

For period ended March 31, 2015

## Dear Fellow Investor:

Wall Street has been obsessed with the actions of the Federal Reserve for at least as long as the older of us has been investing. On Thursday afternoons in the 1970's, everyone watched the Dow Jones news wire for the money supply report that might hold clues about the Fed's next policy move. More recently, the Fed has been extraordinarily "accommodative" in the six years since the financial crisis, and there is considerable investor anxiety about how stocks will react to a return to "normal" interest rates. It is almost comical to watch the stock market rally or swoon in response to every small bit of economic data. The logic seems to be that a sign of economic strength (good news) is "bad" because it might encourage the Fed to abandon its "zero interest rate policy" (ZIRP). Conversely, a sign of economic weakness often triggers a rally since it may discourage the Fed from tightening.

The Fed's (and the Treasury's) actions immediately after the Lehman failure were important and effective. In succeeding years, though, the creation of trillions of new dollars and their use to pump up asset prices (via "quantitative easing" or "QE") may prove to have been counter-productive. It seems likely that we have "borrowed" investment gains from the future via QE. More importantly, to the extent speculators have used cheap, short-term credit to buy (riskier) higher yielding assets ("carry trades"), they face potential trading losses if rates rise suddenly. Their scramble to exit these trades could trigger market liquidity issues.

Another interesting result of aggressive central bank activity, in Europe and Japan as well as the U.S., is that a significant amount of sovereign debt (bonds issued by countries rather than companies) now carries *negative* interest rates. This is unprecedented. One might call it surreal. Berkshire Hathaway Vice Chairman Charlie Munger admits to being "flabbergasted" by the negative yields. He says, "...of course I'm confused. Anybody who is intelligent who is not confused doesn't understand the situation very well. If you find it puzzling, your brain is working correctly." (Forbes, 3/26/2015)  
Charlie has a way with words.

Interest rates *are* important to investors. When rates return to more normal (higher) levels, holders of longer-term bonds may suffer significant declines in the market value of their holdings. Higher bond yields also offer stiffer competition for stocks, and all things being equal, rising rates are negative for stock valuations. Higher rates can also depress corporate profits and companies' enthusiasm for expansion.

Thus, we are *very* interested in how the general level of interest rates may change over a period of years. We want to know how our companies are preparing for a higher rate environment. However, we do *not* make any important investment decisions based on day to day actions or pronouncements of the Fed. We believe that obsessive "Fed-watching" is misplaced effort.

## Portfolio Positioning

We often write about wanting to buy stocks at 50-60% of our estimate of business value. Today, we find ourselves (again) holding stocks that are more "fairly" priced—above our "buy" price but with room to appreciate over time.

Berkshire Hathaway is a concrete example of one of our "in-between" stocks. In the 2014 annual report, Warren Buffett was uncharacteristically specific about how he believes investors should think about Berkshire. He has long held that Berkshire's business value, or "intrinsic value," was considerably higher than its "book value." He has stated that the company would be willing to buy back shares of Berkshire at up to 120% of book value since that would still represent a "significant discount" to intrinsic value.

This year he suggested that Berkshire's intrinsic value was very likely to rise over time and investors *planning to hold shares for many years* would probably earn good returns if they bought shares near the 120% of book value level. He went on to say if they paid twice book (200%), that it might be several years before they showed a profit

(echoing Ben Graham, a stock may be a bargain at one price but an over-valued speculation at another). Finally, he warned that if investors intended to hold the stock for only a year or two, he could offer “*no* assurances, whatever the entry price.”

Berkshire’s book value per A share at March 31 is (very) roughly \$150,000. Warren’s guidelines would suggest that a \$180,000 purchase today (120% of book) should work out well over time and that a purchase at \$300,000 (200% of book) might result in “dead money” for several years. At March 31, the stock was selling at \$217,500 (about 145% of book). At this price, it trades at a modest discount to our estimate of intrinsic value. We are “comfortable” holding it but not “excited” about buying more. This is how we feel about many of our stocks.

So we face a common dilemma—stocks are not cheap and they face some headwinds. All eyes are on interest rates and they *will* rise eventually. Another tangible factor that is beginning to have an effect on company earnings is the strong dollar. A strengthening dollar makes U.S. exporters less competitive and depresses the reported earnings of global companies as profits earned in other currencies are converted into a smaller number of dollars. There are other things going on in the world that usually distract investors and it seems possible they will again.

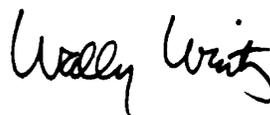
Our game plan has been (1) to place extra emphasis on companies that can “make their own breaks” and continue to grow in a less benign environment, (2) to be disciplined about trimming holdings as prices approach “full value,” and (3) to continue to visit companies and build our “on deck” list for a time when stock prices are cheaper. As a result, some of our core positions sell at relatively high price-to-value (P/V) levels and our cash reserves remain higher than usual. (Trimming successful positions also means realizing some long term capital gains that have been earned in past years.) This plan has worked reasonably well as the market has risen and we think it

will help us deal with (but not be immune from) future volatility and market corrections.

Our portfolio managers discuss the specific companies that have contributed to (or detracted from) their funds’ results in the quarterly fund commentaries. They provide capsule comments on portfolio additions and deletions and generally explain what worked and what didn’t.

Our annual shareholder meeting will be on May 14th at a different place this year—the Omaha Marriott Regency. Long-time shareholders may remember meeting there in the 1980’s and ‘90’s. We will begin at 4:30 pm with some comments from the investment team and then take questions. We hope you will join us for the investment discussion and to say “hello” to our client service colleagues you speak to during the year. Thanks again for being a supportive group of shareholders.

Sincerely,



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*As of March 31, 2015: Berkshire Hathaway, Inc. – Class B represented 4.7%, 4.6%, 7.6%, 2.7% and 2.3% of the Value, Partners Value, Partners III Opportunity, Research and Balanced Funds’ net assets, respectively.*