BERKSHIRE
ASSET MANAGEMENT

October 2012

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DIVIDEND STRATEGY

Third Quarter 2012 Commentary

DIVIDEND STRATEGY COMMENTARY:

Despite lackluster fundamentals in the world economy, most world equity indices pressed higher again in the third quarter. The S&P 500 rose another 6.35% for the quarter, bringing its year-to-date gain to over 16%. This return compares quite favorably to other world benchmarks.

Berkshire Dividend Strategies have captured an attractive portion of the index return while maintaining what we believe is a more conservative risk posture. After all the market is up substantially in the last 12 months but has anything really changed in the macro environment?

Europe is still a mess, China continues to slow and growth estimates for the US have now dwindled to a paltry 1.2%. It is surely a weak recovery especially in light of (possibly because of?) the massive monetary and fiscal stimulus that has been thrown at it. Yet GDP growth of 1.2% is all we have to show for it? If a recovery was something tax payers bought at a store, surely we would all ask for our money back.

What has changed is that investors now know exactly how ferocious the policy response will be from the central banks both at home and abroad. "Whatever it takes", this is the mindset of Ben Bernanke, head of the US Federal Reserve, and Mario Dragi, head of the European Central bank.

"Whatever it takes" means much more money printing disguised as ever evolving, byzantine liquidity and credit facilities. Yet, none of these measures take the place of the real solutions: time, true organic growth and paying off debt with real dollars.

Investors continue to throw money at bonds. Yet the fixed return they offer gets vaporized with each additional central bank bond purchase. Investors should realize these securities are the exact instruments central banks are deliberately trying to devalue! The inflation that central banks are trying to create allows the debtor to pay back bond holders with cheaper dollars. Some have called currency devaluation a " gentleman's default" and in central bankers' minds this takes the pressure off those institutions who went on the borrowing binge and now can't pay it back.

So how do we generate returns and combat a world awash in cheap dollars?

We seek to grow dividends. We seek to not trade pieces of paper but to invest with managements who can take our clients' investments and build permanent, lasting value. We invest in companies with strong brands, efficient operations and products customers will pay a premium for. We seek management who can develop innovative products and launch them in fast growing markets and economies. We seek managements that are true stewards of capital. They know when to reinvest earnings for growth, buy back stock, make acquisitions or pay dividends.

So, regardless of what a particular benchmark has done year to date, by these measures the fundamental quality of our portfolio remains strong and in line with our expectations. Most of our companies' fundamentals are strong, generating excess cash, and now are offering us healthy "pay raises" in the form dividends. What is even better is that our investors still don't have to pay a lot for this potentially good hedge against

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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inflation. Valuations are still attractive in US equities. So, in a world awash in cheap dollars, we think the dynamism our companies bring to the table is far more attractive than a bond or that high priced shiny metal that generates no current cash and simply sits there and stares at you.

Does Dividend Screening Work?

Investors often ask: "What role does screening play in your investment process?"

Our firm spends considerable resources on Baseline and Bloomberg to access their equity data bases. The screening tools at our finger tips are robust.

HOWEVER we've always believed that screening is part of the process but screening is not a process in itself. Human judgment, a reservoir of accumulated knowledge, a view toward the future and bottom up analysis are all critical. Screening can help you get the list down to a manageable number but it is only a starting point.

There are many examples where blind faith in the screen is a waste – but a few really stand out – Citigroup in 2007 and the home building sector in 2008. In the case of Citigroup, everyone looked at the past screens and said "this dividend is safe". Only a prescient view of future loan losses and the magnitude of the housing crisis would have helped you avoid that land mine.

Secondly, if you relied heavily on low price to book value like one famed manager did in 2008 – it screamed "buy the home builders!" The screen did not, (and could not) tell you book value was going to decline. So only going past the initial screen and analyzing the integrity of book value and direction of land values could help you avoid that value trap.

The last example of where blind screening can go wrong is with cyclical businesses. Their P/E's tend to often look high when earnings are depressed but set to improve. Sometimes cyclical businesses perform their best when their P/E's look the worst. Counter intuitive? Yes. A screen can only tell you so much. You need a framework to look prospectively at earnings. And value must always play a role.

If our dividend strategy only screened for companies that increased dividends say 5 years in a row, we could also miss some good opportunities that have treated us well of late – like financials. Most financials now flunk most dividend screens because of 2008-2009. Investors have to remember that for years these were the staple of popular dividend strategies (see the Citigroup discussion). These companies are now sitting on piles of capital that can't get deployed into loans because the demand isn't there. What's more is loan losses are coming in far better than expected. Going forward we believe financials will be one of the sectors that experiences some of the most robust dividend growth, but traditional screening would likely rule them out entirely.

While there is institutional appeal and simplicity, devotees to a mechanical, blind screening process can either find themselves missing opportunities or falling into value traps. They miss the adaptive nature of markets. So while it is never "different this time" it is also never exactly the same. With all the uncertainty that is ahead, clearly some fluidity and forward thinking will be needed. Screening will be just one of many tools in a portfolio manager's tool box to build a portfolio that will grow and protect assets.

Commentary Disclosures:

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