Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: Missing the Point + Introducing..... – February 17th, 2023

#TGICF!

Casual Friday is going LIVE!
Casual Friday is getting a bit of a refresh. We love the scale, simplicity and efficacy of the printed format, but realize other mediums let us create and you consume differentiated content and insight.

Introducing: *"Casual Friday Live"* an interactive broadcast where the Berkshire team discuss the topics presented in the week's printed edition.
It's a supplement to, not a replacement of the email/print version you are reading now.

This new format will allow us to:
• Expand and go deeper on the week's topics
• Bring on special guests to share investment / practice management insights and yes even people from the "Casual" part of Casual Friday. Think: leisure, fitness, travel health experts and other aficionados we think will enhance your lifestyle. We might even invite financial advisors to speak as guests.
• Allow advisors to ask questions
• Create a replay link so you can listen on your schedule.

We are planning to go live bi-weekly starting 2.27.23 at 11:30 EST via LinkedIn Live Events and StreamYard. *20-30 minutes tops! Email us suggestions/what you might like to hear in this format!*

Missing the Point?
In Q4 22, about 75% of S&P companies reported. After the final tally, it looks like earnings will contract about 2.2% one of the worst contraction in some time. (Source Credit Suisse). Before you freak out, while negative, the imminent earnings recession is perhaps the worst kept secret on planet earth right now. Remember the old adage "if it's in the papers, it's in the price". If everyone is talking about it, it must be exerting at least some downward pressure on prices.

It’s got us thinking about the typical earnings season:

“Earnings miss expectations”
“Earnings beat lowered expectations.”
“Earnings beat but guidance was weak”
“Earnings beat consensus but didn’t beat the whisper numbers”

BLAH BLAH BLAH…

Its surface level financial white noise at its worst. And I still want to meet these mystical people who are “whispering”.

We’ve long opined the market has a fetish-like obsession with “earnings.” A cursory and surface level look at earnings is NOT, in our opinion the best way to divine a company’s worth, nor are earnings the most important component of long-term value creation. And when you start looking deeper over what the market constantly obsesses over, there is usually even less to like.

Let’s not forget what investing really is: fractional ownership in a company that entitles you to receive your proportionate share of actual cash (in the form of dividends) and the potential to sell it at higher price later (appreciation). That’s how a true owner really thinks about it, and it’s how Berkshire thinks about it. It’s an obvious point but clearly it gets lost in the chatter.

So, let’s go deeper. Read a typical earnings report and you will generally see the use (or abuse!) of two numbers: “adjusted EPS” (versus GAAP) and “Ebitda”
Two components, employee stock-based compensation and depreciation are usually big “upward fudges” to adjusted EPS vs. GAAP and often inflate what is happening in financial reality.

Awarding employees large amounts of stock is commonplace in the tech sector. Consider Alphabet (GOOGL). * In 2022 it awarded $19 Billion+ in employee stock compensation. Some have argued this is not a true expense (no cash changes hands), hence some analysts add back to EPS to obtain an “adjusted EPS”. Essentially, owners of GOOGL own the free cash flows of the business. When $19Billion+ of new stock is issued, share count increases so your share of the cash flow decreases. Clearly there is an impact. Let’s frame it this way. If you were the sole shareholder of a private business that was earning $1,000,000 per year and suddenly you had 10 new shareholders who owned 10% of the company would you sit there and say “’that’s not an expense”? Hardly. And In GOOGL’s case recent EPS release there was nearly 7% difference in actual vs. adjusted EPS.

Depreciation is non-cash expense on the income statement that attempts to account for the decline in value of things like property plant and equipment --- the very things that allow a company to produce revenue and earnings in the first place. Wear and tear reduce earnings so clearly it's a cost. But because no cash changes hands, its usually an add back to compute and raise adjusted earnings. To many this justifies the use of **E**arnings **B**efore **I**nterest **T**axes **D**epreciation (EBITDA) because it answers: "how much discretionary cash is available to all providers of capital." Umm paying taxes is not at managements discretion. Maybe that's why Buffett calls EBITDA "BS cash flow."

But in time, productive capacity needs to be replaced with actual cash which is where capital expenditures come in. Cap- ex is the on-going outlay needed to keep a company competitive, growing, and producing products and services. This is a real cost to a business owner. For example, telecommunication companies often report higher levels of deprecation adding to adjusted earnings. But they have to build maintain expensive networks and eventually they replace or upgrade the networks to remain competitive. The cycle is ongoing. Capex can be lumpy; however an analyst can smooth expected capex by understanding the assets being depreciated. This work can lead to clarity of future free cash flows and ultimately a more accurate valuation of the business.

Noise vs. Truth

Is there a way to get to the "truth" behind what ultimately drives value? To us, real value comes from generating cash that can be paid to its owners AFTER *real* costs are accounted for and AFTER considering the amount of *reinvestment* needed to maintain growth. Period. Berkshire computes this measure free cash flow as

Net income (the real one)
+ deprecation and selected non-cash charges
MINUS Capital spending.
= Free cash flow.

No number is perfect, but in our minds, this number is as close to reality as you are going to get because it's what is what is really available to shareholders after reinvestment. Management can then decide if it wants to make acquisitions, pay dividends, or buy back stock. It's what Berkshire values in theory and in practice. So while the market obsesses over nominal eps growth, we are obsessing over real cash…the type of cash we hope ends up in your clients investment accounts and grows each year.

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See you on Casual Friday Live!

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Berkshire Asset Management, LLC

*Berkshire Dividend Strategy does not own shares of GOOGL. For a complete list of holdings click here: https://berkshireasset.com/wp-content/uploads/2023/01/Dividend-Strategy-Scorecard-4Q2022-Advisor-Edition.pdf

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Berkshire Asset Management

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Definitions: The S & P 500 Index is a market capitalization weighted index of the largest 500 U.S. stocks. It is a market-value weighted index (stock price times # of shares outstanding), with each stock's weight in the index proportionate to its market value. The index is designed to measure changes in the economy and is representative of most major industries. Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992. Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The index was developed with a base value of 200 as of August 31, 1992. You cannot invest directly in an index. BEst (Bloomberg Estimates) Earnings Per Share (EPS Adjusted) estimate returns Earnings Per Share from Continuing Operations, which may exclude the effects of one-time and extraordinary gains/losses. Beta is a measure of volatility vs. an index. Upside/Downside capture ratios refer to a portfolios performance as a percentage of either positive returns (upside) or negative returns (downside) vs. an index. Standard Deviation is a measure of total risk. Alpha, Beta and capture ratios are represented as calculated by Morningstar.

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