Five Things To Know
Dropping Rates & Injecting Capital
Interim Commentary
6pm Sunday March 15, 2020

It is 6pm Sunday evening. As I reflect on the week that passed….and the week in front of us….I thought it might be helpful to offer a few insights or opinions:

1) **The volatility last week will be one for the record books**. If it is not "thee" most volatile…it will be viewed in the Top 3. Bonus points go to everyone with the intestinal fortitude to hang in there.
   It is important to point out that if we are not engaging in short-term trading, it does not need to impact us.

2) Although we don't know this as fact, we are pretty sure that **one, or several, investment funds, private partnerships or hedge funds "blew up" last week…especially on Thursday**. When you see indiscriminate selling in every asset class (stocks, real estate, gold, US Treasuries) at the same time it signals that someone had to raise fast cash regardless of the consequences.

   Normally, if there is heavy volume selling stocks, the price of US Treasury bills (seen as a safe haven) will go up. This did not happen on Thursday.
   Our guess is that several investment funds were heavily leveraged to juice their investment returns. **Declines in market prices forced them into a "margin" call in which they had to pay down their borrowed money.**

   When everything is going your way debt makes you look very smart. When using debt and very unexpected things happen….you blow up.
   We will never be able to say it enough….leverage kills.
   As Warren Buffett says, "You never know who is swimming naked until the tide goes out."
   Well….the tide is out and several investment firms are painfully exposed.

3) As of Sunday evening, **the Federal government has dropped the Fed Funds Rate to zero**. They are also injecting $1.5 trillion of liquidity into the credit markets and are engaging in "quantitative easing"—a process in which the government will buy up to $700 billion of mortgages and Treasury securities in an effort to force liquidity into the market and keeps interest rates low.

   Although we question how effective this will be, it is better than nothing.

4) **The combination of the coronavirus and the oil shock** at the same time are interesting. We are fortunate that interest rates and inflation are low while employment is at record levels.

Having coronavirus and the oil shock strike us as being somewhat like 9/11 and 2008.

There will be a disruption in our economy in which the coronavirus runs its course. Unfortunately, to mitigate greater damage we are forced to shut down for 30 to 60 days….if only we could fast-forward through March and April. Although those are sales and earnings we will never get back, we see an end to the pain.

It will not surprise us if this "Corona-Oil" event sends us into a recession. We will not be surprised to see negative Gross Domestic Product over the first and second quarters with a return to positive growth in the third and fourth quarters of 2020.

5) **How Are We Prepared?**

We have always preached to our clients that they should have access to **liquid assets that cover 6 to 12 months of spending needs**. If you have ample liquidity, you are insulated from the daily gyrations of the stock market.

We own stocks based upon where we are attempting to go in **ten or more years from now**. If we are positioned for the long-term, then short-term gyrations should not alter our long range strategy.

For our clients that are living out of their portfolios—especially those in retirement—since 2008 we have loudly suggested **limiting distributions to 3% of market value**. Doing so allows a person to fund living expense for today while being able to reinvest for the long term such that a portfolio will maintain its purchasing power.

We do not trade on margin for our clients. **If you have not borrowed money, you will not get a margin call….no matter how chaotic things get**. That gives our clients the ability to withstand tremendous volatility and focus on the long-term.

The research we do, and the quality we require from our investments, is quite different than most firms.
There are two things that probably matter most to our clients.

1) We look for **businesses possessing wide economic protective moats** (think about a moat protecting a castle). A good example is either the Union Pacific Railroad or the Burlington Northern Railroad. Both have a footprint that would be impossible to duplicate. They each own more than 32,000 miles of track west of the Mississippi River. Trains are five times as efficient at transporting heavy goods over long distances.

Although the current environment will curtail rail activity for a period of time, our rails will not be displaced and their economic value will not be materially diminished over the next decade.

If anything, our wide moat businesses will get stronger during an economic downturn.

2) **Debt**. As discussed previously, debt kills. We use a proprietary metric to assess the "obligations" owed by any business.
Our formula works like this:

Short Term Debt
+Long Term Debt
+Preferred Stock
+Pension Funding Shortfall
+(Annual Cost of Leases X 7 Years)
(-) Cash On the Balance Sheet
= Total Obligations

Total Obligations Are Divided by Annual After Tax Earnings

We are extremely hesitant to take a position in a business if they cannot pay off all of these obligations using 5 Year of After Tax Earnings.

This 5 X Obligation Ratio instills a discipline that prevents us from investing in most businesses…and especially the riskiest ones.

Although the market gained lots of attention across the world, it was pretty much business as usual.

The number of phone calls and emails we received did increase….from about five per day to ten per day.

Our time was focused on making sure our best ideas are in our portfolios. That is accomplished by doing high quality research and then having the discipline and focus to implement our ideas.

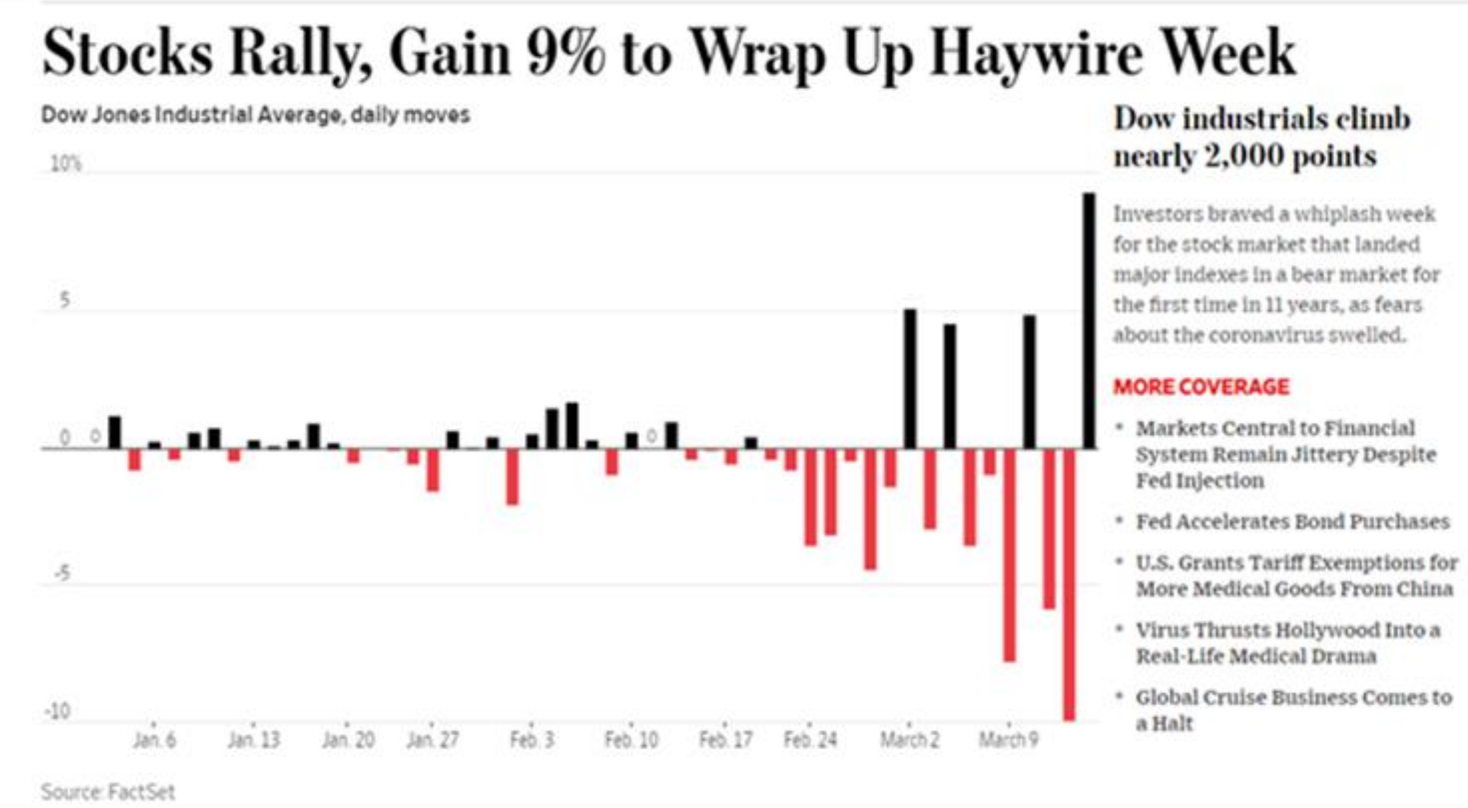
Although the state of world affairs is unsettling to many, **WE FEEL VERY GOOD ABOUT WHAT WE OWN ON BEHALF OF OUR CLIENTS**.

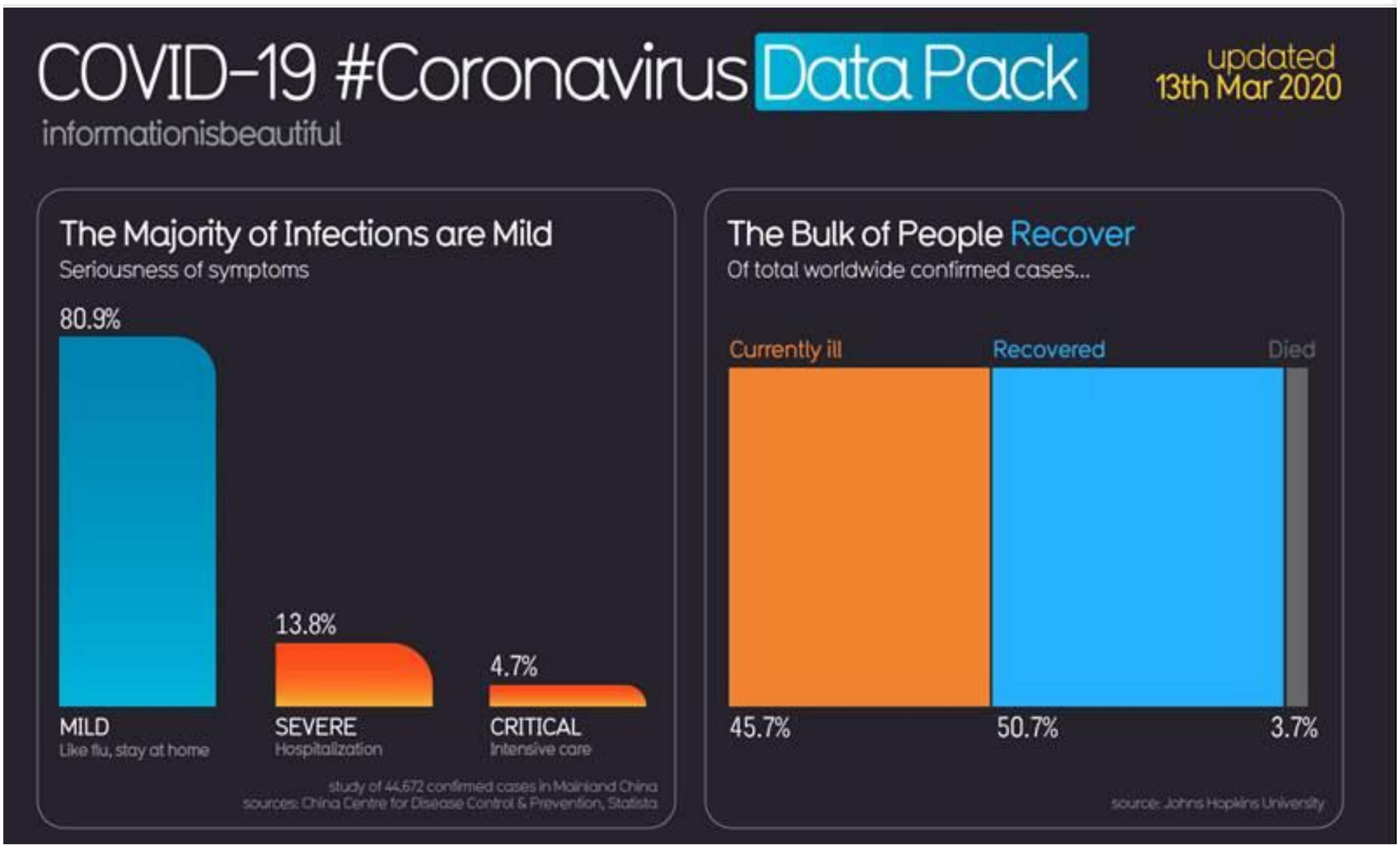
As always, the more we hear from you, the more we can offer advice and provide value. Let us know how we can assist.

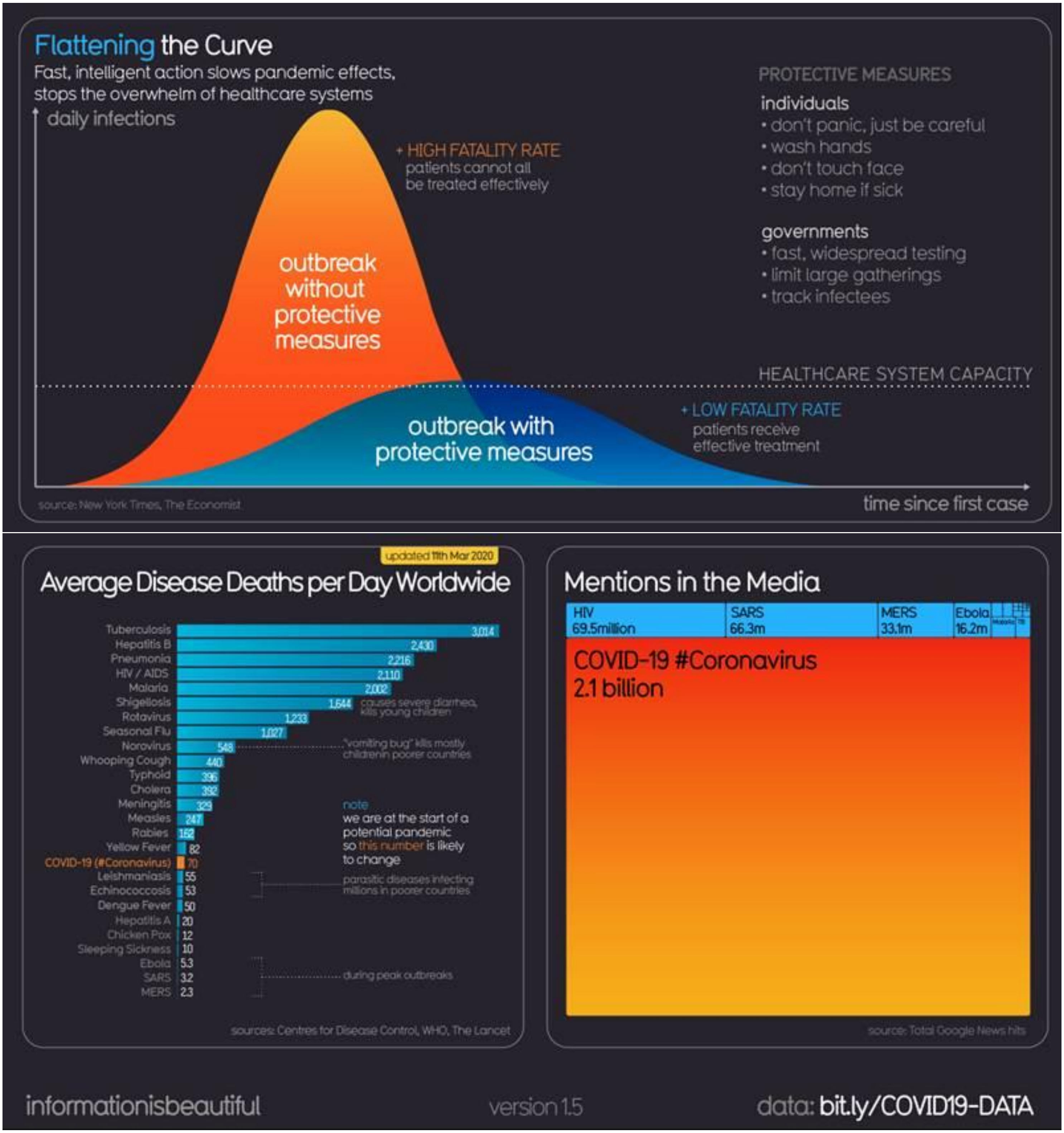
I am sure the weeks and months ahead will be interesting…..as such….don't be shy!

Thanks for your continued support.

Warren, Tammy, Jon, Nate, Joseph and Dave






Flattening the Curve
Fast, intelligent action slows pandemic effects, stops the overwhelm of healthcare systems
daily infections
+ HIGH FATALITY RATE
patients cannot all be treated effectively
outbreak without protective measures
PROTECTIVE MEASURES
individuals
• don't panic, just be careful
• wash hands
• don't touch face
• stay home if sick
governments
• fast, widespread testing
• limit large gatherings
• track infectees
HEALTHCARE SYSTEM CAPACITY
+ LOW FATALITY RATE
patients receive effective treatment
outbreak with protective measures
source: New York Times, The Economist
time since first case
updated 11th Mar 2020
Average Disease Deaths per Day Worldwide
Tuberculosis 3,014
Hepatitis B 2,430
Pneumonia 2,216
HIV / AIDS 2,110
Malaria 2,002
Shigellosis 1,644
causes severe diarrhea, kills young children
Rotavirus 1,233
Seasonal Flu 1,027
Norovirus 548
"vomiting bug" kills mostly children in poorer countries
Whooping Cough 440
Typhoid 396
Cholera 392
Meningitis 329
Measles 247
Rabies 162
Yellow Fever 82
COVID-19 (#Coronavirus) 70
Leishmaniasis 55
Echinococcosis 53
Dengue Fever 50
Hepatitis A 20
Chicken Pox 12
Sleeping Sickness 10
Ebola 5.3
SARS 3.2
MERS 2.3
note
we are at the start of a potential pandemic so this number is likely to change
parasitic diseases infecting millions in poorer countries
during peak outbreaks
sources: Centres for Disease Control, WHO, The Lancet
Mentions in the Media
HIV 69.5million
SARS 66.3m
MERS 33.1m
Ebola 16.2m
COVID-19 #Coronavirus 2.1 billion
source: Total Google News hits
informationisbeautiful
version 1.5
data: bit.ly/COVID19-DATA