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Berkshire Hathaway

Late in March 2011 it was announced that David Sokol would be resigning from the Berkshire Hathaway management team. He was widely thought to be the named successor, from the operations side of the shop, to Warren Buffett. On CNBC the morning of March 31 he talked about what happened. What amazes me is that he does not believe he did anything wrong. Here are the facts as I understand them.
In December 2010 Sokol bought shares in Lubrizol, a specialty chemical maker. He received a list of takeover candidates from consultants at Citigroup in his role as a senior manager at Berkshire Hathaway, and the only firm he liked from the list was LZ. He proceeded to purchase LZ stock for his personal account. Then he pitched the company to Buffett, who was not interested. The timing is still a bit murky to me on this, but he then sold the shares. He stated in the CNBC interview that he only trades 3 or 4 times per year, yet he sold his LZ shares within a week, and after Buffett turned him down. He states that this was for tax planning reasons, which seems to be a bit of a tall tale, so I assume there was a small loss. Then he was able to set up a dinner with decision makers at LZ, with the help of Citi, and the LZ board met. It is hard to imagine that he could have done this as an individual investor. He bought about $10 million of LZ shares the day after the LZ board met, again for his personal account.

He stated that the shares were about 100,000. Normal volume for LZ during this period seems to be half a million per day, so this is material. Spikes in volume occurred December 9 and December 17. The deal was announced March 14. I spent a couple minutes at that time calculating a value for LZ based on some simple ratios and felt it was worth $225 per share, versus the $135 BRK planned to pay. I tipped my hat to Mr. Buffett on another smart play. Full disclosure: I am a Berkshire Hathaway shareholder.

So what looks unethical, and maybe illegal, about this set of events?

- If the Citigroup consultant who set up the dinner with LZ and Sokol had bought shares and was caught, he would go to jail. Why is this different? Sokol claims that because he does not have discretion over capital at BRK that he has no restrictions on his actions. WRONG!

- Mr. Sokol is clearly among the top echelon of the Berkshire management team. He would not receive packets of information about other companies if he were not. He is an insider, and this was insider trading.

- Mr. Buffett goes to great lengths to portray Berkshire as a leading ethical company. Yet he has no compliance officer monitoring stock trades of his senior managers. This is disappointing, especially since he has so few insiders to monitor. Of course back when he was dealing with partnerships A owned B and B owned C and C owned A and they were all trading with each other. There was not much transparency back then and it all worked out (after an investigation), so that should have alerted WEB to have this covered.

- How common are these practices among Wall Street insiders? I read a piece on Bernie Madoff that said regulators and competitors were comfortable with his actions when it was assumed that he was front running. Why is this okay? Where are our regulators? Maybe we should have them work on commission and get a cut for each year a cheater spends in jail. No wonder it is so hard to beat the market!

- Another interesting piece of information about the Sokol resignation is why it was not immediate. Apparently he is still employed until a week before the Berkshire Love Fest in late April. Are there other bonuses that don't kick in until that time?

- Why did Sokol's assistant deliver the resignation? This seems odd to me, that an unexpected resignation would be sent without any discussion. That leads me to think it was not unexpected.

Realistic Withdrawals

In the April 2011 issue of Money, in an article on page 32, they discuss a methodology designed by Financial Engines (William Sharpe) to distribute money accumulated into retirement for individuals. Essentially they invest a core portfolio to provide initial income and put the rest in equities. As those equities grow the bond portfolio grows and the income generated by the bonds increases. It's not clear how, in today's low interest rate environment that this works unless the retiree has saved enough to have a cushion.

This method reminds me of something I have thrown out a number of times for institutions like insurers. Rather than invest all of your required assets (reserves and capital) in a dedicated segmented bond portfolio that matches your liability constraints to conservative asset requirements, match liabilities with assets using best estimate assumptions with a small amount of conservatism built in. In today's environment this would free up the portfolio managers to invest in dividend paying stocks that pay out more than investment grade corporate bonds.

Update on December Investments

In December I discussed 5 individual stocks that my filter shows to be attractively priced. Note that this is a first pass test that requires an investor to do additional research before purchasing the shares and should not be viewed as a recommendation to buy. Let's see how they are doing so far. By way of comparison, the S&P 500 was at 1257.64 at the end of December 2010 and at the end of March 2011 was at 1325.83 for a 5.4% increase. None have reached levels where my filter suggests selling.

- WHR was 88.83 and now is 85.36 (-3.9%)
- TEL was 35.40 and now is 34.82 (-1.6%)
- HBI was 25.40 and now is 27.04 (6.5%)
- COP was 68.10 and now is 79.86 (17.3%)
- GME was 22.88 and now is 22.52 (-1.6%)

Disclosure: long positions in TEL, HBI and COP on April 1, 2011.

Three of the 5 have lagged the broad index, while only 1 has beaten materially so far. This is not surprising as a value investing style requires patience. I always seem to be early on my purchases. As I have noticed this I have started to take initial positions and then add to them as prices drop or are stable over time. Rarely does a stock I select jump immediately. When it does that is a nice surprise. I buy to hold for a long time.

March 2011 investment filter

Four companies meet my filter requirements for a margin of safety at the end of March 2011. Consider these public tests of my filter and not recommendations. They are (with end of March price)

- XRX 10.65
- KMT 39.00
- GME 22.52
- BTU 71.96

Disclosure: long positions in XRX and BTU on April 1, 2011.

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