THE BUFFETT BALANCE

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Last year we wrote about the type of stocks that legendary investor and CEO of Berkshire Hathaway (BRK) Warren Buffet looks for.[1]

In short, Buffett prefers quality companies–high profitability without excessive leverage–that trade at reasonable valuations.

Through year-to-date September 2019, Berkshire generated an approximate 23%[2] unrealized gain on the value of its equity portfolio. Although the company has yet to report full-year results, we anticipate that strong U.S. equity performance in 4Q 2019 further supported BRK's investments.

Despite a potential banner year for BRK's equity portfolio, the performance of Berkshire Hathaway shares lagged the S&P 500 Index by the greatest margin in a decade. Berkshire Hathaway[3] shares returned 10.9% versus the S&P 500 Index return of 31.5%[4].

As a conglomerate with businesses ranging from insurance to railroads, BRK's 20.5% return deficit to the S&P 500 Index cannot be attributed to its equity portfolio. BRK's diversified stock holdings are intended to be held long term and should be viewed as a stabilizing anchor for BRK shares when its operating businesses fall out of favor.

As admirers of Buffett's value- and quality-centric investment philosophy, we describe the screening process in our WisdomTree U.S. Quality Shareholder Yield (QSY) and U.S. Quality Dividend Growth (DGRW) Funds as including a "Buffet factor" in stock selection.

Similar to BRK's equity basket[5], QSY and DGRW can be used to serve as anchors in investors' U.S. equity allocation.

They say don't meet your heroes, but they didn't say anything about comparing yourself to them. How do DGRW and QSY stack up against BRK's holdings?

Let's draw comparisons from three perspectives: quality, capital return and value.

Quality

In aggregate we find that the quality screens built into DGRW's and QSY's methodologies are effective. The return on equity (ROE) and return on assets (ROA) quality screens, measures of company profitability, are above Berkshire's portfolio.

Figure 1: Quality Comparison

	Return on Assets	Return on Equity	Net Income Margin
QSY	3.2%	17.5%	14.3%
DGRW	6.6%	25.3%	16.1%
BRK	2.0%	15.4%	20.6%
S&P 500 Index	3.6%	15.5%	15.2%

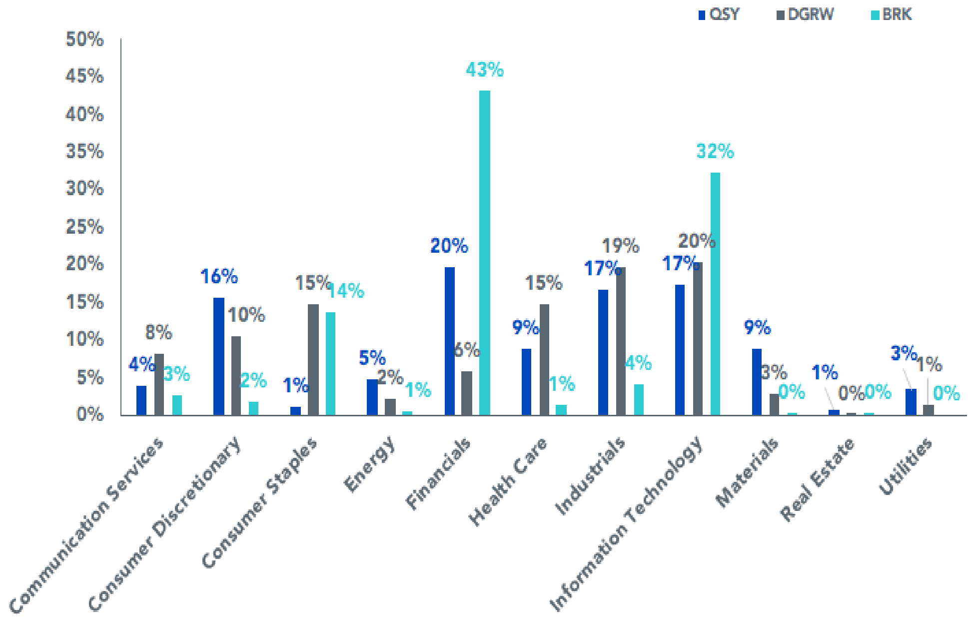
Sources: WisdomTree, FactSet, as of 12/31/19.

For standardized performance of Funds in the chart, please click their respective tickers: DGRW, QSY.

For definitions of terms in the chart, please visit our glossary.

DGRW is a quality standout based on ROE and ROA, which can partially be attributed to lower exposure to the Financials sector (6% of total weight). Financials are the top sector exposure for both QSY and BRK, with Berkshire's exposure being significantly larger (43% of total weight) than QSY's (20%).

Figure 2: Sector Exposures



Sources: WisdomTree, FactSet, as of 12/31/19. Weights subject to change.

BRK's Financials exposure is highly concentrated (27% of total weight) in large U.S. banks, including Bank of America, JP Morgan, Wells Fargo and Goldman Sachs, which on average have $2 trillion in assets. These massive balance sheets flow directly through the denominator of ROE and ROA and reduce the level of return. Apple, with $338 billion of assets, has the largest balance sheet of any company in DGRW.[6]

If we remove the impact the balance sheet may have on profitability and substitute revenue in the denominator, we calculate the net income margin (profit margin). We notice that BRK's Financials exposure is now somewhat advantageous.

The average net income margin for the large banks is 20%, driving the aggregate result for BRK in figure 1. With a larger and more diverse collection of holdings, the aggregate profit margins of DGRW and QSY reflect a wider range of outcomes.

Capital Return

The funds also focus on capital return—DGRW specifically targets dividend payers, while QSY targets companies returning significant levels of capital to shareholders through both dividends and share repurchases.

The ability to return capital to shareholders can be closely tied to other quality metrics. The free cash flow margin links profitability with potential for capital return. It measures the amount of cash flow available to shareholders for every dollar of revenue earned.

QSY, DGRW and BRK generate similar free cash flow margins, but QSY is ahead of the pack when it comes to increasing the amount of cash returned to shareholders year-over-year.

Figure 3: Capital Return Comparison

	Year-over-Year Percentage Change					
	Free Cash Flow Margin	Free Cash Flow	$ Amount of Buybacks	Shares Outstanding	$ of Amount Dividends	Dividends per Share
QSY	17.1%	20.9%	56.3%	(4.7%)	14.7%	21.8%
DGRW	17.5%	15.7%	24.1%	(0.7%)	9.6%	11.0%
BRK	18.5%	20.4%	31.1%	(4.6%)	2.3%	12.2%
S&P 500 Index	17.3%	11.2%	32.7%	(0.5%)	11.7%	12.2%

Sources: WisdomTree, FactSet, as of 12/31/19. Past performance is not indicative of future results. You cannot invest directly in an index. Index performance does not represent actual fund or portfolio performance. A fund or portfolio may differ significantly from the securities included in the index. Index performance assumes reinvestment of dividends but does not reflect any management fees, transaction costs or other expenses that would be incurred by a portfolio or fund, or brokerage commissions on transactions in fund shares. Such fees, expenses and commissions could reduce returns. WisdomTree, its affiliates and their independent providers are not liable for any informational errors, incompleteness or delays or for any actions taken in reliance on information contained herein.

Value

Buffett would likely argue that paying a fair price for quality, capital return or any desired characteristic is the most important part of the screening process.

DGRW's 2.4% dividend yield and QSY's 8.4% shareholder yield provide a compelling investment case that strikes a balance between quality, capital return and value. QSY's valuation looks especially discounted relative to the peer group (figure 4) with similar profitability and a high-level cash payout.

Figure 4: Value Comparison

	Dividend Yield	Buyback Yield	Shareholder Yield	Free Cash Flow Yield	Trailing Price-to-Earnings	Forward Price-to-Earnings
QSY	1.7%	6.7%	8.4%	6.3%	14.8x	14.0x
DGRW	2.4%	2.3%	4.7%	3.4%	19.0x	16.2x
BRK	1.9%	5.0%	6.9%	3.3%	17.0x	15.3x
S&P 500 Index	1.8%	2.2%	4.0%	2.8%	22.0x	18.6x

Sources: WisdomTree, FactSet, as of 12/31/19.

Performance is historical and does not guarantee future results. Current performance may be lower or higher than quoted. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Performance data for the most recent month-end is available at wisdomtree.com.

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For standardized performance of Funds in the chart, please click their respective tickers: DGRW, QSY.

For definitions of terms in the charts above, please visit our glossary.

From our analysis, we can conclude that DGRW and QSY are on par with Berkshire's portfolio in terms of quality, capital return and value.

Importantly, these mid- and large-cap Funds achieve aggregate characteristics similar to Berkshire's holdings without concentrated exposure to a single sector, while being valued at a discount to the S&P 500 Index.

Those investors seeking exposure to Buffet's style of investing in a more scalable and systematic fashion should consider adding QSY and DGRW to their core U.S. equity allocations.

[1]As of 12/31/19, QSY and DGRW did not hold Berkshire Hathaway.

[2]Source: Berkshire Hathaway 10-Q filing for the period ending 9/30/19. Return measured as equity security investment gains for the first nine months of 2019 as a percentage of the fair value of equity securities as of 12/31/18.

[3]As measured by Berkshire Hathaway Class B Common Shares for the period 12/31/18–12/31/19.

[4]As measured by S&P 500 Index for the period 12/31/18–12/31/19.

[5]Per Berkshire Hathaway's 13-F filing for the period ending 9/30/19. BRK's equity portfolio consists of individual stocks, or equity securities. QSY and DGRW are exchange-traded funds (ETFs), whose shares are listed on a stock exchange and trade like equity securities at market prices. ETFs allow you to buy or sell shares that represent the collective performance of a selected group of securities.

[6]As of 1/31/20. DGRW held 4.6% of its weight in Apple and did not hold Bank of America, JP Morgan, Wells Fargo or Goldman Sachs. QSY held 0.8%, 0.8% and 0.6% of its weight in Apple, Bank of America and JP Morgan, respectively; QSY did not hold Wells Fargo or Goldman Sachs.

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You cannot invest directly in an index.

DEFINITIONS

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.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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.

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.

Dividend : A portion of corporate profits paid out to shareholders.

Share Repurchase : A transaction in which a company purchases its own shares from the marketplace.

Free Cash Flow : A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

Dividend yield : A financial ratio that shows how much a company pays out in dividends each year relative to its share price.

Shareholder Yield : A data point that references the combination of dividend yield and buyback yield.