BERKSHIRE
ASSET MANAGEMENT

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DIVIDEND STRATEGY

Second Quarter 2012 Commentary

Market Backdrop

Most stock markets pulled back in the second quarter 2012 but the S&P 500 managed to hold on to strong gains, increasing 9.49% for the year. Consistent with our goal, the portfolio tended be down less during periods when market pulled back.

Berkshire Dividend portfolios did not match that index on a total return basis so far this year, but they continued to generate strong cash flow growth through healthy dividend increases. We expect cash flow growth at least in the high single digits for the year. Should our companies accomplish that objective, we believe low valuations will allow for further price appreciation on top of that growth rate.

On the positive side, our top performers included Microsoft, Abbott Labs and Kimberly Clark. Ironically, some of our laggards were the highest yielding stocks in the portfolio. This justifies our belief that intelligent dividend investing is not only about shopping for the highest yield. Earnings growth matters, valuation matters and catalysts matter.

On the negative side, a macro factor that held back performance should be noted by all investors: Stocks with high price earnings ratios outperformed stocks with low ones by nearly a 2-1 margin. The highest 20% of stocks by P/E in the S&P 500 average 27 times earnings! This group rose on average over 16%, nearly twice that of the average stock in the market. Since we tend favor lower P/E multiples this explains much of our underperformance.

Softening World Growth Favors US Dividend Oriented Strategies

The European economies continue to be a problem and there is increasing evidence of a slow-down in China. In other emerging markets, such as India and Brazil, growth expectations are now half of what was expected just two short years ago. Slow growth and persistently low interest rates continue to justify a high allocation to quality dividend growth strategies.

With all the bad news around the world, the U.S. market is acting as a safe haven with U.S. stocks outperforming many world markets. This makes sense since many of the largest companies in the U.S. have already gone through painful restructurings as a result of the turmoil in 2008. Balance sheets have been repaired, workforces have been right sized and companies have been forced into finding new efficiencies. Much of the rest of the world has yet to come to that reckoning, let alone follow the needed prescription. All anyone seems to hear out of Europe is the clanking of a can down an ever shortening road.

"Watch Out For Everything"

If the market could actually think out loud about its long list of worries, it might sound something like this: "Let's see… We have to watch Europe because it's a mess and remedies seem to make the problems worse, not better. We have to watch out because everybody thought China could provide a lift to a struggling world economy, but now it too seems to be slowing sharply, not to mention it appears the credit bubble there is popping. And, oh yeah, I suppose all the countries in the Pacific Rim like Japan, Korea and Vietnam who export to China will be in trouble too. The Australian and Brazilian economies made a ton of money exporting raw materials to China so we have to watch out for that. But, wait! We have the United States - it's a safe haven, right? On second thought, we seem to have structural unemployment and debt problems. So these worries affect about 70% of the world's GDP. I guess we have to watch out for EVERYTHING!"

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 20 years, we have successfully implemented highly focused equity, fixed income and balanced portfolios. Our guiding principle is a belief that success is achieved by combining rigorous, well crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference… Diligence, Integrity and Focus.

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"But Don't Put Your Head In the Sand"

Against that backdrop, how can anyone in their right mind be even remotely bullish about stocks? On the fundamental side, there is one bright spot emerging from an unlikely source: the U.S. housing market which drives 40% of the U.S. economy. And, since the U.S. economy is the world's largest, housing, therefore, is a huge driver of world growth. As we wrote last quarter, mortgage delinquencies are decreasing, inventory is getting worked off far faster than anticipated and prices are stabilizing.

Mortgage payments as a percentage of income are getting smaller thanks to low interest rates. As people have an aversion to ownership, there is increased competition for rental properties so rents are rising. This means more properties will support debt service and provide positive economic returns to the owners who will then be able to get credit more easily and buy more properties. Thus, a virtuous cycle can begin, providing a much needed boost for the banking and financial sector which make up a huge swath of our economy.

The next positive is valuation. When you look at the macro news, you get depressed. But when you look at individual company news, you get excited. GE sells for 2/3 cheaper than it did 11 years ago. Dividend yields on companies with rock solid balance sheets approximate 3.5% while ten year treasuries yield 1.5%.Some high-quality U.S. industrials sell around 10-12 times earnings, have solid global growth prospects and 1/3 of their capitalizations are made up of cash. Certain banks trade below liquidation value meaning you can buy them, liquidate all the assets, pay off all the liabilities and still have money left over.

We are sober to the macro threats but we always will favor bottom up investing. And just because the world looks bleak does not mean investors should do nothing. So, how do we mix the macro and the micro to end up with a portfolio that captures good opportunity while controlling risk?

"Safe, Cheap and Somewhat Defensive"

We own a large swath of very stable, predicable businesses with fantastic balance sheets. Many of these companies are in the healthcare, consumer staple space and should perform well in a down market. Most pay very attractive dividends.

"High Quality Industrial, but Somewhat Cyclical"

Despite a weak economic backdrop, many industrial companies are trading at valuations not seen in decades. They have cut jobs and gained efficiencies so they have lots of earnings leverage even if the economy continues to plod along. Should the economy surprise to the upside, earnings growth will be even greater. Their financial flexibility is quite high, meaning that if they don't see growth opportunities, they can increase dividends or buy back stock.

"Pure Contrarian"

As we have stated in prior missives, we believe there is always the place for a well thought-out rational, analytical, yet contrarian, position in companies loathed by other investors. This is the case with some banks and financial-oriented companies in our portfolio. Our financial selections tend to be conservative and are *not* the kind which have been in the newspapers for all the *wrong* reasons. Most banks are continually vilified by Congress, the media, investors, etc. like no other sector we've ever seen. So, if a simple strategy of buying the most out-of-favor stocks can have any merit, by that measure, financials are possibly the greatest investment opportunity of our lifetime. Plus, we don't think the fundamentals are nearly as bad as Wall Street does.

"Research Driven"

We pride ourselves on individual valuation work on companies. There will always be situations where the market ignores the fundamentals, doesn't see a catalyst or overreacts to a missed quarter, but the long-run earning and cash flow generating ability is attractive. We believe we have these opportunities in our portfolio as well and, regardless of market direction, they are cheap enough that, at some point, they will deliver attractive returns to our clients.

Thank you for the trust you have placed in us and your continued affiliation with our firm.

Commentary Disclosures:

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