

- I Estimate of GEICO price
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- I Estimate GEICO price
  - Use Value Line data (p. 12)
  - $E(R_{\text{GEICO}}) = 6.86\% + 0.75 \cdot 5.5\% = 11\%$  p.a.  
(See footnotes 15 and 32)
  - Price estimates range from \$58.32-\$79.85.  
(See Excel spreadsheet)

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- II Why did Berkshire Hathaway (BH) share price increase upon announcement of GEICO acquisition?

- When Warren Buffet talks, market listens:
  - Midas's touch or modern alchemy
  - With 50.4% ownership in GEICO, Buffet knows a lot: an insider.
  - It makes sense to follow a buy trade of an insider.
  - More importantly, his track record talks by itself.

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- III Buffet's track record

- Berkshire Hathaway (1977-1995)  
Stock price rose from \$89 to \$25,400 at a return of 36.9% p.a.
  - 14.3% p.a. return for all large stocks, and
  - 9.6% p.a. return on S&P 500See Figure 1.

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- Scott & Fetzer (1986-1994)
  - BW's initial investment: \$315m.
  - Dividend from Scott & Fetzer: See Exhibit 5
  - IRR of 26.7% p.a. based on no dividend growth after 1994, i.e., value in 1995 is assumed at \$661m = \$79.3/12%.
  - I use beta of BW 0.95 to arrive at 12%.
  - Cf: 12.6% return on large company stocks

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- GEICO (1976-1995)
  - \$45.7m investment in 1976 rose to \$1.96b in 1995 at a growth rate of 21.7% p.a.
  - IRR: 28.2% p.a. at 1995 price of \$55.75.  
29.5% p.a. at 1995 price of \$70.
- Any mistakes?
  - See Exhibit 3: two successes & one under water
  - See Excel for holding period return.
  - An example of diversification benefits?

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#### IV Buffet's investment philosophy

- Economic, not accounting, reality
- Consider the opportunity cost
- Focus on 'intrinsic' value
- Maximize value creation
- Align interest of managers and owners, i.e., avoid 'agency' problems.

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- Scorn the use of risk-adjusted discounted rate: Buffet discounts cash flows at a risk-free rate.
  - *Beta is precise but wrong.* (Intuition vs model)
  - Maybe Buffet knows so much about a company that the cash flows are almost risk-free. Still, they are risk-free.
  - This view is hard to reconcile with his focus on opportunity cost.
  - Matching risk-free cash flows with a risk-free rate is consistent with the CAPM.

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#### • Diversification

- “*Figure businesses out that you understand, and concentrate.*”
- Exhibit 1: insurance accounts for 88.5% of pre-tax operating profit and 82.6% of assets.
- Exhibit 2: some industry concentration
  - Insurance
  - Banking (AMEX, Freddi, PNC, Wells Fargo)
  - Newspaper (Gannett, Washington Post, Buffalo News)
  - Consumer goods (Gillette, Coca-Cola, Candy)

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#### • Top share of the “look-through” earnings:

- Coca-Cola: 11.26%
- Wells Fargo: 7.09%
- It does not appear that any single investment or industry dominate BW's earnings.
- Buffet actually diversifies his portfolio (See p. 5 and footnote 8 for a list of his subsidiaries.)

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#### • Efficient Market Hypothesis (EMH):

- *People believing in EMH is like playing bridge without looking at his cards.*
  - EMH: stock prices fully and quickly reflects all publicly available information
    - ⇒ Stock price is “fair”: equal to “intrinsic” value
    - ⇒ There are no bargains to be found in the market
- EMH does not deny a group of investors with superior information who earn abnormal returns on their information.

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#### V Prognosis

Can Buffet maintain his stellar track record?

Would the GEICO purchase help Buffet in maintaining his record?

- The \$70 bid price doesn't appear unreasonable given our estimate of intrinsic value. The discount rate used, however, was 11%.
- What if we use BW's historical return of 28% as discount rate?

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- To get an IRR of 28%, GEICO's share price in year 2000 should be about \$228. See Excel sheet.
- Is GEICO purchase a good or bad move?

## VI Summary

- Estimate GEICO share price based on dividend data and using PV.
- Estimate investment performance of BW and compare them with some benchmarks.
- Interpret stock price response to the announcement of GEICO acquisition.
- Examine an example of good investment philosophy.