makes a very large foolish acquisition	0.8	1.5	4.1
Changes in regulations and regulatory actions can adversely affect operating results and ability to allocate capital.	1.5	1.0	3.8
Investments of the insurance subsidiaries are unusually concentrated in a small number of equities: decrease in their fair value could affect the ability to write new policies.	1.0	1.2	3.8
Investment philosophy that worked in the past no longer works as well because the market place is more sophisticated, markets are more efficient, and BHI is too big and cumbersome	1.0	1.1	3.6
Unable to get qualified personnel to manage and operate its various businesses	1.0	1.0	3.3
Cyber security risks	1.0	1.0	3.3
Derivative contracts may require significant future cash settlement payments and result in significant losses	1.0	1.0	3.3

Conclusion Overall none of the risks are particularly surprising. Also our estimates of damage should any of the risks occur are low compared to most companies. In any case, many of the main risks such as a general deterioration of economic conditions are outside the control of BHI and apply to business in general.

Is Berkshire Hathaway at a Reasonable Price?

Most analysts use various discount cash flow methods to calculate what is referred to as intrinsic value of a company and compare this to the actual price. They then assume that if you purchase shares at a discount to the intrinsic value eventually the price will rise to this value. There are three problems with this approach. First, the calculations involve extreme assumptions that cannot be tested. Second, by slightly varying the assumptions almost any value you like can be "validated". Third, even if a "true" value could be calculated, there is no way that it is possible to calculate whether it will take days or years, or never, to reach this price.[12]

For the Conscious Investor Fund, usually we would decide whether or not a company is at a reasonable price by using Conscious Investor®. Simply, we would calculate the future total return using the propriety proprietary tool STRETD® under default or margin-of-safety settings. However, as we have seen, BHI is really a combination of three types of companies, an investment company in listed companies, a holding company of private businesses and a fixed-interest investment company. For this reason, it makes sense to look at valuing Berkshire Hathaway from different angles. If we find they support each other, then we can have increased confidence in the results.

Book Value

Every year on the opening page of the Berkshire Hathaway Annual Reports, Buffett lists the percentage change in book value since 1965 compared to growth in the S&P500 accumulation index. Since that year, book value has grown by an average of 19.2% compared to 9.7% for the Index. Given the central role of book value, or equity per share, in Buffett's analysis of BHI, this is an obvious place to start.

The book value of equities and cash instruments is obvious, namely their actual market value. The fully-owned companies are more interesting. Consider See's Candies, bought by Buffett and Munger in 1972 for $25 million. Since then, with only an added investment of $40 million, it has earned $1.9 billion pre-tax for BHI. But See's is still carried on the books at its original price.

As Buffett explained, "The carrying value of the "losers" we own is written down, but "winners" are never revalued upwards."[13]

This led Buffett to make the following statement and offer:

> *Today, the large – and growing – unrecorded gains at our "winners" make it clear that Berkshire's intrinsic value far exceeds its book value. That's why we would be delighted to repurchase our shares should they sell as low as 120% of book value. At that level, purchases would instantly and meaningfully increase per-share intrinsic value for Berkshire's continuing shareholders.*[14]

This offer essentially puts a floor under the price of BHI compared to its book value. (Originally the level was 110%, but after a while even Buffett thought that this was unrealistic.) The only period Buffett was able to take up this offer was in 2012. During the year, BHI achieved a total gain for its shareholders of $24.1 billion and it used $1.3 billion of that to repurchase its stock.

The following chart shows the history of the PB ratio at the end of each calendar year since 1981. We see that the PB ratio was rarely below the 120% level.

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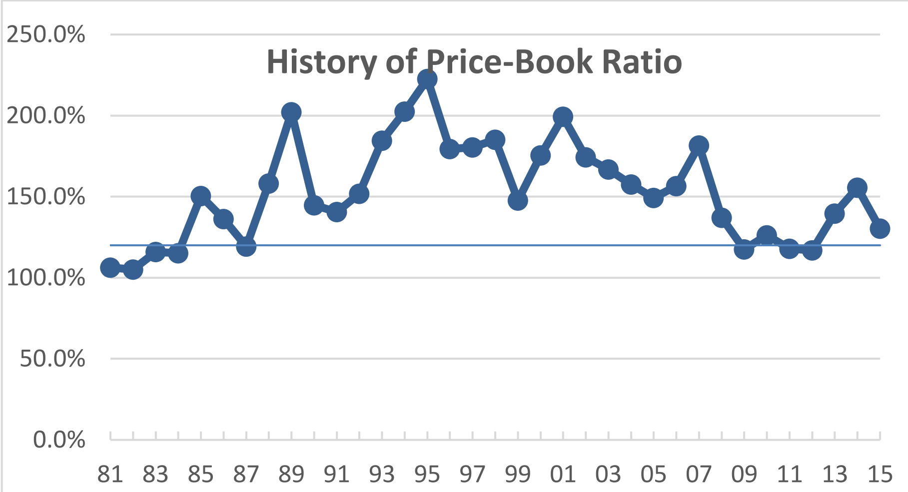
[12] See *The Conscious Investor* (Wiley) for more details on the strengths and weaknesses of a range of valuation methods.

[13] Berkshire Hathaway Annual report 2013

[14] Berkshire Hathaway 2015 Annual Report



Conclusion: Currently the price of a Class A share is $216,400 and book value is $157,329 so PB is 137.55%; not the 120% required by Buffett, but also not so far off. Taking a long-term view, the current PB ratio is certainly on the low side so it would not be out of place to purchase (or own) Berkshire Hathaway shares.

What about Dividends?

Some investors only invest in shares because they pay a higher dividend yield. Generally, this is foolish because they often forgo a much higher return in capital gains in order to get a few percent more in dividends.

Just the same, many investors are adamant that they will never invest in Berkshire Hathaway since it does not pay dividends.[15] They talk about not wanting to dip into their capital. Yet, at the same time, these same investors are usually eroding their capital by investing in second-rate companies.

Most investors would be far wealthier with a more secure future if they focused on total shareholder return, capital gains plus dividends, rather than dividend yield. Investing in Berkshire and selling whatever was necessary each year to live on would benefit most "dividend chasers".

So just because BHI does not pay dividends is not a rational reason to avoid buying shares in the company.

Note: This does not mean that the Conscious Investor® Fund avoids companies that pay dividends. Quite the opposite. Including dividends is an important input in estimating the future success of an investment. But we will never base a decision solely upon the level of dividends.

Conclusion*:* It is not possible to evaluate Berkshire Hathaway using dividends (unless you are one of those investors who insist on dividends-in which case the value is zero).

Valuing the Components of Berkshire Hathaway

This approach is in two parts. For the first part use the pre-tax earnings per share of the fully-owned subsidiaries of BHI to estimate the value of these companies. At the end of 2015 they were $12,304.

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[15] Actually Berkshire paid a dividend in 1967 totalling 10 cents a share. Whenever this is raised, Buffett claims he must have been in the bathroom when it was authorized.

Now assume that the total value of these companies is 8 times these earnings.[16] This gives the value $98,432.

For the second part use the dollar value of the per share cash and equity investments. For the end of 2015 this was $159,794. We consider this their base value.

Adding this value to the estimated value of the subsidiaries just described gives $258,226 as the estimated fair value of BHI. The current price of a Class A share is $216,400, which is 83.80% of the fair value. In other words, BHI is trading at a 16.2% discount to fair value. How does this compare with previous ratios of price to fair value? The following table shows the history of this ratio at the end of each financial year.

Year	(1) Per share cash and investments	(2) Pre-tax Earnings from Businesses	(3) Value of businesses (× 8)	(4) Value of Class A share	(5) Share price (Class A)	(6) Ratio of Price to Value
2011	$98,366	$6,990	$55,920	$154,286	$114,755	74.38%
2012	$113,786	$8,085	$64,680	$178,466	$134,060	75.12%
2013	$129,253	$9,116	$72,928	$202,181	$177,900	87.99%
2014	$140,123	$10,487	$83,896	$224,019	$226,000	100.88%
2015	$159,794	$12,304	$98,432	$258,226	$197,800	76.60%

Table: Comparison of Share Price with Estimated Value

Column (1) is the per-share amount held in cash and equity investments. It is listed as the face- value of these investments. Column (2) is the pre-tax earnings from the subsidiary business of BHI while column (3) is an estimate of the value of these businesses. (They are valued on a multiple of 8.) Column (4) is the sum of Columns (1) and (3) and is an estimate of the fair value of a Class A share. Column (5) Is the share price at the end of each year and Column (6) is the ratio of Columns (5) and (4), the lower the better.

The Table shows that the current ratio of 83.8% is approximately mid-level.

Conclusion*:* This approach to valuing BHI is not entirely satisfactory since we are assuming that the value of businesses held by BHI is a multiple of eight times their pre-tax earnings. Just the same, we get another indication that BHI is trading below fair value.

The Conscious Investor® Approach

The aim of the Conscious Investor® approach is to obtain a confident estimate of the average annual future return of an investment: is it likely to be a mediocre 5-6%, a healthy 10-11%, or a Wealth Winning 15% or above? Instead of actually using Conscious Investor®, let us see what we can do with some simple calculations to get sensible estimates of the likely future return for Berkshire Hathaway.

[16] The use of the multiple 8 is probably quite conservative, particularly for the larger companies which Buffett refers to as his “Powerhouse Five”: BNSF, Berkshire Hathaway Energy, Marmon, Lubrizol and IMC.

Over the past five years, the EPS of BHI have grown by an average of 16.1% per year with a stability of 87.9%. Since this is a high stability, it is reasonable to start with the assumption that EPS will continue to grow at this rate for the next five years.

Next assume that the P/E multiple remains constant over the next five years. Since we know that

Price = P/E multiple × EPS,

we conclude that the price will grow by a healthy 16.1% pa over this time.

What if the growth does not continue at this rate, or the P/E multiple is lower? We can perform a sensitivity analysis to see what effect this would have on performance. The following table shows the average annual return over the next five years if the growth varies by ±10% from 16.1% and the P/E multiple varies by the same amount from its current level of 14.5. If they both drop by 10%, the expected average annual return will be 12.1%. If they both grow by this amount it will be 20.0%.

Sensitivity Analysis for the Expected 5-Year Return

Estimate of Return		P/E Multiple		
		13.1	14.5	16.0
EPS Growth	14.5%	12.1%	14.5%	16.7%
	16.1%	13.7%	16.1%	18.3%
	17.7%	15.3%	17.7%	20.0%

Conclusion: Given the overall safety of Berkshire Hathaway and the low prevailing interests rates, even the worst case of 12.1% per year is considerably better than any cash rates that are available. Importantly, the table also shows that there is a marked likelihood that the return could exceed 15% per year.

What can we conclude? Few people would disagree that Warren Buffett is brilliant at business and investing and that, in Berkshire Hathaway, he has created an extraordinary company based on enduring principles. In this Report I have tried to peek under the curtain in order to examine some of the reasons why BHI is so extraordinary. Secondly, I have tried to show that it is likely to be a successful investment for many years to come. This is why we like having Berkshire Hathaway in the Conscious Investor® Fund.

Conscious Investor® and the Teaminvest Methodology

The investment process used by the Capital Allocation Team for the Fund consists of four steps: Filtering using Conscious Investor®; Applying the Teaminvest investment methodology; Calculating the price to pay and when to sell; and a Final Checklist. Full details of these steps are contained in the Information Memorandum. Here we just give a brief summary of the first two steps.

Conscious Investor® filters and analyses all companies listed on the ASX in three steps: Filter, Research and Return. The main components of the filter stage zero in on companies with attributes such as strong and stable growth in earnings and sales, high and consistent return on equity and not too much debt. The research stage helps to limit the results to companies for which these attributes are likely to continue. Finally, the return stage calculates what maximum price to pay to be confident about getting the required rate of return over the long term. It uses automatic margin-of-safety calculations based on stress testing the investment assumptions.

The Teaminvest Methodology focuses on the following four areas. Wherever possible the Capital Allocation Team scores the areas to increase the precision of the decision process.

- How does the company make money? What is the business of the company? Who are its customers?
- Investments should be like castles with deep moats: What are unique features of the business that separate it from its competitors? These “economic moats” are scored in terms of depth and durability.
- Risks need to be identified: All businesses face risks that could weaken the continuing success of their operations. These risks are identified and are scored according to the likelihood of their occurring over the next economic cycle and their potential damage if they do.
- Is management honest, open and rational? As part of examining the business, evaluation is made whether or not it is believed that the board and senior management are acting honestly, rationally and in the best interests of shareholders. Specific areas that are looked at include the number and type of related party transactions and the remuneration structure for the CEO and senior management. The Capital Allocation Team scores remuneration in terms of clarity, alignment and quantum.

The Capital Allocation Team prepared this report for members of the Conscious Investor® Fund. It does not take into account anyone’s personal circumstances. Remember, what happened in the past is not always what will happen in the future.

Questions? Contact us:

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