MORE WISE WORDS FROM WARREN

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Warren Buffett's annual letter is always rich in history, stories and lessons worth heeding.

Four of my favorite passages this year deal with familiar topics to readers of our blog:

1. Quality investing versus value investing
2. A focus on high-quality, long-term dividend growers
3. The Japan value thesis and the importance of not betting on currencies, i.e., the case for hedging FX
4. The gambling culture expanding in stock trading

1. The True Architect of the Quality Investing Style: Warren's Pivot from Value

The first passage of Warren's letter I snipped in its entirety was a tribute to Charlie Munger. Warren refers to Charlie as the architect of Berkshire Hathaway.

Warren repeats one of my favorite passages on quality investing: buying 'fair businesses' at value prices is inferior to a strategy of buying high-quality businesses at *fair* prices.

Warren attributes this foundational idea, which is Berkshire's current ethos, to Charlie, who convinced Warren to move beyond the classic Ben Graham value discipline. The real long-term winners at Berkshire were not traditional low-priced value stocks but the high-quality and growing franchises.

When I first started investigating dividend investing with Jeremy Siegel, we did it from the lens of a value investor focusing on higher-dividend-yielding baskets.

But over 10 years ago, WisdomTree made a similar quality pivot when we launched our quality dividend growth Index franchise, and now our flagship Fund (WisdomTree U.S. Quality Dividend Growth Fund, DGRW) has over $11 billion in assets and is our largest equity ETF. We've since expanded the quality focus to small caps, international markets and even a non-dividend paying universe.

But half of the ranking system for DGRW I have often described as the **Buffett factor**, which focuses on high ROE businesses using little debt to drive up that ROE (which is why we included ROA in the selection process as well).

Buffett's homage to Munger in this year's letter leaves no doubt all quality investors must stand united and refer to Charlie Munger as the original ***architect*** of the quality investing style, while Buffett was the world's best ***general contractor*** for this factor.

WISDOMTREE®

Charlie Munger – The Architect of Berkshire Hathaway

Charlie Munger died on November 28, just 33 days before his 100th birthday.

Though born and raised in Omaha, he spent 80% of his life domiciled elsewhere. Consequently, it was not until 1959 when he was 35 that I first met him. In 1962, he decided that he should take up money management.

Three years later he told me – correctly! – that I had made a dumb decision in buying control of Berkshire. **But**, he assured me, since I had already made the move, he would tell me how to correct my mistake.

In what I next relate, bear in mind that Charlie and his family did not have a dime invested in the small investing partnership that I was then managing and whose money I had used for the Berkshire purchase. Moreover, neither of us expected that Charlie would **ever** own a share of Berkshire stock.

Nevertheless, Charlie, in 1965, promptly advised me: "Warren, forget about ever buying another company like Berkshire. But now that you control Berkshire, add to it wonderful businesses purchased at fair prices and give up buying fair businesses at wonderful prices. In other words, abandon everything you learned from your hero, Ben Graham. It works but only when practiced at small scale." With much back-sliding I subsequently followed his instructions.

Many years later, Charlie became my partner in running Berkshire and, repeatedly, jerked me back to sanity when my old habits surfaced. Until his death, he continued in this role and together we, along with those who early on invested with us, ended up far better off than Charlie and I had ever dreamed possible.

In reality, Charlie was the "architect" of the present Berkshire, and I acted as the "general contractor" to carry out the day-by-day construction of his vision.

Charlie never sought to take credit for his role as creator but instead let me take the bows and receive the accolades. In a way his relationship with me was part older brother, part loving father. Even when he knew he was right, he gave me the reins, and when I blundered he never – **never** –reminded me of my mistake.

In the physical world, great buildings are linked to their architect while those who had poured the concrete or installed the windows are soon forgotten. Berkshire has become a great company. Though I have long been in charge of the construction crew; **Charlie** should **forever** be credited with being the architect.

Source: Berkshire Hathaway.

2. The Importance of Long-Term Dividend Growers Is Related to Quality Investing

Last year, we highlighted the dividend growth prominent in American Express and Coca-Cola, two companies Berkshire has held over the last 30 years.

In this year's letter, Warren again emphasized the importance of the long-term dividend compounding that comes from these high-quality businesses.

During 2023, we did not buy or sell a share of either AMEX or Coke – extending our own Rip Van Winkle slumber that has now lasted well over two decades. Both companies again rewarded our inaction last year by increasing their earnings and dividends. Indeed, our share of AMEX *earnings* in 2023 considerably exceeded the $1.3 billion *cost* of our long-ago purchase.

Both AMEX and Coke will almost certainly increase their dividends in 2024 – about 16% in the case of AMEX – and we *will* most certainly leave our holdings untouched throughout the year. Could *I* create a better worldwide business than these two enjoy? As Bertie will tell you: "No way."

Though Berkshire did not purchase shares of either company in 2023, *your* indirect ownership of both Coke and AMEX increased a bit last year because of share repurchases we made at Berkshire. Such repurchases work to increase your participation in *every* asset that Berkshire owns. To this obvious but often overlooked truth, I add my usual caveat: *All* stock repurchases should be price-dependent. What is sensible at a discount to business-value becomes stupid if done at a premium.

The lesson from Coke and AMEX? When you find a truly wonderful business, stick with it. *Patience* pays, and one wonderful business can offset the many mediocre decisions that are inevitable.

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Source: Berkshire Hathaway.

Our piece summarizing why our quality dividend growth Indexes have held exposure to these same stocks is linked here.

3. Japan Remains a Top Idea Outside the U.S.

My team has authored at least four separate pieces—starting in September 2020 after Berkshire's purchases first became public—to follow Warren into the Japan trade (1st, 2nd, 3rd and 4th).

When Warren first issued yen-denominated debt to finance his Japanese equity purchases, his motives were not clear. But the latest letter clarifies his decision: Warren doesn't think anyone has the ability to predict currency movements, so he wanted to neutralize his exposure.

It is a good thing he did: Berkshire gained almost $2 billion from hedging the yen. Since his first purchases in 2019, the yen's weakness would have subtracted from the results of picking good stocks. We believe investors habitually make a big mistake by always betting on the U.S. dollar's demise and taking on foreign currency risk like they do.

Plus, in Japan, U.S. investors earn over 5% to hedge the yen due to prevailing interest rate differentials. You can execute a strategy similar to Buffet's decision to issue yen bonds by using WisdomTree's currency-hedged ETFs.

More broadly, Buffett acknowledges that many things can go wrong on an investment thesis, and he doesn't want to let currency be that issue.

We still like Japan as a top idea for investing outside the U.S. And while many want to say the yen looks cheap and it is time to go unhedged, we'd remind you of Warren's point:

"Neither Greg nor I believe we can forecast market prices of major currencies. We also don't believe we can hire anyone with this ability."

More allocators should follow his lead and stay neutral on currencies rather than trying to time it or remaining unhedged. Remember, unhedged exposure is a perpetual bet that the dollar will weaken versus the yen.

Additionally, Berkshire continues to hold its passive and long-term interest in five very large Japanese companies, each of which operates in a highly-diversified manner somewhat similar to the way Berkshire itself is run. We increased our holdings in all five last year after Greg Abel and I made a trip to Tokyo to talk with their managements.

Berkshire now owns about 9% of each of the five. (A minor point: Japanese companies calculate outstanding shares in a manner different from the practice in the U.S.) Berkshire has also pledged to each company that it will not purchase shares that will take our holdings beyond 9.9%. Our cost for the five totals ¥1.6 trillion, and the yearend market value of the five was ¥2.9 trillion. However, the yen has weakened in recent years and our yearend unrealized gain in dollars was 61% or $8 billion.

Neither Greg nor I believe we can forecast market prices of major currencies. We also don't believe we can hire anyone with this ability. Therefore, Berkshire has financed most of its Japanese position with the proceeds from ¥1.3 trillion of bonds. This debt has been very well-received in Japan, and I believe Berkshire has more yen-denominated debt outstanding than any other American company. The weakened yen has produced a yearend gain for Berkshire of $1.9 billion, a sum that, pursuant to GAAP rules, has periodically been recognized in income over the 2020-23 period.

In certain important ways, all five companies – Itochu, Marubeni, Mitsubishi, Mitsui and Sumitomo – follow shareholder-friendly policies that are much superior to those customarily practiced in the U.S. Since we began our Japanese purchases, *each* of the five has reduced the number of its outstanding shares *at attractive prices*.

Meanwhile, the managements of all five companies have been *far* less aggressive about their own compensation than is typical in the United States. Note as well that each of the five is applying only about ⅓ of its earnings to dividends. The large sums the five retain are used both to build their many businesses and, to a lesser degree, to repurchase shares. Like Berkshire, the five companies are reluctant to *issue* shares.

An additional benefit for Berkshire is the possibility that our investment may lead to opportunities for us to partner around the world with five large, well-managed and well-respected companies. Their interests are far more broad than ours. And, on their side, the Japanese CEOs have the comfort of knowing that Berkshire will always possess huge liquid resources that can be instantly available for such partnerships, whatever their size may be.

Our Japanese purchases began on July 4, 2019. Given Berkshire's present size, building positions through open-market purchases takes a lot of patience and an extended period of "friendly" prices. The process is like turning a battleship. That is an important disadvantage which we did not face in our early days at Berkshire.

Source: Berkshire Hathaway.

4. The Gambling Culture Today in Stock Trading

While many believe the market is becoming more efficient and harder to beat over time (and the evidence shows active managers are struggling to keep up with passive, and flows are increasingly going passive), Buffett believes the emotional tendencies of the market, in some ways, are getting worse.

> *Though the stock market is massively larger than it was in our early years, today's* ***active*** *participants are neither more emotionally stable nor better taught than when I was in school. For whatever reasons, markets now exhibit far more casino-like behavior than they did when I was young. The casino now resides in many homes and daily tempts the occupants.*

For those investors who stay grounded in Warren's wise words, strategies like our quality dividend growth focus can help them stick to long-term, prudent strategies that try to capitalize on the casino-like mentality that causes stocks to deviate from fair value. Market prices are not so efficient. They are noisy, and we think rebalancing back to a concept of relative value will be rewarded over the long run.

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Quality : Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over tim.

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over tim.

Foreign Exchange (FOREX, FX) : The exchange of one currency for another, or the conversion of one currency into another currency.

Return on Equity (ROE) : Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on assets (ROA) : Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them.