

# perspective

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## Prospectus

Webster's definition of this noun, as common in the vernacular of Wall Street as is the use of hyperbole by used car salesmen, should not overly offend anyone  $\frac{3}{4}$  except perhaps the SEC, which might find it too effusive. "Prospectus: a circular containing information or plans (regarding the) ... issue of securities etc., *designed to win support* (my emphasis)." While the SEC, as the investors' watchdog, attempts to limit issuers to the "full disclosure" of all relevant facts, we all know that the sizzle outside the prospectus is what most often sells the steak. Rarely would the contents of a "red herring", like a piece of raw fish, cause investors to salivate. Many investors would compare buying into a public offering on the strength of a prospectus alone, to selecting a mate without the excitement of a kiss. The tug-of-war between issuers and underwriters on the one hand and the regulators on the other is to be expected. The parties to the transaction have different and often conflicting interests and objectives. Each has his or her own spin on things. The SEC attempts to ensure that all relevant information is disclosed with the same degree of impartiality as we have come to expect from the window sticker on a new auto in the dealer's lot.

Imagine then the surprise of those who recently read the prospectus filed by Warren Buffet with the SEC regarding the offering of 450,000 shares of Berkshire Hathaway Inc. Class B common stock. Before I explain, let me make a confession. Sometime ago I quietly swore to refer less frequently to Warren Buffett. However, as this letter painfully demonstrates, old habits are not easily broken. Just as I was ready to opine on a subject thought to be both timely and pertinent, he penned something that was even more so, and in so doing pre-emptively rendered my ideas to the status of an afterthought. The filing of the aforementioned Berkshire prospectus has left me with no other option but to willingly cede space and one more time succumb to an old habit..

The shock to which I alluded is that said prospectus was, as if to defy Webster and a

protocol as old as speculation, *designed to discourage support* for the offering of Berkshire shares. The "window sticker" said "don't buy this offering". There was no sizzle, for there was no steak. This was the first time in 30 years of reading disclosure documents that I have encountered a prospectus that sought to genuinely dissuade investors from participating. However, investors were not deterred by the force and cogency of his forewarning and duly subscribed to 450,00 shares — three times the size of the original offering. Think of how many shares could have been sold if Buffett had but touted the stock in the mildest of manner.

The following is quoted verbatim from the *cover* of the prospectus:

WARREN BUFFETT, AS BERKSHIRE'S CHAIRMAN, AND CHARLES MUNGER, AS BERKSHIRE'S VICE CHAIRMAN, WANT YOU TO KNOW THE FOLLOWING (AND URGE YOU TO IGNORE ANYONE TELLING YOU THAT THESE STATEMENTS ARE "BOILERPLATE" OR UNIMPORTANT):

1. Mr. Buffett and Mr. Munger believe that Berkshire's Class A Common Stock is *not undervalued* (my emphasis) at the market price stated above (\$11,110). Neither Mr. Buffett nor Mr. Munger would currently buy Berkshire shares at that price, *nor would they recommend that their families or friends do so* (my emphasis).

2. Berkshire's historical rate of growth in per-share value is NOT indicative of possible future growth. Because of the large size of Berkshire's capital base (approximately \$17 billion at December 31, 1995), Berkshire's book value per share cannot increase in the future at a rate even close to its past rate.

3. In recent years the market price of Berkshire shares has increased at a rate exceeding the growth

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in per-share intrinsic value. Market overperformance of that kind cannot persist indefinitely. Inevitably, there will also occur periods of underperformance, perhaps substantial in degree.

4. Berkshire has attempted to assess the current demand for Class B shares and has tailored the size of this offering to fully satisfy that demand. *Therefore, buyers hoping to capture quick profits are almost certain to be disappointed.* (my emphasis) Shares should be purchased only by investors who expect to remain holders for many years.

Why, you might ask, did Buffett even consider selling a piece of the company in the first place? Berkshire offered shares of its Class B Stock in "response to promotions involving Berkshire stock by persons unrelated to Berkshire." Specifically, Buffett objected to the proposed offering of unit investment trusts, "miniature" Berkshires, that owned Berkshire shares and/or shares of Berkshire investees, but were priced to sell at around \$1,000, 1/30th of the share price of Berkshire Class A common. The promoters were usurping the power of the Board of Berkshire, effectively imposing a partial 30-to-1 stock split, and exposing prospective unit holders to considerable and unnecessary costs, both of which Buffett strongly opposed.

Buffett's elaborate explanation of the ill effects of the market presence of the unit trusts is worthy of a closer look for reasons beyond their immediate and disruptive application at Berkshire. The trusts, Buffett warned, will be "promoted by sales people motivated by substantial incentive commissions, who management believes would inevitably seek to sell the trusts by making misleading references to Berkshire's past performance. Many investors in such trusts, having been brought in by highly aggressive marketing, would be relatively unsophisticated and would have bought with totally unrealistic hopes that future growth in Berkshire's stock price would resemble its past growth." He goes on to suggest that new demand from the unit trusts, given the source of funding, and the reluctance of most low-cost-basis Berkshire shareholders to sell at any price, might cause an "unrealistic increase in Berkshire's stock price, unrelated to changes in the stock's intrinsic value...."

He likened the consequences of the unit trust market activities to the "bull pools" of the 1920s — "the price of a popular stock was pushed to artificial heights through activity that combined orchestrated bursts of buying with

restricted supply." Buffett went so far as to suggest that the results for Berkshire stock could even be more extreme because of higher tax rates today inhibiting sellers and the current practice of using high commissions to motivate sales people. The new trusts destined Berkshire, against its will and without its assistance, to be associated with stock promotions that were almost sure in due course to create many disappointed investors who had not fully understood the risks they were taking."

Buffett admits that a corporation may not object to a "temporary and unrealistic spike" in its stock price because of such activity. Shareholders can sell shares, or the company can issue shares at the unrealistic price, causing an increase in the intrinsic value of shares unsold. "Current shareholders, however, can attain neither of these advantages without disadvantaging some other party. For present and future shareholders as a group, there can be no 'free lunch' from a temporary spike in the price-value ratio of their stock." Spoil-sport Buffett has surely angered the securities brokerage, investment banking, or corporate public relations world with these heretical statements.

Fearing that the aggressively promoted unit trusts would, as a poor quality substitute, harm Berkshire's business reputation, Buffett was forced to respond with the least-objectionable alternative, the issuance of Class B shares. Obviously, a stock split would have been the easiest option. However, a split might have encouraged the same kind of "unsophisticated, price-insensitive" buying that the trusts would have excited. Buffett's aversion to stock splits reveals an unusual, but internally consistent perspective on the relationship between great business leader/owners and their absentee brethren. Corporate executives would do well to study Buffett carefully on this matter. He has not been flattered by a host of imitators.

Buffett's misgivings about unit trusts may be no less applicable to the mutual fund mania that has gripped the nation. The marketing of funds, long built upon an image of respectability and prudence, has degenerated into a process that resembles the goings-on in a used car lot. Did you ever think that air miles would be offered as an award for mutual fund purchases? Many offer little more value than the proposed Berkshire unit trusts. This Perspective is our attempt to keep you informed on matters that are both timely and important, even if we have to lean on Buffett to do so!

That buyers heavily oversubscribed the Berkshire offering must have caused Buffett to shake his head in disbelief if

not dismay. As for us who watch from a distance, the episode should serve as a concrete example of the myopia that has blinded investors in recent years as stock prices have levitated into outer space, far above the gravitational pull of historical valuation benchmarks. As if to add insult to injury, those who neglected to get in on the unusual offering designed to satisfy all comers (and who we can only presume did not lay eyes on the prospectus and for whom therefore Buffett's words of caution were not revealed), bid the stock in the secondary market \$110 above the initial offering price of \$1,100 in the days immediately following. Given that those who willingly, if not enthusiastically, exchanged \$500 million in real money for advertised-as-overpriced shares in Berkshire were not goaded by highly-paid commission-driven salesmen nor by the expectation that a shortfall in the supply of stock would cause the shares to skyrocket in the secondary market, the conventional reasons to disregard Buffett's advice are simply not present. Incidentally, the underwriting discount was xx%, compared to the normal 7%. It certainly appears that reason and logic were temporarily supplanted by a dangerous and pervasive euphoria. It is hard to conceive of how Buffett's warnings could have been stated more emphatically or how the response, therefore, could have been more explicit in identifying the rootless state of mind of the investing public.

Warren Buffett's cover page message seems clear to us. Berkshire's stock has been lifted to unsustainable heights by the seemingly endless bull market in financial assets. Says Buffett, "In recent years the market price of Berkshire shares has increased at a rate exceeding the growth in per-share intrinsic value. Market overperformance of that kind cannot persist indefinitely. Inevitably, there will also occur periods of underperformance, perhaps substantial in degree." Can the same not be said about countless other companies? The market prices of many that we follow have risen far above their intrinsic (albeit growing) worth. We may be accused of reading more into Buffett's admonition than he had intended but we simply cannot fathom a more rational interpretation. *Inevitably, there will also occur periods of underperformance, perhaps substantial in degree.* Our goal of achieving above average long-term rates of compounded return would be compromised by failure to prepare for what Buffett concludes is an "inevitable" outcome.

Inevitable, of course, is not clock bound. The new crop of easy money enthusiasts who joined the Berkshire fold on May 5 at \$1,100 per share (to say nothing about those chastened few who paid as much as \$1,220 in the secondary market) have discovered just how short a time period might be to qualify as at least the first stage of "inevitable". Within a month of the offering Berkshire Class B shares had swooned to as low as \$990. With the benefit of the tailwind of the recent market rally, they closed at \$1,040 on August 6. Did they really think Buffett had ulterior motives? Act in haste and on impulse, repent for a lifetime.

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