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From: Julien B. Booth

Re: Market Observations 2.25.2024

Happy early Spring. I hope you are doing well.

New circumstances tend to be calamitous for an economic unit if they are either very large, or very rare relative to the size and lifespan of that unit.
Geerat Vermeij – Great Mental Models vol. 2

We can simplify the relationships between fragility, errors, and anti-fragility as follows. When you are fragile, you depend on things following the exact planned course, with as little deviation as possible. When you want deviations, and you don't care about possible dispersions of outcomes that the future can bring, since most will be helpful, you are anti-fragile.
Nassim Taleb – Anti-Fragile

The following memo is intended to provide several observations that are occurring in financial markets, but more broadly across industries and our culture. Somewhat ironically, as I drafted this note, Warren Buffett published his annual letter, disclosing $167 Billion in cash. As our largest holding, Berkshire is prepared for anything, and the definition of anti-fragile.

Executive summary:

1. **Technical changes in markets can create irrational decision-making.**
2. **Structural inflation is accelerating economic natural selection.**
3. **Portfolio construction favors larger and/or highly cash rich businesses. Simplify.**

We have a well known bias for low risk, conservative investments. As a business Founder, I prefer to invest in businesses that we know well, understand, and can expect a highly probable outcome. We love looking at actual financial statements and have the capacity to understand them. Analysis takes time, and requires deep experience. At present, the world does not much want for such things. These underlying trends are not confined to any industry; they are present in every industry and organization.

I present two charts. Chart 1.0 is a structural phenomenon – index based, passive and, algorithmic based investment products now exceed active management. Chart 1.1 is the rise of 0 days to expiration options. 0 days to expiration options are ultra short term bets on stocks and indexes.

Neither of these trends are concerned with the underlying business fundamentals. Feedback from our clients, vendors, and my beloved wife (healthcare) confirm similar changes across industries.

Structural Inflation

The post 2008 period created 15 years of below market interest rates (1%) and a massive distortion of capital allocation. When the cost of borrowing is 1% most every investment can be projected to perform well – the longer this went on the more fragility it created. 2022 changed the world, interest rates had a generational upward move (40 years). The world is re-ordering in real time as the cost of money re-prices.

Chart 2.0 and 2.1 demonstrate the relationship between interest rates and inflation. The hope is rates will come down – but our inflation appears far more entrenched. The interest rate markets are not predicting a meaningful decline. The result, less robust companies/organizations are being merged out of existence. Adapt or die as a close friend often reminds me.

Behavioral Observations

The modern markets seem to always seeking a new story. We saw this in spades during Covid (see Zoom, Peloton, etc.) AI is a new narrative. AI is real; AI has/will accelerate change; and AI is nothing to fear. Just as Internet 1.0 ushered in structural acceleration, AI is the next iteration. Quick anecdote - we used primitive AI while at NC State circa 1995 to optimize lumber mill profitability. AI has long been ubiquitous and is being used extensively.

However, like the 2000 period, the AI narrative will likely create meaningful economic value in areas not so widely followed by the hyperventilating media. I fear investors are being caught up in the storytelling of Wall Street bankers.

My single favorite observation is the relative size of NVDA, chart 3.0. Nvidia's value exceeds the US Entire Oil/Gas industry, and the GDP of all but 11 countries. I will defer judgement to the reader. Chart 3.1 concerns the performance of large companies vs. small; small companies are out of favor, regardless of their quality.

Net/net Portfolio Management

Given the structural changes in financial markets, our approach has been to actively simplify our process. You have likely noticed a concentration into larger and fewer portfolio positions.

Floating rate bonds are proving especially helpful, the longer rates stay elevated the more they pay quarterly. Most of these were purchased to yield in excess 8%. We are very happy with the 3-4 year visibility we have at these rates of return.

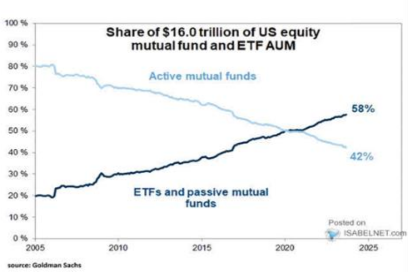
Berkshire, Goldmoney, and Visa have been additional hedges to the structural environment. Berkshire and Visa have worked well, Goldmoney not so much. As a small cap stock (chart 3.1), there are primarily technical reasons for its underperformance; the underlying business quality and cash flows has never been better.

The rates of change in business are accelerating, and change creates discomfort. Businesses built to last will endure and be far stronger.

I welcome your feedback and hope these notes help clarify how we think.

Thank you,

Julien



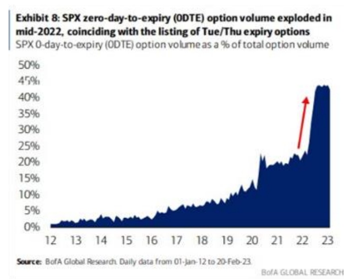


Chart 1.0 & 1.1
Investors are largely now investing passively, without regard to the underlying financial condition. 1.1 ultra short-term options now largely drive price.

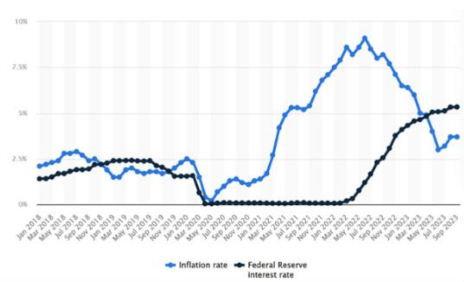


Chart 2.0 & 2.1
Bond interest rates follow inflation. Note 2022 spike in rates.

S&P 500 Energy Sector ETF ($XLE) vs. NVIDIA ($NVDA)

Ticker	Name	Market Cap ($Billions) As of 2/9/24	Net Income (TTM, $Billions)
XOM	Exxon Mobil Corp	404	36
CVX	Chevron Corp	280	21
COP	ConocoPhillips	131	11
SLB	Schlumberger Ltd	67	4
EOG	EOG Resources Inc	65	8
PSX	Phillips 66	63	7
MPC	Marathon Petroleum Corp	63	10
PXD	Pioneer Natural Resources Co	53	5
OXY	Occidental Petroleum Corp	50	5
VLO	Valero Energy Corp	49	9
HES	Hess Corp	44	1
WMB	Williams Companies Inc	41	3
OKE	ONEOK Inc	40	2
KMI	Kinder Morgan Inc	37	2
HAL	Halliburton Co	31	3
BKR	Baker Hughes Co	29	2
FANG	Diamondback Energy Inc	27	3
DVN	Devon Energy Corp	27	4
TRGP	Targa Resources Corp	19	1
CTRA	Coterra Energy Inc	18	2
EQT	EQT Corp	14	3
MRO	Marathon Oil Corp	13	2
APA	APA Corp	9	2
	Energy Sector Totals ($XLE)	1574	147
	Nvidia ($NVDA)	1782	19

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Chart 3.0 & 3.1
NVDA stock value is larger than entire US Oil and Gas energy. Chart 3.1 – large company vs. small