

Why do we talk about book value?

The much anticipated Berkshire Hathaway annual letter penned by Warren Buffett will be released tomorrow. Book value has always been a key topic for Mr. Buffett as well as QV. Book value (BV) is defined as the assets of the firm minus its liabilities or simply its net worth. The BV grows as the firm generates net income or profits. If a firm does not pay a dividend, the BV will grow by the earnings each quarter. If the firm pays out a dividend, the BV will grow by the net earnings minus the dividend.

Beginning in 2000, Warren Buffett began his letter with an excerpt from the annual report which reported the annual percentage change in the book value per share of Berkshire Hathaway versus the annual percentage change in the S&P500 Index including dividends. Since Berkshire Hathaway does not pay dividends, the book value increases by the level of earnings over time. The point of his disclosure is to display the increase in the net worth of Berkshire Hathaway. The change in stock price is not displayed because Mr. Buffett believes the stock price will fluctuate, but the true value of the company is the book value. This is one of the reasons Mr. Buffett states “only buy something that you’d be perfectly happy to hold if the market shut down for 10 years.” As shown in the chart of Uni-Select, a long held company in the Small Cap Fund, the share price moves in the same direction as the book value per share. The change in the stock price is not perfectly correlated, but over a long period of time the direction is the same.

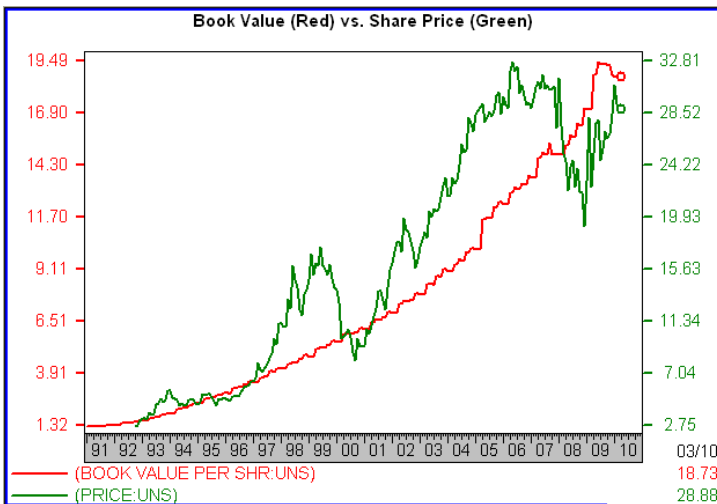
John Hussman of Hussman Funds describes these estimates very critically, “While stocks are often recommended to investors based on analyst estimates of operating earnings expected over the coming year, it is important to recognize that these estimates are invariably lowered over the course of the year – even up to the day before the actual earnings reports are released.”

Furthermore, expected operating earnings typically exclude one-time items such as integration costs and/or restructuring costs. The problem with this definition is sometimes one time items occur year after year.

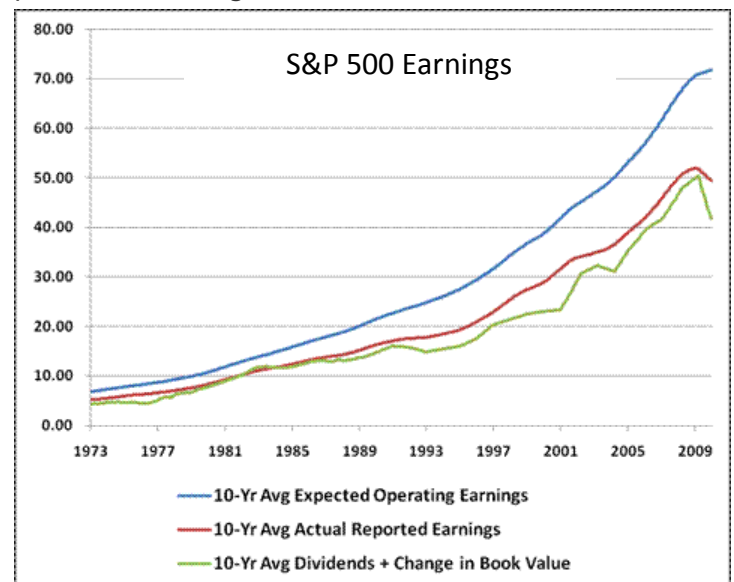
Actual reported earnings are earnings presented according to General Accepted Accounting Principals (GAAP). They are typically lower than the expected operating earnings because they include all expenses including these “one-time” items.

The final type of earnings is the owners earnings which can be described as the increase in book value plus the dividends paid out by the company. The difference between reported and owners earnings can be affected by things such the payment of stock options which affect the book value per share.

The chart below displays the difference in the types of earnings described above for stocks in the S&P500. You can see the estimates by the “experts” are typically way off the mark. David Dreman’s statements in a *Forbes* article in 1997 summed up this chart perfectly. “The inaccuracy of these forecasts shows how dangerous it is to buy or hold stocks on the basis of what analysts predict for earnings.”



Source: CPMS & QV Investors



Source: www.hussmanfunds.com

Why don't we talk more about earnings?

What type of earnings should we talk about? Expected operating earnings, reported earnings or owners earnings?

Expected earnings are the estimates put forward by Wall Street and Bay Street analysts. They are educated guesses based on discussions with the companies and suppliers, as well as extrapolating historical trends.

The key for QV is to ensure we focus on the companies that are creating consistent earnings which improve the book value of the firm over time. We also need to ensure when we argue a company is appropriately valued it is based on a contemplation of what type of earnings we are reviewing.