



Wedgewood Partners Second Quarter 2013 Client Letter

Review and Outlook

Our Composite (net-of-fees) gained approximately 2.00% during the second quarter of 2013. This compares with the gain in the Standard & Poor's 500 Index of 2.91% and 2.06% in the Russell 1000 Growth Index. For the first half of 2013 our performance lagged behind the stock market and our benchmark by considerable margins: 7.95% (WWP) vs. 13.82% (S&P 500 Index) and 11.80% (Russell 1000 Growth Index).

Our largest performance detractors for the quarter were Cognizant (-18.2%), Apple (-10.4%) and Qualcomm (-8.7%). Our biggest winners were Monster Beverage (+27.4%), Priceline (+20.1%) and Charles Schwab (+20.0%).

Our portfolio activity during the quarter continues to be more sloth-like than usual for – our last new stock purchases were last year in October (Priceline and Monster Beverage). During the quarter we trimmed back positions in American Express, Google and Monster Beverage. We sold Expedito's International. We added to existing positions in Cognizant and EMC.

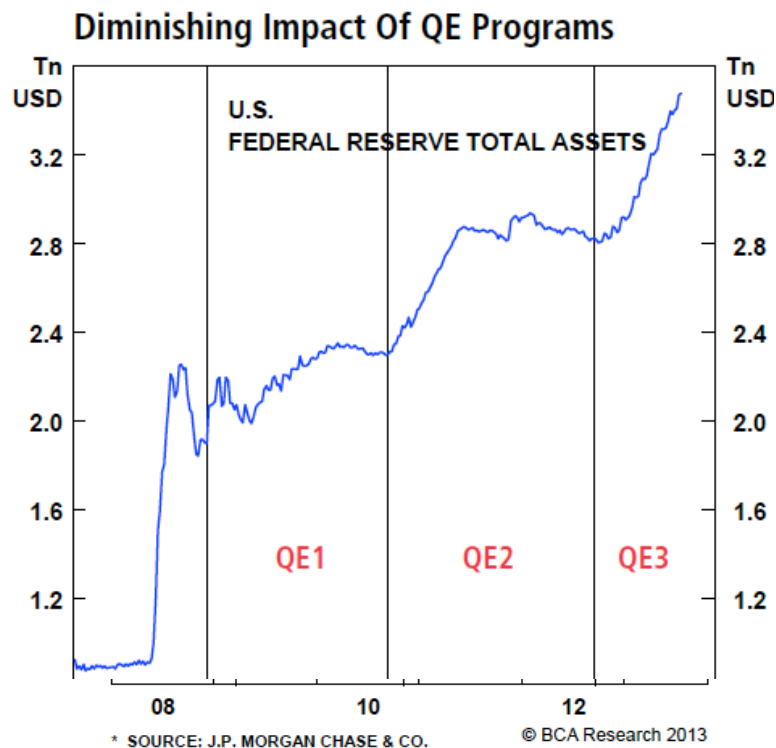
In our last Client Letter we discussed our observations and opinions on both the Federal Reserve's "QEternity" monetary policy, as well as the current (and future) state of both corporate profit margins and earnings. We would like to continue our discussion on both these topical matters.

In our view, the Federal Reserve's large hand in driving the "chase for yield" may have begun a marked change in May when the 10-year Treasury note fell to a minuscule yield of just 1.60%. Heretofore, the mantra of the Fed-driven markets - in both the bond market and stock market - has been "bad" news is "good" and "good" news is "bad." Said another way, "bad" economic news will force the Fed to replenish the current \$3.5 trillion monetary punch bowl. However, the bond market seems to be sniffing out a different economic reality than Bernanke & Co. The quick ramp of the 10-year yield to 2.70% may also signal a change in investor/speculator attitude and behavior. In our view, the insatiable chase for dividend yield over the past twelve months or so was ultimately unsustainable. Multi-decade valuation

highly in “defensive” yield-bearing stocks will likely see to that. In addition, according to Bloomberg, the most-indebted U.S. companies have gained (+25%), the most in nearly four years compared with the rest of the stock market - almost double the gains for businesses with cash rich balance sheets and the least need to borrow.

In our opinion, the bond market, for the first time since the depths of those dark days in late 2008, may now be leading the Fed. In addition, while “good” economic news may still be “bad” for the bond market, the stock market needs “good” news to drive better earnings growth. The last chapter of the “chase for dividend yield” may usher in a renewed appetite for a “chase for growth,” to coin a phrase. If so, we would expect our portfolio of “low dividend yield, high growth” companies to perform much better in such an environment.

The thought of the bond market sniffing out better economic times ahead may seem at odds to many as the U.S. economy (and much of the rest of the world) limps along at a growth rate of little more than recession-stall speeds. Indeed, the next three graphics depict the Fed’s conundrum. While A.J. Bernanke has had the Fed’s heavy foot on the monetary accelerator for four straight years, very little gasoline (velocity of money) is finding it’s way into the economic racecar’s engine.



(An economic aside: According to Wiki: The velocity of money is the average frequency with which a unit of money is spent on new goods and services produced domestically in a specific

period of time. Velocity has to do with the amount of economic activity associated with a given money supply.)

Velocity of Money and the Money Supply

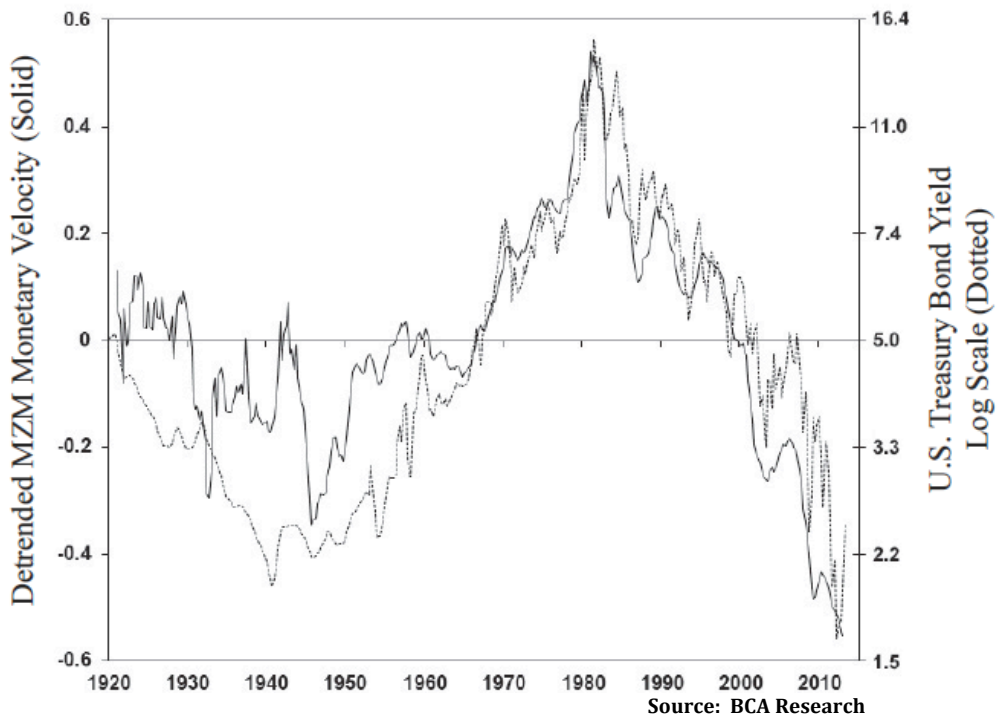
March 1, 1970 through March 31, 2013



M2 = measure of money supply; USD = U.S. dollar; Velocity = the rate at which money is exchanged. In this case Velocity is the ratio of nominal GDP to a measure of the money supply (M2). The turnover rate of the money supply. RHS = right-hand side y-axis
 Source: US Federal Reserve, DoubleLine Capital

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GDP—Money Velocity vs. Treasury Bond Yield



Source: BCA Research

While we at Wedgewood are certainly not trained economists, we do observe that if the “quantitative” elements of economic theory are unable to satisfactorily explain the none-too-small matter in the generational collapse in the velocity of money, perhaps the “qualitative” view offers the answer. The rate of inflation – particularly high rates of inflation (see 1945-1958 and 1970-1980 in the graphic above) - drives outsized increases in the velocity of money. The generational peak in the velocity of money in the early 1980’s has been followed by four seminal economic events over the past thirty years - the collapse of inflation, the Dot-Com collapse, the housing collapse and the stock market collapse in 2007-2009.

Now, we are all quite aware that the monetary wizards on Constitution Avenue, as well as our fiscal policy wizards on both ends of Pennsylvania Avenue, have done yeomen’s work in order to stimulate the economy - and repair both the populace’s balance sheets and investment statements. No doubt the booming stock and bond markets are D.C.’s exhibit A and B on what trillions in monetary expansion and trillions in deficit spending can do to stimulate financial assets. However, the economic impact or “wealth effect” that Bernanke & Co. is counting on is unlikely to come to pass as most people largely consume from sources of permanent income rather than from their widely fluctuating financial assets. Indeed, memories of two great bear markets in stocks since 2000 are not short.

If past bull markets are prologue then the future performance of both stock and bond markets could be a bit more problematic. In our opinion, the U.S. economy – at least for the continued health of the stock market – needs to be resuscitated to full health. But what about the health of the U.S. economy? Can all the king’s QE and all the king’s budget deficits *ever* put the U.S. economy back on decent growth path again? We believe the answer to that query is to be found in those earlier velocities of money graphics. In our view, the collapse in the velocity of money is part and parcel due to a collapse of confidence.

In the final analysis (at least circa-2013), the greatest impact, perhaps, of QEternity has had two very different purposes. The first, to allow banks the restorative opportunity to earn a risk-free “reserve” rate of 0.25%; and second, the larger purpose to enable the banking system to have wherewithal to support a huge increase in the confidence-sapped public’s desire to hold more cash. Said another way, all of this QE “cash-money” that Bernanke & Co. “created” through QE has simply been absorbed by the countless millions who are much more interested in holding cash, than spending it. In this sense QEternity would not only be lackluster at best as a purported \$2.3 trillion stimulus but also not so inflationary either.

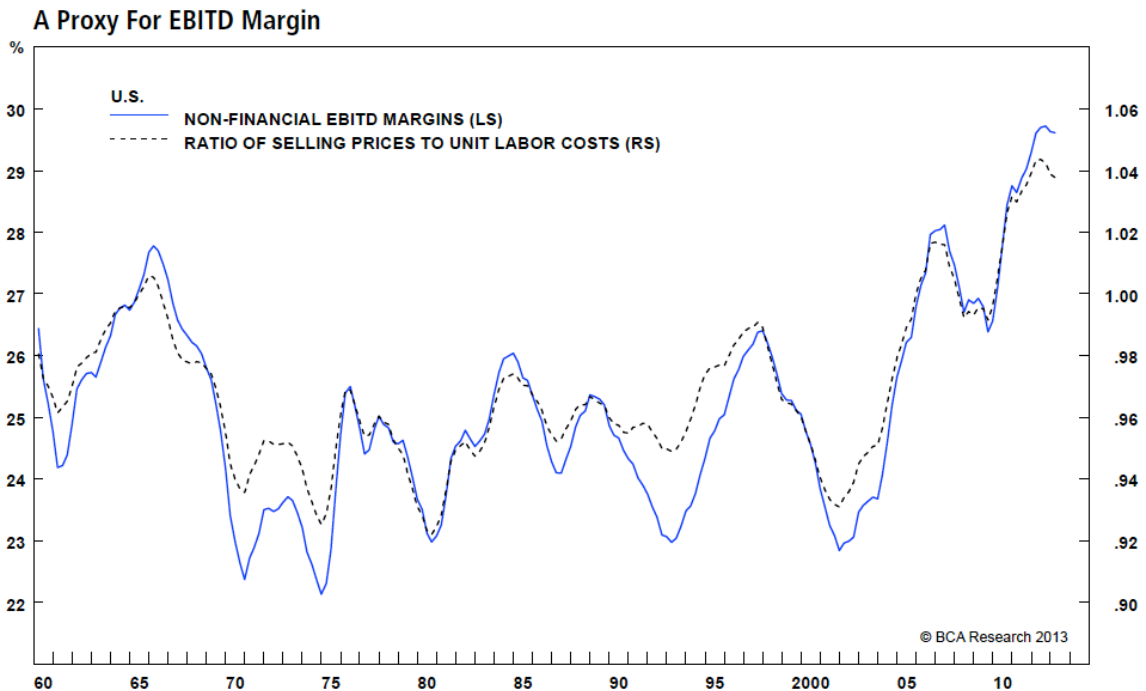
In light of the limitations of QEternity, we are reminded of the human reaction and emotion when an ambulance leaves an accident scene and then turns off its emergency lights. The immediate effect on the onlooker is that pulse rates quickly recede and great relief that all must be well. Similarly, what kind of toll has been taken on the collective confidence of economic participants given the fact that Bernanke’s ambulances are still on the scene with sirens and lights blaring after four

long years now? Can the U.S. economy ever stand on its own again? Again, maybe the bond market is telegraphing that the U.S. economy is finally out of the intensive care unit – at least.

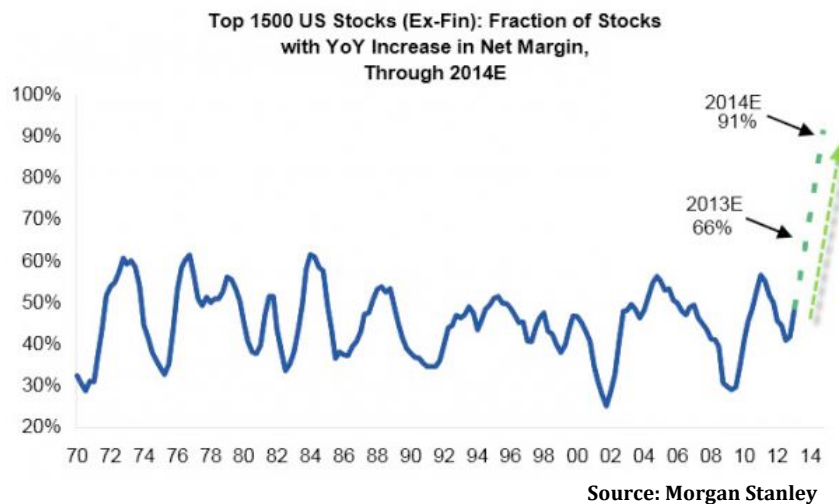
In our view, the Great Bull Market of 2009-2013 needs a much healthier U.S. economy as a new tailwind for continued corporate profit growth as previous tailwinds, such as rising margins, look to become headwinds. We spent a considerable amount of space in our last Letter discussing our views on the matter of the current multi-decade highs in corporate profit margins. Specifically, we wrote:

The good news is that Corporate America is "lean-and-mean." The bad news is that Corporate America is "lean-and-mean." Indeed, historically stretched profit margins foretell weak profit growth over the following 4-year period. The historical norm for corporate profits is approximately 6% of GDP. The current level is nearly 70% above that. If margins revert back to historical norms, corporate profits over the coming 4-year period would decline at a 10% to 12% annual rate. In our view, there exists little margin of safety on both the operational leverage front and balance sheet leverage front in much of Corporate America

In this Letter we would like to comment on a few other related corporate profitability issues. The increase in corporate profits has surely “outperformed” the lackluster economic recovery – remarkably so. Yet, in our view, when one considers the current state of the underlying components of corporate profits its difficult to envision a decent growth scenario without a renewal of economic growth.



Muted labor costs have been a significant driver of corporate profit margins. According to BCA Research, compensation expenses, adjusted for consumer prices, are still at year-end 2008 levels. In addition, while measures of productivity remain steady at elevated levels, previous margin tailwinds such as falling interest rates, and declining depreciation charges (largely from 2008 through late 2012) are likely to become headwinds. Corporate tax burden is volatile, linked to economic activity yet remains quite low by historical standards. Even the juice from low tax-regime overseas profits seem to be as good as it can get. The combination of these factors leaves revenue growth as the likely key driver of future profit growth. Furthermore, if margins do recede even a bit, it would take double-digit growth in revenues just to maintain single-digit earnings growth. Lastly, the graphic below depicts the current euphoric consensus expectations for *even* further margin expansion – we remain less sanguine.



In terms of current portfolio positioning, due to the net trimming of a few holdings during the second quarter, your portfolio is still sitting on approximately 6-7% cash. At the present time, our bench of prospective new companies to invest in is still quite bare. It's not that we haven't identified terrific companies that we would like to own - there are plenty in fact. The gating factor continues to be valuation, particularly in the context of a booming bull market. That said, our current short list of our most attractive purchase candidates largely reside within your current portfolio.

Philosophy and Process

Two critical activities in our investment process include finding companies that have both sustainable competitive advantages and the potential to generate double-digit growth over a multi-year time horizon. While we have often seen and heard

companies and investors use “growth” and “competitive advantage” interchangeably, we think there is an important distinction between the two.

We believe the key evidence for a competitive advantage is when *profit per input* is higher relative to competitors. For example, Apple’s per unit profitability for computers, tablets and smartphones is considerably and consistently superior to its original equipment manufacturer (OEM) competitors in each of their respective product segments. We believe this is a by-product of Apple’s differentiated approach to competition, which includes a focused product set and vertical integration, especially as it relates to hardware and software development.

As for growth, simply put, we consider it to be when *profit per investment* input is higher relative to some previous level. As for our invested companies we require to see growth clock in at a double-digit, annualized rate over a multi-year cycle, but realize that growth is rarely linear.

Now, both definitions for growth and competitive advantage include “profit per input,” so it is understandable if and when “growth” and “competitive advantage” are conflated in common discussion. However, we seek to avoid making investment decisions as if the two were interchangeable and do not assume that the two are perfectly correlated. In other words, a company could exhibit consistently superior profitability relative to its competitive peer group, however growth of this profitability over a multi-year period could be non-existent. For example, Expeditors International remains competitively superior, exhibiting best in class returns on invested capital, in the third-party logistics provider industry. We believe this advantage stems from its scale, as well as its tight organizational integration, which creates stickier customer relationships (i.e. high switching costs), as well as excellent visibility into shipping supply. However, over the past several quarters, we have noted that the Company’s addressable market is exhibiting symptoms of a slow motion, *secular* contraction, particularly due to miniaturization of technology as well as a lack of general macroeconomic volatility. While neither of these industry factors directly impacts the existence of Expeditors’ competitive advantages, they do serve to reduce the Company’s ability to leverage this advantage for growth. As a result, we liquidated our positions during the quarter.

We are of the opinion that the Company certainly has the financial resources to innovate its way back to growth, or potentially outlast competitors. That said, new products that can simultaneously take revenue share and incrementally add to profitability seem unlikely. Finally, we would expect consolidation to occur only before competition exits the market, given the highly fragmented nature of the industry. We are not particularly fond of the fact that we sold the stock at a historically cheap valuation, but we believe that the long-term appreciation of equities is predicated on the growth and improvement of a business’ fundamentals; and while Expeditors has maintained profitability share, we expect industry dynamics will depress growth to levels below what we believe is acceptable.

Difficult industry dynamics are inevitable, which is why our expectations for growth are not usually linear and instead viewed over a multi-year cycle. In the face of industry headwinds, a company's growth can suffer near-term, but competitive advantages can serve as an offset and provide a route back to growth. An illustrative example of the successful defense of profitability and subsequent growth is Cummins. During the macroeconomic downturn that began in late 2007, worldwide demand for heavy-duty diesel engines dramatically declined, meanwhile new EPA regulations required engine manufacturers to step up investment in technology to maintain EPA compliance. Given this pressure on industry revenues and profitability, notable on-highway engine competitor, Caterpillar, exited the market in 2010. Meanwhile engine sales of Cummins rival Navistar continue to be hindered, as they are not yet compliant with the EPA's 2010 standards. Throughout this period, Cummins continued to reinvest in research and development (R&D), while tapping into many decades of experience in building engines and components. Even though we are currently in the midst of a prolonged world-wide macroeconomic slowdown, we believe Cummins has room to grow as two of its largest rivals have exited or been effectively suspended from competing - which frees up total addressable market. Further, as clean-air and engine efficiency standards continue to evolve around the globe, we expect Cummins to continue reinvesting in R&D, which should continue to differentiate its offerings against a less competitive industry.

Coach is another example of a terrific business that leverages a competitive advantage to offset difficult industry growth dynamics. As the U.S. women's handbag market has become more saturated with competition, Coach's growth has slowed in recent years as it ceded share in this segment. However, the Company is maintaining overall profitability by expanding into the less competitive men's category, as well as into underserved, lower tier cities in China and other emerging markets. Coach has demonstrated that its vaunted worldwide distribution and brand portability are distinct competitive advantages that enable this competitive "pivoting." This, we believe, will enable the business to grow at a double-digit rate for several more years.

Company Commentaries

Apple

Apple's stock continued its streak of absolute and relative underperformance during the second quarter. However, in our view, the Company's long-term competitive positioning is strong and intact, particularly due to their aggressive, multi-billion dollar reinvestment in its supply chain, which should bear fruit over a multi-year period. While much has been said about Samsung since it recently surpassed Apple in terms of units sold, we think "units sold" is a poor proxy for competition, at the very least, until we figure the profits generated by those units. As of

the first calendar quarter 2013, we estimate Apple generated \$215 in operating profit per iPhone, compared to Samsung, which generated about \$90 per smartphone. Clearly, Apple's collective smartphone value proposition is superior to Samsung and considerably more than the rest of their rival peer group - which collectively continue to generate losses. However, Apple's profitability per iPhone during all of 2012 averaged about \$265, while Samsung averaged about \$80. So at the margin, Apple ceded roughly \$50 of profitability per iPhone relative to its 2012 average. This per unit profit decline could suggest that Apple's competitive edge has eroded. However, Samsung only picked up about \$10 per unit, and the rest of the competitive field narrowed their losses by about \$5 to \$10 per unit, which begs, *where did the other \$30-35 of profit per iPhone go?*

Given that Apple's average iPhone prices have not changed in proportion, it is certainly not accruing to Apple's customers. Perhaps some of that value accrued to customers of Apple's competitors? But if that were true, Apple's competitive cohort probably would have exercised some pricing power by now, but they have not done so, considering prices by smartphone segment have been relatively flat.

Now, as we have noted in the past, Apple's capital expenditure budget has risen rapidly over the years, meaning Apple is aggressively reinvesting into its business. Apple's "cost of sales" as a percent of revenues has risen nearly ten percentage points compared to the first calendar quarter of 2012. As a result of this dramatic rise in costs over a relatively short period of time, we suspect that much of the profitability per unit has gone to Apple suppliers. While it is unsettling to see per unit iPhone profitability decline, we believe that Apple will eventually realize returns on these expenditures, particularly by increasingly exercising more scale over its asset and supplier base.

So we realize that Apple's rival peer group is making competitive inroads, but we do not think they are as dramatic, nor as sustainable, as the market seems to be implying and that the majority of Apple's lower profitability represents current investments in future returns. Indeed, considering that the stock ended the quarter at close to just a 4X Enterprise Value to EBITDA multiple, and although the past few quarters have been difficult for Apple shareholders, we believe patience and a focus on Apple's long-term growth of their best-in-class ecosystem will be rewarded in due course.

EMC

During the quarter, we increased our weighting in EMC Corp. after the stock had been flat over the trailing 12 months, compared to the over 20% run-up in the S&P 500 Index. Combined with EMC's double-digit free cash flow generation, the stock has gotten cheaper, in our view, through benign neglect. Much of the neglect stems from perceived threats to EMC's role in enterprise data centers. However, as a developer of IT infrastructure, it is normative for EMC to face competition from

disruptive new technologies and workflows, especially at the enterprise scale. For example, just a few years ago, EMC's most relevant competitors seemed to be Hewlett Packard, Dell, IBM and NetApp, whereas today, Amazon and a host (no pun intended) of other players in the acronym-heavy cloud services industry are more apt at competing with EMC for a dollar of profitability. However, across our multi-year holding period, one of the most powerful competitive advantages at EMC has been its robust distribution network. While not nearly as exciting as the technology that gets distributed, EMC's distribution advantage presents formidable barriers to entry for both legacy and new competitors. The Company can rapidly scale emerging technologies across an unparalleled, information infrastructure-focused direct sales force and customer base that is over half a million and growing. Of course, most of EMC's competitors know this, but cultivating several hundred thousand points of sale is "easier said, than done." For instance, in 2009, EMC purchased a competitor Data Domain and its roughly \$300 million in annual revenues. Not quite four years later, EMC's Data Domain unit is generating revenues at an over \$1.5 billion annual run-rate (over 400% growth). In a similar vein, during 2010 EMC purchased Isilon Systems, a competitor in scale-out storage with roughly \$200 million in annual revenues. Less than three years later, this EMC unit is generating revenue at an over \$1 billion annual run-rate (again, over 400% growth). It is not clear if these companies would have been able to grow this quickly as standalone competitors that did not have access to EMC's distribution network. What is clear is that significant value was generated for EMC clients and shareholders, thanks to this distinct advantage.

As for VMware (EMC holds a significant ownership share in VMW), after several years of enabling, at least, primitive versions of private clouds for more than 500,000 customers worldwide (including 100% of the Fortune 100), investors are concerned that the proliferation of open source substitutes and public-cloud alternatives will significantly erode the Company's future earnings power. VMware trades at a historically low valuation (a low teen enterprise value to free cash flow multiple, which is half to one-third of its recent range), but we think its longer-term growth and profitability prospects are not as dire as the market is implying. While the natural progression for smaller and mid-sized business ("SMB") IT departments seems to be the utilization of lower-cost, subscription-based public cloud services, this will not likely be a winner-take-all market, especially since EMC has aggressively established itself in the "channel" - which is the network of thousands of value-added resellers and consultants to SMB IT departments. Further, VMware has a several year head start in cultivating a developer ecosystem, with several thousand applications, many of them mission critical, explicitly supported. In the interim, VMware's product scope is rapidly expanding, thanks to robust reinvestment, where their expertise in abstraction technology puts them at the "tip of the arrow" as data centers become more dependent on the software layer. Further, the value proposition of the public cloud is less robust for larger enterprises, especially those that have long-established investments in on-site infrastructure, so we believe the barriers to entry into this market segment by VMware rivals and substitutes will be much higher, relative to SMB.

In the future, we expect EMC (and VMware) to maintain its competitive positioning in the perpetually changing technology infrastructure industry by continuing to dedicate significant resources towards expanding their product scope – both through acquisition and organically - and then maximizing those investments by leveraging their expansive distribution capabilities. So while we recognize the highly competitive nature of enterprise IT innovation, we believe that there is substantial future growth and value still to be recognized in our EMC investment.

Cognizant Technology Solutions

Cognizant is caught in the nation's political crosshairs. In the midst of the earnest debate on immigration reform, whereby such heady matters as amnesty and border security dominate the discussion, investors' fears have been stoked by a seemingly unremarked element of the Senate's version of the Border Security, Economic Opportunity, and Immigration Modernization Act of 2013. Very specific language was included in the Senate draft that would, at worst, restrict businesses from broadly relying on highly skilled employees with temporary visas ("outplacement") and in less severe cases, drive up the cost of employing such workers. While this legislative attempt strikes close to the heart of Cognizant's value proposition, we believe that the most punitive provision of this proposed legislation (outplacement) has a low probability of becoming law.

Consider that similar legislation (from the same congressmen) was proposed in 2009 but did not get out of committee. The difference in 2013 is that the legislative climate in the Senate is slightly more favorable, so a comprehensive bill including the outplacement provision made it through the upper house. However, the House of Representatives do not have many (if any) advocates for this specific provision. In addition, the large majority of Fortune 500 businesses currently utilize the services that would be prohibited by the outplacement provision, so broad economic disruption is a possible outcome of any law that contained this provision. In other words, we think it is unlikely that any new advocates will emerge to require that outplacement be included in the lower house bill. Ultimately, both chambers must agree to final language, but given the sparse support for the outplacement proposal, we believe it will not be included in any final law.

In our view, the stock's sharp -20% drop has priced in some onerous assumptions about future revenue growth and margins. Thus, we believe that Cognizant represents an exceptional risk-reward proposition - regardless of legislative outcomes. As such, we added to our existing position in the shares.

Qualcomm

Qualcomm was one of our poorest performers during the quarter, declining nearly 9%. In fact the shares in this long held position (at approximately \$60), are little changed since reaching that level in February 2011. Qualcomm is the leading arms merchant across the entire spectrum of mobile telecommunications and mobile computing. The Snapdragon processor has found its way into 780 devices at more than 85 carriers. The Company reports that the chip is currently being designed into more than 550 future smartphone designs – from low-end to high-end.

However, their lucrative competitive position is under attack on quite a few fronts. At the high-end, concerns over global smartphone saturation has dampened growth expectations. At the ultra competitive low-end of the smartphone market (more akin to richer features in more traditional cell phones) where integrated semiconductor chips can sell for as little as \$10, the Company has a more difficult time differentiating their chips from other suppliers – most notably Asian supplies.

While the Company maintains a healthy +30% market share in the low-end, Mr. Market, in our view, is convinced that a collapse in the Company's average selling price of their chips and chipsets is imminent. The Company has long raged such battles. Over the past ten years, the range of smartphone average selling prices (ASP) has remained relatively steady between \$190 and \$220. Over the past few years, the Company's royalty rates have been based on smartphone ASP of approximately +\$210. We expect a sentiment change on ASP pricing as Apple (a key Qualcomm base-band chip client) rolls out a refreshed iPhone lineup later this year. Indeed, while the iPhone 4 and iPhone 4S still sell briskly in the millions of units, these two smartphones are positively geriatric at 21 and 36 months old, respectively. That said, a prospective drop of -10% in ASPs to \$195 over the next few years - a foregone conclusion as the Company has said as much - the question is whether or not volume will pick up, in proportion, to offset the ASP decline.

Qualcomm's licensing revenue is typically a function of device ASPs and volume. We view ASPs as a double-edged sword and as a result, over the longer-term, should exhibit a flat to slightly declining trajectory. As the value proposition of smartphones become more attractive due to lower prices (compared to smartphone prices just a few years ago), we expect low-priced feature phone subscribers will ultimately trade up to low-end smartphones with higher ASP's, relative to their feature phone predecessors. In addition, given the highly commoditized nature of low-end smartphones, we expect volume will closely offset, if not outpace average selling price declines. On the "high-end," we think spectrum innovation from Qualcomm and telecom operators will drive a continued desire by consumers to upgrade devices in order to take advantage of faster, more efficient networks.

In addition, fears of a rejuvenated Intel - making inroads in the mobile processor space with their next generation Atom-based mobile processors - are also weighing on the shares. Lastly, concerns over declining royalty rates at the Company's über-

profitable patent licensing division are quite real down the road. As the smartphone market migrates from 3G/4G, then on to LTE-only devices, royalty rates will no doubt decline. Even with declining LTE royalty rates, the Company still possesses best-in-class IP in apps processing, WiFi integration, power efficiency and smartphone carrier roadmaps to propel robust unit growth. The Company has over 300 devices approved, based on their LTE chips, and over 400 design wins on future LTE devices. Further, the industry research firms of Gartner and Strategy Analytics expect cumulative smartphone unit sales of approximately *5 billion* from 2012 to 2016.

In summary, Qualcomm's competitive edge is its unrivaled patent portfolio of 3G and 4G air-interface technologies. Around two-thirds of the Company's consolidated operating profits are generated by licensing this technology to electronics manufacturers, most notably feature phones and smartphone OEMs, which seek to include cellular equipment in their devices. At \$60 per share, the market implied growth rate of the company (revenues) is less than 10%, as well as assuming a 300-400 basis point decline in operating margins. Given that Qualcomm is our 5th largest holding, we certainly believe that the market is over-discounting the concerns chronicled above.

Berkshire Hathaway

We attended the 2013 Berkshire Hathaway annual meeting in early May and it was a strong reaffirmation of our investment thesis on Berkshire. The Company's (as well as the Company's key subsidiary companies) considerable competitive position and competitive advantages are intact.

This was the fifth annual meeting we have attended since 2006. While the "Woodstock for Capitalist" atmosphere in the exhibition hall, at the numerous parties, gatherings, restaurants, plus investor conferences we attended were ever present (we would expect no less), the quality of the Q and A session was among the best we have experienced. The quality of the questions asked of Warren Buffett and Charlie Munger were, on the whole, top-notch. Buffett's answers, as usual, were patiently answered, detailed, informative and well communicated. Munger was his usual quick and cryptic to the point and hilarious self. While the Q and A session lasted for six hours, Buffett and Munger both focused many of their answers and replies on three key themes of Berkshire's distinct and differentiated culture and enduring competitive advantage.

The first is Berkshire's unique philosophy of decentralized management (to the point of *abdication* per Munger) relative to any other Fortune 500 company. Buffett and Munger's decades-long history of buying companies large and small, and then allowing management significant autonomy to run all aspects of their respective companies (with exceptions to capital reinvestment) significantly reduces the CEO burden for Buffett (and his successors). Such guarantees of management autonomy

and business permanence under the Berkshire corporate “umbrella” provide Berkshire a unique advantage in purchasing businesses. Buffett expounded on this critical point in the telling of the story of a business owner who wanted Berkshire to buy his business. The owner desired to have the sale of his business to have as minimal of an impact to both his business and his family as possible – particularly to his employees, as selling to a competitor or private equity might threaten their careers.

Buffett: *"A person a few years ago came to me and he was in his 60's. He didn't want to retire. But he had experience in buying a business, which had soured. And wanted to put to bed the risk of selling, that what he had built would be destroyed, or family destroyed. He thought about it a year, if I sell it to a competitor, they are logical buyer. Competitor would come in and put their people in charge. They would have synergy ideas, his people would all get sacked, and acquirer would be like Attila the Hun. He didn't want to do that to his people. Private equity should load up with debt and sell it later. So when he came to me and he said, it isn't because you are so attractive, but you are the last man standing. People who stayed with me, I'll get to sleep well at night knowing they are ok. Our competitive advantage is that we don't have many competitors. Also, shareholders are partners. That is unusual.*

The second is Berkshire’s willingness and rapid ability to deploy billions when opportunity knocks – most often when the markets are seized in panic. No other company of size can match Berkshire’s competitive advantage on this score.

Buffett: *"My successor will have more capital than me when markets are in distress. At those times few people have capital and even fewer have willingness to commit. It is unusual to have capital at times of turbulence, when ability to say yes quickly with large sums sets you apart. I would not worry about that successor being willing to deploy and being called upon. Berkshire is the 1-800-number when there are panics in markets. It happened a couple times in 2008 and once in 2011. Not our main business, but if Dow falling down a 1000 points for a few days, they will call Berkshire. Our reputation will become even more solidified, when Berkshire does it when I'm not around. It becomes even more the Berkshire brand."*

Munger: *"We have tried to stay sane when others like to go crazy. That is competitive advantage. Second, we have used golden rule, where we treat subsidiaries how we would want to be treated if we were subsidiaries. People come to us who don't want to go elsewhere. That is long-term advantage. We have tried to be a good partner and that is an advantage. We are leaving behind a competitive place, and have gone to a place more unusual. This was a very good idea, I wish we had done it on purpose. [laughter]."*

The third theme is essentially the “synthesis” of Berkshire’s “culture” (a favorite word of Buffet) and “system” (a favorite word of Munger). Berkshire’s

conglomeration of best-in-class businesses (and investment portfolio), prudently levered on a +\$77 billion ocean of very low cost of float and capital, has literally become a perpetual cash generating machine. Cash is currently flowing to Berkshire's coffers to the tune of approximately \$1.4 billion per month. In addition, quarterly earnings have reached record levels at \$4 billion and 2013 will likely mark the sixth consecutive year since the last recession that the Company's operating return on equity will increase – reaching a record 8%.

These three themes are Berkshire's enduring competitive advantage. They have painstakingly been built over the past +40 years. Furthermore, Berkshire has been built to survive and thrive long after Buffett and Munger have departed the scene.

Buffett was adamant that Berkshire's culture would "reject" the wrong CEO "like a foreign tissue" and that Berkshire's corporate culture will be maintained after he's gone.

Buffett: *"We worry all the time. Culture and the businesses we own are very important. After I'm gone, the trains will still be running and people will still buy GEICO insurance. The key is preserving the culture and having a successor at CEO with more passion and brains than I have. We are solidly in agreement about who that individual should be. The culture has intensified. We always knew what we were about. Making sure that everyone who joined us thought the same. Everyone who bought into this, that took time. It is one of a kind now and will remain one of a kind. Any foreign type behavior would be cast out. It would be rejected like a foreign tissue if we got the wrong person. We have a board that is especially dedicated. We have people who have brought their companies to Berkshire Hathaway. People have self-selected in. Whoever succeeds me, there will be newspaper headlines saying it is not the same thing, but it will be the same thing."*

Munger chimed in on the matter as, well...as only Munger can:

Munger: *"I want to say to the many Munger's in the audience, don't be so stupid as to sell these shares."*

Buffett: *"That goes for the Buffet's too!"*

As always, we had hoped (clamor?!) for as much information and minutiae on Berkshire's key businesses. If we had any disappointment in the 2013 meeting, it was on this score. Though Buffett specifically noted GEICO at the outset of the meeting on GEICO's terrific policy growth. Buffett noted that GEICO might reach one million in new auto policies in 2013 – or 2/3rds of all industry growth. GEICO is also on the verge of passing Allstate to become the industry's second largest auto insurer.

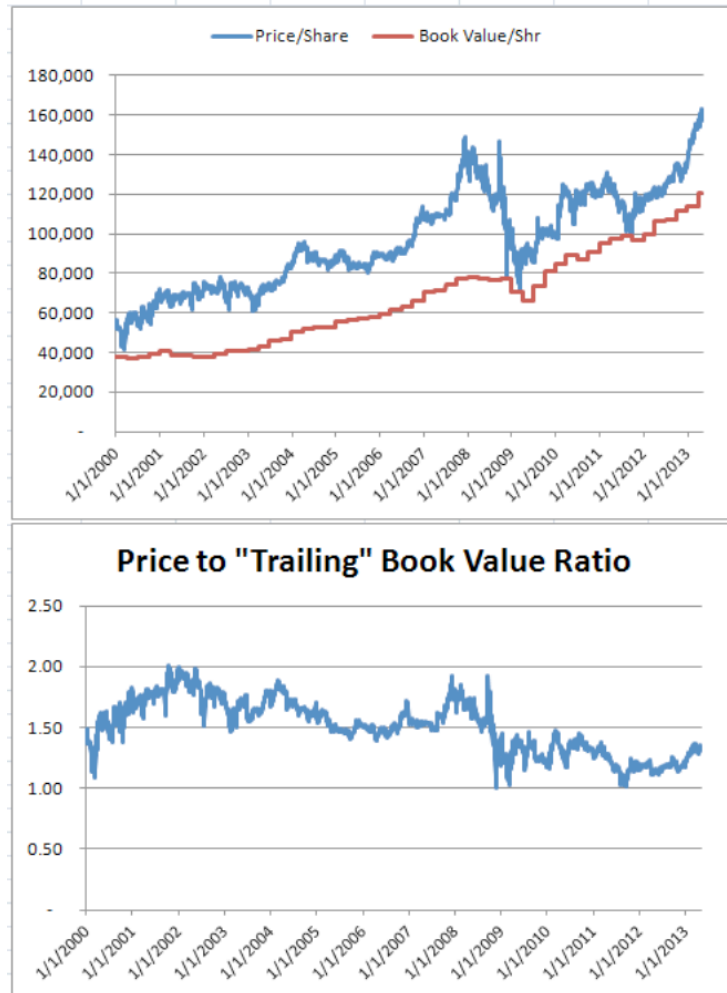
Buffett: *"One highlight in the quarter was the pick-up at GEICO. The strengths I mentioned in 2012 have gotten even stronger. A lot of it is seasonality related to month on month policy gains, but our closure ratio and persistency have improved significantly. The rise in persistency equals pure gold. The number of people who get a quote from us and go on to get a policy, the closure rate, is rising. Mathematically each policy is worth about \$1,500 to us. If we get 1 million policies we will see a \$1.5 billion in gain in intrinsic value that isn't captured in our accounts."*

Other meeting items of note and interest to us were Buffett and Munger's disquisitions on the matters of corporate profits, the Fed's monetary policy and D.C.'s fiscal policies. On the whole the two generally shared the same concerns that we have on the same as we outlined in our last Client Letter (linked on our website). Buffett's words were certainly more sanguine than Munger's more dire tone, but we did note both of their admonitions – particularly on the Fed's "huge experiment" in expanding their balance sheet to \$3.4 trillion and the likely consequences of the end of this expansion, as well as the concomitant consequences of unwinding of the Fed's balance sheet.

Buffett: *"My basic answer is I don't know... It will be the shot heard around the world when the central bank first indicates it will stop buying financial assets or start selling from their now enormous \$3.4 trillion balance sheet...we're in uncharted territory... that's a lot of securities...There's all this liquidity that's been created...It hasn't really hit the market because the banks have let it sit there...We really are in uncharted territory....It certainly has the potential to be inflationary...It hasn't been so far...My guess is some Fed members are probably disappointed they haven't seen more inflation."*

Munger: *"What has happened has surprised everyone who thought they knew the answers, in particular the economists. Who thought Japan would have twenty years of stasis? Economists should have more caution that they know how to stay out of trouble...They should therefore be humble about further predictions on the effects of the money-printing."*

In terms Berkshire's current valuation, the stock at \$113 remains reasonably attractive at just over a 17% premium to Buffett's stated stock buy back level of 1.2X book value (\$96.43). The graphics below are instructive. Since 2000 there has been two periods of distinct valuation ranges. From 2000 through 2008, the stock traded between 1.5X and 2.0X book. Long-time Berkshire shareholders will recall the great bargain Mr. Market offered up in early 2000 when the shares fell to nearly 1.0X book. (Buffett offered to buy back shares in his 1999 Chairman's Letter. No one would ever take him up on his *gracious* offer.) Since 2008 the shares have largely traded between 1.0X and 1.5X.



Source: Rational Walk

It is important to note that 1.2X book should not be construed as a valuation “floor” in the stock. While Buffett has been quite vocal in communicating his desire to make large, multi-billion stock purchases at 1.2X, such desire is not a guarantee. We could easily envision a scenario whereby the stock market could be once again in a general bear market – and Buffett could choose to expend the Company’s cash hoard for better bargains. 2008 and early 2009 were instructive on this score. Excluding his \$34 billion acquisition (60% in cash) of Burlington Northern in late 2009, Buffett spent a cool \$46 billion on investments and acquisitions in 2008. *Please notice the behavior of Professor Buffett – investing tens of billions in the teeth of a bear market, while today, as the stock market begins its 5th year of the current bull market, Buffett’s cash/liquidity sits relatively idle at an even “cooler” \$50 billion.* Class dismissed...

On behalf of Wedgewood Partners we thank you for your confidence and continued interest. We hope these Letters give you some added insight into our portfolio strategy and process. As always, please do not hesitate to contact us if you have any questions or comments on these commentaries.

Sincerely,

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