Wedgewood Partners 1st Quarter 2016 Client Letter

<u>Berkshire Hathaway: *Still* The Greatest Growth Company Wall Street Has Never Heard Of</u>

Review and Outlook

Performance for Wedgewood Partners' Large Cap Growth composite portfolio during the quarter ended March 31, 2016 (net-of-fees)[i] was +1.00% compared to the Russell 1000 Growth benchmark's gain of +0.74% return and the S&P 500 Index's gain of +1.35%.

Relative contributors during the quarter included Berkshire Hathaway, Apple, Stericycle, Schlumberger, and Kraft Heinz.

Berkshire Hathaway completed its largest acquisition in its history, closing on Precision Castparts for over $37 billion in total consideration. Berkshire Hathaway will continue to favor purchasing operating businesses, as opposed to securities, given the rapid growth of cash flow and management's long-held policy of retaining all earnings. We continue to believe that Berkshire Hathaway is under-rated as a growth company, as very few companies of this size retain all of their earnings for reinvestment – a hallmark of growth. In fact, of U.S.-based companies with a market cap in excess of $50 billion, there are just eight that have 0% earnings payout ratios (last 12 months). Notably, over the past decade Berkshire Hathaway's retained earnings have grown from $47.7 billion to $187.7 billion.

Company Name	Market Capitalization (USD, Millions)	Company Country Name	Payout Ratio (%) LTM
Alphabet Inc	520,944.59	United States of America	0.00%
Berkshire Hathaway Inc	349,681.97	United States of America	0.00%
Facebook Inc	323,650.55	United States of America	0.00%
Amazon.com Inc	283,935.27	United States of America	0.00%
Celgene Corp	84,591.74	United States of America	0.00%
Priceline Group Inc	64,154.75	United States of America	0.00%
Biogen Inc	61,134.33	United States of America	0.00%
Salesforce.com Inc	50,706.62	United States of America	0.00%

Source: Thomson Reuters Eikon

If Berkshire Hathaway is not careful of the company it keeps, at least on this score, then it "risks" being misconstrued as a growth company! (Please note: Alphabet and Priceline Group are also in the portfolio.) Readers will note too that three of the four "FANG" stocks are listed in the table below. We will have more on Berkshire Hathaway later on in our Letter, but for a precursor on how un-loved the shares of Berkshire stack up against the beloved FANG stocks, please digest the table below from Semper Augustus Investments Group.

	Sales *	Net Profit *	Price/Sales	Price/Earnings	Market Cap #
Facebook	$17.9 B	$3.6 B	17.0x	83x	$305 B
Amazon	107	0.6	3.0	545	325
Netflix	6.7	0.12	7.6	425	51
Google/Alphabet	75	18.5	7.1	29	534
Total	$206 B	$22.9 B	5.9x	53x	$1,215 B
Berkshire Hathaway	$220 B	$25 B	1.5x	13x	$325 B

* Sales and Net Profit are 2015 Estimates
# Market Cap at December 31, 2015

Relative detractors during the quarter included Express Scripts, M&T Bank, Perrigo, Visa, and Alphabet.

Express Scripts sold off after their largest customer by revenues, Anthem, threatened to sue the Company for issues related to contract pricing. We believe the lawsuit has little merit based on our research. Further, despite the contract running through 2019, we believe the market has already priced in the complete loss of the Anthem business, with shares trading near all-time low valuations, at just 10x consensus 2017 estimates. We believe the rapidly increasing supply of high-cost drugs and therapies continues to drive secular demand for Express Scripts' best-in-class cost-containment services, which are insulated by the Company's scale and increasingly rare independence.

Q1 Top Contributors	Avg. Wgt.	Contribution to Return
Berkshire Hathaway Cl B	8.95%	0.67%
Apple	8.74%	0.50%
Stericycle	4.93%	0.43%
Schlumberger	5.51%	0.38%
Kraft Heinz	4.30%	0.38%
Q1 Bottom Contributors		
Express Scripts	6.40%	-1.68%
M&T Bank	2.17%	-0.75%
Perrigo	4.94%	-0.61%
Visa	4.36%	-0.06%
Alphabet Inc Cl A	2.68%	-0.06% [1]

[1] Portfolio contribution calculated gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended. Past performance does not guarantee future results.

After a very difficult relative performance year in calendar 2015, our process performed much more favorably during the volatile first quarter of 2016. While our product is "focused" in the sense that the number of holdings in our portfolio are substantially less numerous than those of most active managers, we believe that the portfolio still has ample diversification, particularly across business models, as we stick to "best of breed" companies, meaning that we usually find just one good idea for a given business model. When we see lopsided performance, similar to what we've seen over the past five or so quarters, we try to remind ourselves – and our clients – that, despite what many might think about focus, our diversification (by business model) and our position limit size (which is 10%) make it very difficult for just a handful of companies to account for all of the relative performance. For example, during the first quarter of 2016, we owned 19 companies across composite portfolios, where 13 of them contributed positively to outperformance, and just six detracted. The result of having the majority of our stocks outperform was, unsurprisingly, a quarter of outperformance. This compares to calendar year 2015, when we owned 23 stocks, and just six outperformed while 17 underperformed. With such a large number of our companies behind the benchmark in 2015, it was difficult to chalk up the underperformance responsibility to any single business model. Instead, that responsibility laid at the feet of a woefully out of favor investment process.

Even with our focused portfolio, we believe that our investment process should drive our performance, more than any single or even a couple of big winners or losers. For example, looking at each of the past five calendar years, we have never outperformed the Russell 1000 Growth Index in a calendar year if portfolios had substantially[2] less than half of the stocks in the portfolio outperforming. The corollary is that we have never underperformed if we had less than half of the stocks underperform. That might seem obvious, but we reiterate that it takes more than just a few good ideas to drive long-term performance in our focused portfolio. While some focused managers might rely on a couple of "big positions" (i.e. several different companies with the same business models, and/or more than 10% of the portfolio in a single position) to drive things, it is our process that is the "connective tissue" across our holdings that manages both risk and reward.

During the quarter, we initiated a new position in a familiar name, Charles Schwab, which we have owned in years prior, and liquidated our positions in M&T Bank Corp.

We also added to Priceline, Apple, Kraft Heinz, and Stericycle, all due to attractive valuations. We trimmed Qualcomm to fund our Apple purchases, as we continue to limit our collective weighting in those two companies, given that the supplier-customer relationship is quite meaningful to Qualcomm's future cash flows. Both companies were trading at similar ex-cash multiples, but we have relatively more conviction in Apple's future prospects.

[2] In 2011, we owned 27 stocks – 13 of them, or slightly less than half, contributed positively to annual outperformance

Company Commentaries

LKQ Corp

During the quarter, LKQ continued to execute on its mid-single digit organic growth plus M&A strategy. In addition, the Company provided a convincing case for its continued execution at their first-ever Investor Day. The Company also announced the acquisition of Pittsburgh Glass Works for $635 million in enterprise value and finalized the acquisition of the RHIAG group of Italy.

LKQ is both the largest distributor of aftermarket collision parts in North America and the largest distributor of mechanical aftermarket parts in Europe. We think scale is critically important to most distribution businesses, and LKQ is no exception. In North America, LKQ's primary customers are collision repair shops that often participate in volume programs organized by casualty insurers looking for low-cost but high-quality repair parts. These collision repair shops must turn their repair jobs over relatively quickly or risk losing out on volume business. As such, LKQ's unmatched product availability and fulfillment rates are differentiators in the eyes of the Company's customers, while cost-conscious insurers provide another impetus for low-cost, aftermarket collision parts demand, so we expect LKQ's profitability to reflect the return on the inventory and distribution capital expenditure risks that LKQ takes on behalf of its customers.

LKQ's organic revenue growth consists of increasing the penetration of after-market parts to collision and mechanical repair shops, as well as increasing route density. Increasing this "base" off which LKQ can organically grow, is their long-held approach of acquiring several under-scale competitors per year. As we have seen over the past few years, LKQ has very little in the way of rival competition, and the industry is mature, so aside from integration risks, LKQ's accretive growth from acquisition appears to be repeatable. While LKQ contributed to our outperformance during the quarter, we continue to think that LKQ's growth prospects are under-appreciated by investors.

Perrigo

Perrigo was a bottom performance contributor in the quarter, as the company reported a miss in its Branded Consumer Healthcare (BCH) segment. Management attributed the miss to execution issues and dedicated themselves to solving these problems over the coming quarters. We are willing to be patient; in the meantime, as we think that Perrigo's core, private label OTC business is unique and should remain a healthy and sustainable source of internal capital.

Perrigo's BCH segment was established after closing on the acquisition of Omega Pharma (Belgium) in March 2015. Mylan's hostile bid for Perrigo was launched a few weeks later, and did not conclude until mid-November. We think that Perrigo's BCH execution issues are understandable (if not predictable), as management was admittedly distracted by fending off Mylan's hostile bid for the Company during much of 2015. Over the next several quarters, we expect BCH to post improved results, as it is better integrated with Perrigo's corporate planning cycle.

M&T Bank

Our growth thesis for M&T Bank was predicated on the company's ability to maintain its historically successful inorganic growth strategy. We purchased the stock in mid-2013 as the Company moved forward with it's acquisition of Hudson City Bank (announced in August 2012). More than three years later, after extensive AML/BSA expenses (the company spent over $150 million to improve these systems in 2014 alone) and four extensions to the closure date, regulatory approval was finally granted and the acquisition was complete. Of note in the Fed's approval, however, was a restriction stipulating that M&T Bank must fully integrate the Hudson City deal and cure all BSA deficiencies fully before pursuing further growth through acquisition. We fully expect the Company to follow through on the Fed's requirements, but given how cumbersome and expensive it has been to integrate this acquisition, we are not convinced that future acquisitions will be any less cumbersome. Furthermore, we are concerned that future returns on acquisitions will be much lower than we initially expected. As such, we liquidated our holdings in M&T Bank.

Charles Schwab

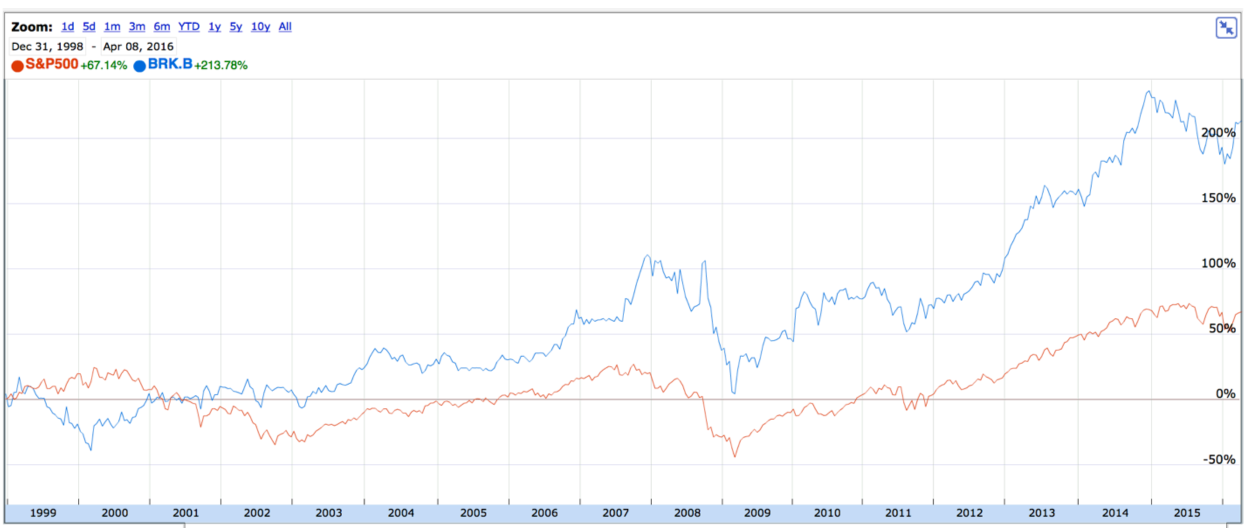
As our conviction in M&T Bank waned, conviction built in another previously held financial, Charles Schwab. We previously held Schwab, ultimately selling the stock for valuation reasons in late 2013, after the stock got well ahead of what we thought were solid fundamentals. Valuation was the driving factor for the sell approximately two years ago, and valuation was the driving factor for this most recent purchase. In other words, little has changed from a fundamental point of view. Schwab has maintained their low-cost leadership (per dollar of platform assets) by leveraging their independent open-architecture asset gathering platform, and scaling over $2.3 trillion in client assets across decades of technology investments. Schwab's low-cost of servicing allows them to pass on lower fees to advisors and clients, which is a key advantage, particularly in the highly commoditized financial services industry. While Charles Schwab's capital intensity has increased over the past several years, they continue to maintain industry-leading pretax profit margins. We expect Schwab to continue gathering assets at a mid-single digit organic growth rate, combined with continued expense leverage, and only modest help from the interest rate environment.

Berkshire Hathaway

"We want to do business in times of pessimism, not because we like pessimism but because we like the prices it produces. It's optimism that's the enemy of the rational buyer. We do not measure the progress of our investments by what their market prices do during any given year. Rather, 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 is whether their moats (competitive advantages) have widened during the year."

Warren Buffett

We have owned shares of Berkshire Hathaway nearly continuously since the end of December 1998. (We exited the shares for a brief period after the share price spiked when the stock was added to the S&P 500 Index in early 2010.) Since our initial investment, the stock has meaningfully outperformed the S&P 500 Index by a factor of better than three-fold (+214% vs. +67%), buoyed by the tailwind of significant corporate growth. An aside: alert readers will note, if not recall, the significant underperformance of Berkshire stock during the first quarter of 2000 at the height of the dot-com bubble. Perhaps recalling too, the cover stories in the financial press then that the new new-world investing had laid waste to dinosaurs like Buffett. Well...Berkshire shares bottomed literally within days of the top in the NASDAQ. Since that seminal bottom 16 years ago, Berkshire shares have gained +292% versus a paltry gain of just +34%. (Cisco Systems has declined -65% since March 30, 2000.) Valuation matters.



Source: Google Finance

Over the course of our decade and a half investment in Berkshire Hathaway, the most common question we have been asked on any stock we have owned – and continue to be asked to this day is – *"Is Berkshire Hathaway a "growth" company?"* We attempted to answer this question back in early 2004 in a Client Letter titled, "Berkshire Hathaway: The Greatest Growth Company Wall Street Never Heard Of" (*as excerpted*):

> *"Even casual students of Buffett have long since learned that Berkshire Hathaway is quite a different entity than it was only ten years ago. Where once Berkshire was not much more than Buffett's personal investment portfolio, the Company is now a conglomerate of mutually exclusive businesses, dominated by a core of insurance companies. Wall Street is not casual about anything. When it comes to Berkshire and Buffett, Wall Street has finally caught on to the reality that the Company is mainly a conglomerate of businesses. Wall Street does not slavishly follow every Buffett buy and sell as Holy Grail secrets any more.*
>
> *"That said, we still think Wall Street once again remains behind Buffett's learning curve. We believe that the Street fails to realize that Buffett has slowly built Berkshire Hathaway into a true growth company. In fact, not only is Berkshire a growth company, but a remarkably rapid one considering the enormous asset base ($180 billion) and equity base ($78 billion). Would anyone believe that a conglomerate could grow operating earnings per-share by 28% compounded over the past five years? The key here is the term <u>per-share</u>. Wall Street worships the mantra of "growth." Too many corporate executives are compensated far too largely for any type of growth – good growth or bad growth. Make no mistake about it: not every type of growth is good for shareholders.*
>
> *"Growth via acquisition and mergers is the most prominent means of growth, and often the most fraught with abuse (Enron, Tyco, WorldCom, etc.). Investors must also be aware of managements' claims of "record" growth. Buffett reminds us that even a simple passbook savings account generates "record" growth every year.*
>
> *"This matter underscores a most underappreciated aspect of Berkshire: <u>non-dilutive</u> growth by acquisition. Buffett has a growing reputation, particularly among large family-owned private businesses, that Berkshire is a terrific home for them since Buffett will not dismantle what these families have built over the years. More to the point, mediocre businesses become good businesses under the Berkshire umbrella. Moreover, good businesses become great businesses. We cannot stress this point enough.*
>
> *"The simple but powerful reason for this is that Buffett dramatically changes the reinvestment equation for Berkshire's wholly-owned companies. Consider the capital reinvestment plight of a good-sized carpet or brick manufacturer. Now such a business may be considered a "good" business by measures such as profitability and market share, but unless the respective CEO can reinvest retained cash earnings accumulated in owner's equity to earn future high returns, such businesses fail to be true "growth" companies. Of course, the carpet CEO or brick CEO can pay out all net earnings as dividends, but this is unlikely; since most CEOs are paid in part (in too many cases, in large part) on the size of the firm. Then the reinvestment of earnings becomes the paramount job of the CEO. So, what is the CEO to do if reinvestment opportunities back into the business are lackluster? Not much. This "lack of sustainable growth" is the simple reality facing the majority of Corporate America. Most businesses, by economic reality, cannot achieve growth much better than their*

underlying industry growth, or faster than the overall economy. We have stated for years that true growth companies are rare.

"Consider the capital reinvestment options if our carpet/brick company is wholly-owned under the conglomerate of Berkshire. Buffett solves the reinvestment conundrum unlike almost any other business we know of. Sure, Buffett can allow CEOs to reinvest in carpets or bricks – but only if the CEO can convince Buffett that these reinvestment opportunities are superior to Buffett's exceptionally wide canvas of reinvestment opportunities. This is highly unlikely since Buffett can invest in any asset, stock or bond, private or public company, or do nothing and just sit on wads of cash. Rare is the CEO who sits on stacks of idle cash. Too many CEOs view any and all activity as progress.

"This is why businesses become better as a wholly-owned subsidiary of Berkshire. Buffett solves the ever-present capital reinvestment dilemma: this is the unique essence that too many investors fail to appreciate about Buffett and Berkshire Hathaway.

"Now back to that pesky matter of "per-share" growth. Berkshire's growth has been driven in large part by acquisition. However, Buffett – unlike most companies –rarely uses Berkshire stock to fund an acquisition. Therefore, as Buffett reinvests Berkshire's many billions of cash into seemingly boring, but profitable businesses, revenues grow, earnings grow and cash flow grows. But since outstanding shares do not grow, <u>per-share</u> growth explodes. Per-share earnings have compounded at 28% for the past five years and 24% for the past ten years.

"So, make no mistake about it –Buffett has masterfully built Berkshire Hathaway into an outstanding growth company.

We would change little in that Letter. However, we did miss a few key elements. We failed to mention the evolving, solidifying culture of management redundancy and independence at each wholly owned business. Buffett ain't making chocolates at See's Candies, and he ain't driving locomotives at Burlington Northern (though he probably wouldn't mind such gigs from time to time). We failed to mention too the swiftness and tax efficiency with which billions can move throughout the Company's conglomerate structure. A huge, and hugely underappreciated, element of Berkshire's key enduring competitive advantages particularly the durability of the Company's +$87 billion of insurance float. We would also add, after another decade of Buffett and Munger adding new diverse streams of revenues, earnings, and cash flow in very long-lived assets via acquisitions, plus significant organic growth within the Company's best-in-class insurance operations, that Berkshire Hathaway has become what capitalism may have never contemplated, a perpetual growing cash flow machine. Notable acquisitions over the past decade ISCAR, PacifiCorp, Burlington Northern, Marmon, Lubrizol, Bank of America, Heinz, and, most recently, Precision Castparts. We do not type such words lightly, but as long as the Company retains all of their earnings (no dividends) for additional future acquisitions, the compounding will continue.

The 50-year compounding of Berkshire Hathaway on a *per-share* basis is without peer in the annals of capitalism. Many have tried to build conglomerate empires over the many years, but few have survived. Fewer still that might have the lights still on are but a shell of their former short-term glory selves. Wall Street has a long history of feeding and promoting faux empire builders who ultimately choke on too much dilutive common stock, too much easy debt, too many accounting schemes, too many lousy businesses acquired – and far too much fraud. Inevitably, the investment bankers stop calling (or returning calls) and the empire-builder CEO now must try to manage their colossus for organic growth and some semblance of true cash flow generation. At best, the colossus has morphed into a colossal mess (envision herding cats). At worst, the jig is up and the lawyers start calling. Berkshire Hathaway is the antithesis of this litany of conglomerate woe.

The table below outlines the growth of a number of fundamental metrics since we first began investing in Berkshire, as well as more recent growth.

Year	**1998**	**2011**	**2015**	**1998 % Change**	**2011 % Change**
Shares Outstanding	1,519,548	1,649,891	1,643,183	+8%	0%
Book Value Per Share	$25.20	$66.57	$103.67	+311%	+56%
Assets	$122,237	$392,647	$552,257	+352%	+41%
Revenues	$13,832	$143,688	$210,821	+1424%	+47%
Pre-Tax Operating Earnings	$4,314	$17,184	$25,214	+484%	+47%
Pre-Tax Operating Earnings Per Share	$0.32	$5.03	$8.20	+2463%	+63%
Insurance Float	$22,762	$70,571	$87,722	+285%	+24%
Investments Per Share	$31.76	$65.58	$106.53	+235%	+62%

Source: Berkshire Hathaway Company Reports

A couple of observations hopefully stand out in the table above, but first a few notes. Assets, Revenues, Pre-tax Operating Earnings and Insurance Float are in millions. The shares outstanding are A-share equivalents. All per-share figures have been converted to 1/1500 B share equivalents.

Observations since 1998:

- The 25X increase in pre-tax operating earnings per share illustrates the dramatic transformation of Berkshire from a "closed-end stock fund" into the mighty conglomerate it is today.

- Over the past 17 years, shares outstanding have only increased *8%.*

- Insurance float increased a terrific +285%, but the change in float during 1998 was substantially increased by roughly $15 billion with the acquisition of Gen Re. Growth in float from year-end 1997 was *+1,137%.* Also of considerable note in June of 1998, Buffett swapped shares of Berkshire for shares in the purchase of Gen Re. At the time when the stock of Coca-Cola was valued at an incredibly rich +40X earnings and the Company's equity portfolio alone made up 115% of book value, Buffett swapped Berkshire stock valued then at 3.0X book value, which tripled the Company's float and "sold" stocks and "bought" a very huge fixed income portfolio. One of the greatest *tax-free* market-timing and asset allocation moves of all time.

- Investments per share "only" grew at a rate of 235%, yet this is far below the other conglomerate-related metrics.

Observations since 2011:

- In an environment where the GAAP earnings of the S&P 500 Index companies was flat (see graphic below), Berkshire increased their pre-tax operating earnings per share by *+63%,* as well as reloading Buffett's elephant gun (investments per share) by +62%.

- Growth in shares outstanding that included the following acquisitions: Bank of America warrants ($5 billion), Heinz ($12 billion), and Precision Castparts ($32 billion)? Zip. Zero.

- While not shown, sourcing the Company's Statement of Cash Flows, specifically cash flows from investing activities less depreciation has collectively amounted to *$101 billion* since 2011. Post-Precision Castparts, Buffett's annual cash for elephant and gazelle hunting should now exceed $25 billion per annum.

At the risk of sounding like a broken record, if an investor endeavors the financial health, growth and prospective growth then follow the cash.

Got Cash?: Berkshire Hathaway "Owner Earnings" ($Billions)

Year	Investing	Financing	+/- Cash	Total Cash Flow	Depreciation	Free Cash Flow	Earnings
-							-
10-Year Total				**$209.6**		***$162.4***	**$148.7**
5-Year Total				**$132.5**		***$101.0***	**$88.6**
2015	$26.7	($3.8)	$8.5	$31.4	($7.8)	**$23.6**	**$24.0**
2014	$19.4	($2.7)	$15.1	$31.8	($7.4)	**$24.4**	**$19.8**
2013	$27.5	($1.0)	$1.2	$27.7	($6.5)	**$21.2**	**$19.8**
2012	$10.6	$0.8	$9.7	$21.1	($5.1)	**$16.0**	**$14.8**
2011	$19.2	$2.2	($0.9)	$20.5	($4.7)	**$15.8**	**$10.2**
2010	$18.3	($8.1)	$7.7	$17.9	($4.3)	**$13.6**	**$13.0**
2009	$11.2	($0.2)	$5.0	$16.0	($3.1)	**$12.9**	**$8.4**
2008	$32.1	($2.3)	($18.8)	$11.0	($2.8)	**$8.2**	**$5.6**
2007	$13.4	($1.4)	$0.6	$12.6	($2.4)	**$10.2**	**$13.6**
2006	$14.1	($2.6)	($1.3)	$10.2	($2.1)	**$8.1**	**$11.0**
2005	$13.8	($5.6)	$1.2	$9.4	($1.0)	**$8.4**	**$8.5**

Source: Berkshire Hathaway Company Reports

"If we think through these questions, we can gain some insights about what may be called "owner earnings." These represent (a) reported earnings plus (b) depreciation, depletion, amortization…less (c) the average annual amount of capitalized expenditures for plant and equipment, etc. that the business requires to fully maintain its long-term competitive position and its unit volume.

"Our owner-earnings equation does not yield the deceptively precise figures provided by GAAP, since(c) must be a guess - and one sometimes very difficult to make. Despite this problem, we consider the owner earnings figure, not the GAAP figure, to be the relevant item for valuation purposes - both for investors in buying stocks and for managers in buying entire businesses. We agree with Keynes's observation: "I would rather be vaguely right than precisely wrong…

"All of this points up the absurdity of the "cash flow" numbers that are often set forth in Wall Street reports. These numbers routinely include (a) plus (b) - but do not subtract (c). Most sales brochures of investment bankers also feature deceptive presentations of this kind. These imply that the business being offered is the commercial counterpart of the Pyramids -forever state-of-the-art, never needing to be replaced, improved or refurbished. Indeed, if all U.S. corporations were to be offered simultaneously

for sale through our leading investment bankers - and if the sales brochures describing them were to be believed - governmental projections of national plant and equipment spending would have to be slashed by 90%.

"'Cash Flow', true, may serve as a shorthand of some utility in descriptions of certain real estate businesses or other enterprises that make huge initial outlays and only tiny outlays thereafter. A company whose only holding is a bridge or an extremely long-lived gas field would be an example. But "cash flow" is meaningless in such businesses as manufacturing, retailing, extractive companies, and utilities because, for them, (c) is always significant. To be sure, businesses of this kind may in a given year be able to defer capital spending. But over a five- or ten-year period, they must make the investment - or the business decays.

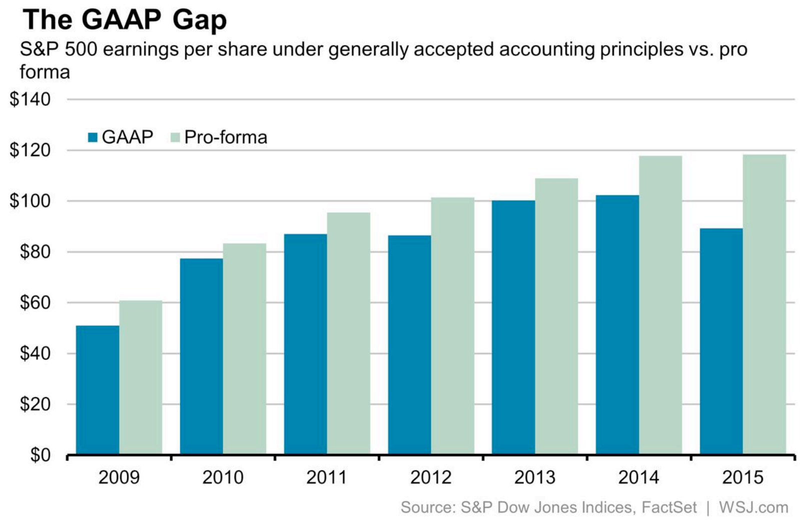
"Why, then, are "cash flow" numbers so popular today? In answer, we confess our cynicism: we believe these numbers are frequently used by marketers of businesses and securities in attempts to justify the unjustifiable (and thereby to sell what should be the unsalable).

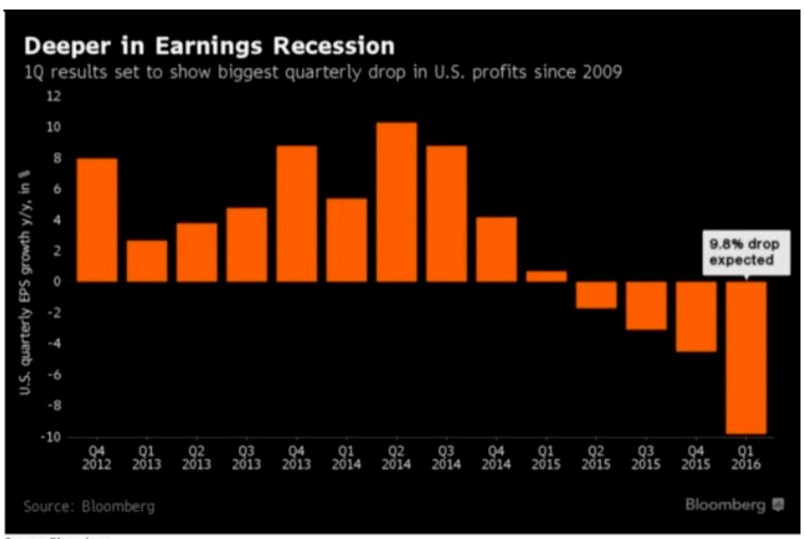
"When (a) - that is, GAAP earnings - looks by itself inadequate to service debt of a junk bond or justify a foolish stock price, how convenient it becomes for salesmen to focus on (a) + (b). But you shouldn't add (b) without subtracting (c): though dentists correctly claim that if you ignore your teeth they'll go away, the same is not true for (c). The company or investor believing that the debt servicing ability or the equity valuation of an enterprise can be measured by totaling (a) and (b) while ignoring (c) is headed for certain trouble.

Warren Buffett
1986 Chairman's Letter to Shareholders

When we consider the current weak economic environment, and the concomitant weakening environment for corporate earnings, we expect Berkshire's enduring earnings growth to be a standout among the largest market cap companies. Bloomberg reports that U.S. corporate EPS growth has been falling since the second quarter of 2014 and has been increasingly negative for the past twelve months. In addition, factor in, that, according to Standard & Poor's, Apple alone has contributed *22%* of the S&P 500's margin expansion. Remember, too, that these earnings per share figures are populated with plenty of convenient measures such as "adjusted net income," "adjusted sales," and "adjusted EBITDA."

Berkshire is quite unique too within their aforementioned long-lived assets. Utilities, pipelines and railroad assets consume many billions in annual capex expenditures. Accelerated depreciation is in effect a "tax-free loan." As Berkshire continues to grow Property, Plant and Equipment faster than depreciation, deferred tax liabilities will continue to grow too. Over the past dozen years the Company's deferred tax liability for PP&E has grown *30X* from about $1.2 billion to over $36 billion. Said another way, Berkshire's GAAP earnings are meaningfully understated. If you want earnings clarity, just follow the money – i.e., cash. The cleanest, most conservative accounting is routinely found in Omaha. Post-Precision Castparts Buffett's acqusition elephant gun gets reloaded every year to the current tune of *+$25 billion…*





Source: Bloomberg

Over time, this asymmetrical accounting treatment (with which we agree) necessarily widens the gap between intrinsic value and book value. 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.

Warren Buffett
2015 Chairman's Letter to Shareholders

We have also put together a table to track the growth in the intrinsic value of Berkshire's stock since the 9/11 terrorist attacks in 2001; Berkshire recorded over a $2 billion loss that year. Working backwards, the last column is the pre-tax earnings of the Company's various and numerous non-insurance subsidaries. The second to last column is the pre-tax earnings of Berkshire's Ft. Knox-like insurance companies. Total Insurance is simply the sum of the prior two columns – Underwriting Profit plus Investment Income. Float and Float Growth are self-explanatory.

Year	IV Share	Invest./ Share	PTOE/ Share	Float	Float Growth	Under. Profit	Invest. Income	Total Insur.	Sub. Op. Income
2015	**$191**	$107	$8.38	$87,722	$3,801	$1,837	$4,550	**$6,387**	**$18,827**
2014	**$175**	$93	$8.19	$83,921	$6,681	$2,668	$4,357	**$7,025**	**$17,511**
2013	**$161**	$86	$7.52	$77,240	$4,115	$3,089	$4,713	**$7,802**	**$15,458**
2012	**$139**	$76	$6.34	$73,125	$2,554	$1,625	$4,454	**$6,079**	**$14,000**
2011	**$116**	$66	$5.03	$70,571	$4,739	$248	$4,725	**$4,973**	**$12,211**
2010	**$112**	$63	$4.91	$65,832	$3,921	$2,013	$5,145	**$7,158**	**$10,113**
2009	**$86**	$61	$2.49	$61,911	$3,423	$1,559	$5,173	**$6,732**	**$4,239**
2008	**$96**	$51	$4.54	$58,488	-$210	$2,792	$4,722	**$7,514**	**$7,757**
2007	**$104**	$60	$4.35	$58,698	$7,811	$3,374	$4,758	**$8,132**	**$6,727**
2006	**$97**	$54	$4.32	$50,887	$1,600	$3,838	$4,316	**$8,154**	**$6,159**
2005	**$64**	$49	$1.51	$49,287	$3,193	$53	$3,480	**$3,533**	**$3,445**
2004	**$65**	$45	$2.00	$46,094	$1,874	$1,551	$2,824	**$4,375**	**$3,065**
2003	**$61**	$42	$1.94	$44,220	$2,996	$1,718	$3,223	**$4,941**	**$2,776**
2002	**$45**	$35	$9.80	$41,224	$5,716	-$398	$3,050	**$2,652**	**$2,667**

Source: Berkshire Hathaway Company Reports

The fun starts with columns 2 through 4. Regular readers of Buffett's Chairman's Letter will recognize the variables that Buffett regularly publishes on how he and Charlie Munger determine the Company's intrinsic value (IV). Buffett breaks down the Berkshire conglomerate into just two parts. The first (column 4) is the Pre-Tax Operating Earnings of the Company's non-insurance businesses. The third column represents the Company's Investments Per Share. Since most of the Company's investments reside on the books of the Company's insurance companies, Investments Per Share is a very good, but arguably conservative measure if the compostion of the investment portolio is largely made up of higher-quality, growing businesses. However, this measure could be aggressive if the portfolio is excessively valued at any given time.

The most important element for an investor is to try to figure out the most fair multiple to capitalize the non-insurance part of Berkshire. We have chosen a pre-tax multiple of 10X, so the IV math for 2015 looks like this: 10 X $8.38 = $83.80, then add the insurance side + $107 = $190.8. With the stock at $142, the shares seem like a bargin relative to IV of prospectively $191.

However, IV calculations are inherently imprecise. If we thought a fairer pre-tax multiple was, say, 12X – given what we believe are the Company's significant and enduring competitive advantages – the IV would be a robust $208 per share. On the other hand, we must also recognize that we should be as conservative as possible in such calculations, so if we capitalize the non-insurance subsidiaries at, say, a 8X multiple, then IV is only $174.

We do take significant clues from the words of Buffett on this critcal topic to help us determine a conservative – but not too conservative – calculation of fair value. Specifically, Buffett has stated that he would like to buy back billions in Berkshire stock at a minimum price-to-book value of 1.2X. Furthermore, and quite significant, Buffett has noted, without equivocation, the rewards to shareholders of such actions.

Share buybacks are *only* advantageous to existing shareholders if they are executed below IV. In classic Benjamin Graham style and discipline, Buffett will only buy back Berkshire stock at a significant margin of safety. Book value at year-end sits at $104 per share. 1.2 X $104 comes to $125, so, $125 is Buffett's fat pitch. If, say, IV is $174 (8X), then Buffett's margin of safety is 28%. In our view, this is not fat enough. At $208 (12X) the discount is 40% - maybe on the high side for Buffet, perhaps not. At $191 (10X) the discount is 35% - a minimum margin of safety discount for Buffett in our view.

Here are a few other observations to consider:

- For the first time, Buffett included insurance underwriting results in the calculation of *non-insurance* operating results. His decision, after 12 years of annual underwriting profits, speaks to his expectation of continued insurance profitability in the years ahead. This decision, well past due in our humble view, underscores the amazing insurance business that Buffett and Ajit Jain have built over the years. There is no comparison anywhere in the world in terms of size, sticky float, and profitability. When Buffett states that the largest IV value over book resides in the insurance companies, believe him.

- We have added underwriting profits in the calculation of PTOE/share for all years.

- The profits of the non-insurance subs eclipsed the insurance side for the first time in 2010 after the sizable acquisition of Burlington Northern. (The purchase of BNSF alone immediately increased the Company's pre-tax earnings by almost 40%, while only increasing the share float by just 6%.)

- Note the underwriting profits in 2006 and 2007, post-Katrina. If Berkshire could ever achieve such results on their current base of float, underwriting profits would approach $5.5 billion.

- In a world of zero to negative interest rates, investment income in excess of $4 billion is remarkable.

What will Berkshire Hathaway look like at the end of the next 10 years? Well, if the Company continues to retain all earnings, and redeploys capital with the same demonstrated success and discipline, shareholder's equity could reach $650 billion and the stock's market capitalization could reach $1 trillion. We'll take such growth...

Conclusion

We hope that our commentary provides a helpful glimpse into our investment process. We believe that our position limits and our best-of-breed investing, provide substantial diversification benefits, without forcing us to dilute our best ideas. Discussing individual companies is a good way to understand our process, but we think that every company that we invest in is different – the business model, the valuation, or even the prevailing opportunity set – can vary. As such, there is limited insight in discussing any individual portfolio holding. When setting our future expectations for investment performance, it is our investment process that ultimately provides the "common denominator" across our portfolio. Far from relying on a couple of big winners (or blaming a few big losers), we believe that true focused investing requires a prudent level diversification and process discipline to construct a portfolio where the *majority of ideas* drive superior results over longer time horizons.

We would also like to announce the well-deserved promotion of our new President, Bill Thomas, who joined the firm last year. Bill has had a substantial impact on the culture and operations of Wedgewood in a relatively short period of time. Not least because he is great at sharing his wealth of experience, but also his excellent performance makes us think we are pretty good at this hiring thing. We'll try not to let it go to our heads.

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

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[i] Returns are presented net of fees and include the reinvestment of all income. "Net (Actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.