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PERSHING SQUARE HOLDINGS: HOW FAR AWAY TO BERKSHIRE HATHAWAY?

September 19, 2023

"What we've said in these meetings, what we've said in the annual reports, we've said exactly what we do. And some of the books about us, they try to hold out that there's a secret beyond that. But I don't think there is.

We try to run Berkshire in a way that we find admirable, and we spell out our reasoning on it. And we hope that maybe somebody latches onto that as a model."

Warren Buffett, Berkshire Hathaway annual shareholder meeting 2000[1]

"A big part of my education as an investor came from reading everything Buffett's ever written and watching him speak – he also came to Harvard business school when I was a student."

Bill Ackman, CEO, Pershing Square Holdings, September 2023[2]

"I've always said that my goal is to have a better record than Warren Buffett.

He's got 60 years track record and I've been at it for 30 years – so I've got 30 years to go."

Bill Ackman, CEO, Pershing Square Holdings, September 2023[3]

1. Introduction: the *conservative aggressive, minority outsider*, investor

"Fund consultants like style boxes such as 'long-short', 'macro', 'international equities'..

At Berkshire, our only style box is 'smart'."

Warren Buffett, Berkshire Hathaway annual shareholder letter, 2010[4]

The aim of this white paper is to review the investment approach used by Warren Buffett's Berkshire Hathaway "BH", and compare it to that of Pershing Square Holdings "PSH", the Amsterdam-listed investment trust managed by Bill Ackman.

The review does not target, nor make, projections. It instead examines the assumptions and rationale that underlie what we term as the *conservative aggressive, minority outsider* approach used by Warren Buffett (reductively, the "Buffettian" approach). We also contend that whilst Buffett's public commentary often points to the more straightforward *what* in investing, he less frequently addresses the reasoning and evidence for the more elusive *why*, which this paper also targets.

At the outset, we also note the differentiation of the Buffettian approach from the more popularly followed concepts of "value investing", particularly in terms of both the Buffettian input assumptions of information bias, stock promotion, combined with herd and gambling behaviour by market participants, as well as its output conclusions, that the Buffettian investor should seek long-term, scaled allocation to significantly robust and competitively advantaged businesses, and which have been valued by the investor not on the basis of their earnings multiples but on the present value of their future cash return relative to the initial cash outlay. The white paper argues that PSH broadly adheres to the Buffettian approach, albeit with variance in some dimensions which are also detailed.

Figure 1: The Buffettian approach advocates for, as a minority investor, conservatism, understandability as an outsider and non-expert, and yet also, aggression in position scaling

conservatism

"Truly conservative actions arise from intelligent hypotheses, correct facts and sound reasoning. These qualities may lead to conventional acts, but there have also been many times when they have led to unorthodoxy."

understandability as an outsider without reliance on third party "experts"

"When we really sit back with a smile on our face is when we run into a situation we can understand, where the facts are ascertainable and clear, and the course of action obvious. In that case - whether other convection or unconventional - whether others agree or disagree - we feel we are progressing in a conservative manner."

Warren Buffett, Buffett Partnership annual letter 1964[5]

aggression in position scaling (1)

"We might invest up to 40% of net assets in a single security"

Warren Buffett, Buffett Partnership annual letter, 1966[6]

aggression in position scaling (2)

"Big opportunities have to be seized. We don't do very many things, but when we get the chance to do something that is right and big – we've got to do it. And to do it on a small scale is just as big a mistake as not at all. You've got to grab them when they come. You're not going to get 500 great opportunities."

Warren Buffett, 2001, lecture at the University of Georgia, 2001[7]

1.1. The underlying assumption set of the *conservative aggressive, minority outsider*, or Buffettian, approach

Our analysis contends that the *conservative aggressive, minority outsider,* or Buffettian, approach rests on three central assumptions: 1) human agents pass on information with bias, 2) promotion influences security prices, and 3) gambling and herd like mentalities are present in market participants and this creates with sufficient regularity discounted investment opportunities in simple and understandable businesses.

As such, the implication of the Buffettian assumptions is that, from an investment perspective, the *insider* has both advantages and disadvantages relative to the *outsider*. The insider has two advantages: they are typically the *promoter* rather than the *promoted to*, and secondly by having direct access to inside information which has not been subjected to bias, the insider has superior information resolution.

By contrast the insider has a handicap, which is that, due to being focused on one business only – they are unlikely to have a consistent opportunity to buy the security in which they are knowledgeable at discounted pricing resulting from irrational gambling or herd behaviour by market participants. Instead, in most cases, the insider will only have access to their security at the promoted pricing that they themselves have also protagonised.

The Buffettian approach contends that the outsider can address their remaining disadvantages relative to the insider by using a differentiated set of rules and principles, primarily:

- The removal of reliance on bias from human "expert agents" by focusing on simple and understandable businesses.
- A value assessment based on long-term participation in cash receipts relative to initial cash outlay, rather than valuation methods which target security price forecast – the security price being that which promoter entities target.
- The deployment of wide search for the rare opportunities that both meet Buffettian principles and where herd behaviour and/or gambling has not only been unintelligent, but also created instances of discounted pricing.

The stringency of the selection criteria that define the Buffettian approach correspondingly results in a low number of securities meeting its criteria: the rareness of suitable opportunity as such then demands scaled positioning. Therefore, the Buffettian approach is both *conservative and aggressive*: conservative in its focus on opportunities which possess the safety to permit scaling, and yet aggressive in its scaling of such correspondingly few opportunities targeted for capital allocation.

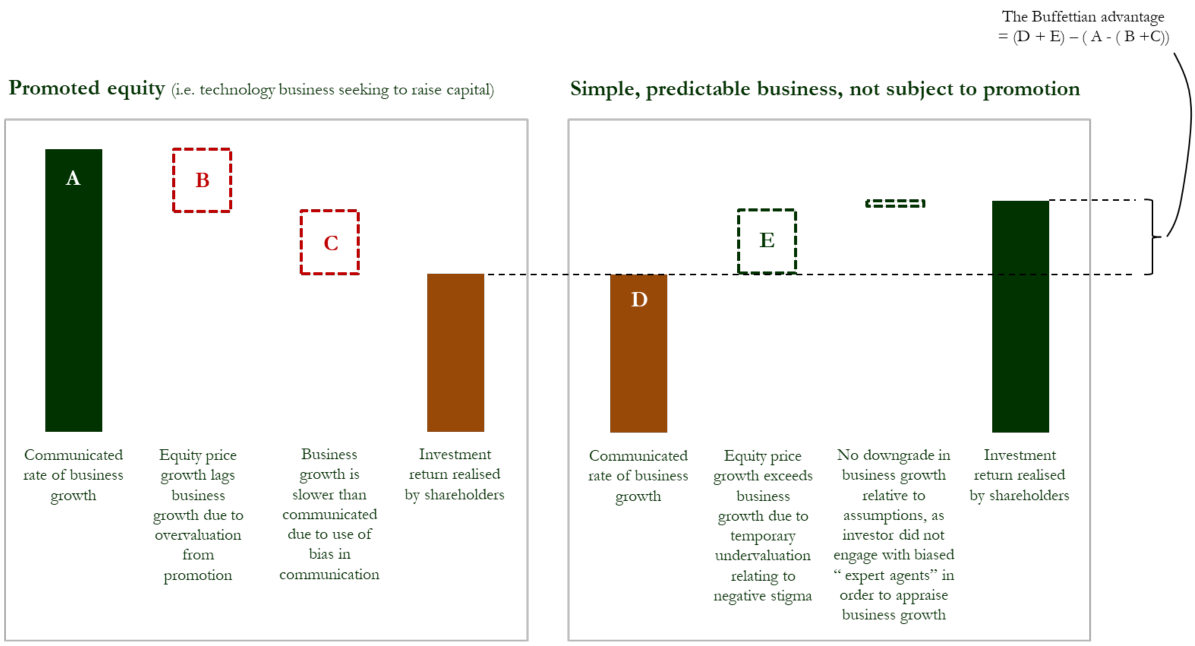
The more common path for market participants is a more diversified exposure to investment opportunities, many of which may have been promoted, for example in faster paced situations such as in the technology sector. Such businesses may often require promotion to meet their capital raise needs, and therefore the Buffettian principles are typically not met. However, the Buffettian contention is also that the truly *smart* investor will not only 1) be cautious with regard to promoted situations given their higher risk of information bias and overvaluation, but 2) will also aim to avoid situations that possess higher market efficiency by their challenge of already having attracted a large volume of high throughput, competitive analysis.

> *"The secret of life is weak competition.. [and] in securities markets, if you have an IQ of 100 and everybody else has an IQ of 80, you are way better off than if you have a 140 IQ and all the rest of them also have 140"*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 1998[8]

> *"Many people think that if they just hire someone with the appropriate labels they can do something very difficult. That is one of the most dangerous ideas a human being can have."*
>
> Charlie Munger, Berkshire Hathaway shareholder meeting, 1994[9]

1.2. The Buffettian approach in graphical and formulaic representation

Figure 2: A graphical illustration of the Buffettian assumption set[10]



As per Figure 2 the contentions necessary for the Buffettian advantage to be met are illustrated: firstly, equity share prices that have been subject to promotion lag the underlying business growth that they are connected to the extent their stock prices already discount future growth. As such underlying corporate growth [A] is lagged by equity price growth by the amount by which corporate growth is already discounted by the share price [B].

Additionally, for promoted businesses the corporate growth on average will deviate from the earnings guidance that has been provided, because agents of the companies (be it the CEO, analysts, or academics) are incentivised in various degrees to add bias to their communication of the prospects of the company. The difference between guided earnings growth, and actual earnings growth is [C]. The result is that the shareholder's participation in the rate of communicated business growth for promoted businesses [A] is depleted by overvaluation from overpromotion [B] and by earnings not meeting guidance [C]. As such, promoted businesses deliver shareholder returns of [A] – ([B] + [C]).

By contrast, the Buffettian approach seeks to identify stable and predictable businesses not subject to promotion [D]. And it combines this with the contention that herd behaviour in public markets is in instances unintelligent, and at sufficient frequency, such that a consistent search for stable and predictable businesses will occasionally identify them at discounted valuations. Hence, the share price growth of these discounted names will exceed their business growth by [E].

Finally, because the Buffettian approach, by focusing on simple and inspectable businesses, does not rely on agents for advice, and as such lowers or removes bias from its analysis process, Buffettian stock selections offer returns of [D] + [E].

Figure 3: Formulaic contention of the Buffettian approach[11]

The growth of simple and inspectable businesses [D], *plus* **the additional shareholder return from instances of their undervaluation [E]**

is, on average, greater than

The growth of promoted businesses [A]

less: **the extent to which their promoted share price already discounts their growth [B]**

less: **the failure of their growth to match the bias within its original guidance [C]**

2. The evidence and reasoning for the Buffettian assumption set

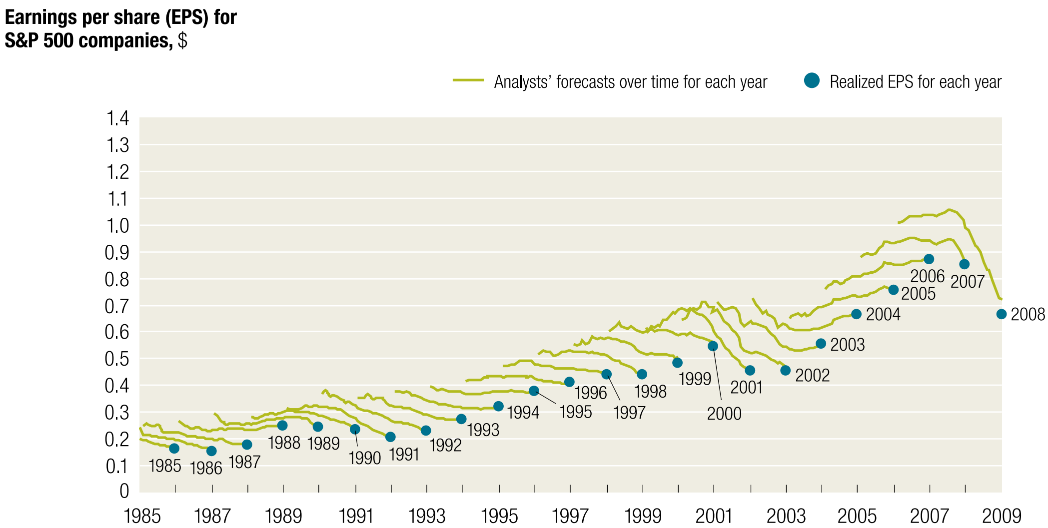
2.1. The addition of bias by human agents in their financial communications

> *"I do not understand why any buyer of a business looks at a bunch of projections put together by a seller or his agent – it is naïve to think that that has any utility whatsoever. We are just not interested.*
>
> *If we don't have any idea ourselves of what we think the future is, to listen to someone who is trying to sell us the business or get a commission on it and tell us what the future is going to be – it is very naïve."*

Warren Buffett, Berkshire Hathaway shareholder meeting, 1994[12]

That human agents add bias in line with their incentives with regard to financial communication is empirically observable, as per Figure 4: with few exceptions, aggregate earnings forecasts exceed realised earnings per share.

Figure 4: Bias in financial communication results in earnings guidance, with few exceptions, exceeding realised earnings per share, and as such offers an empirical measure of [C] (see section 1.2)[13]



2.2 The price impact from the consequent promotion (or demotion) of securities

Bias in financial communication is thereon a core pillar driving security price promotion. For quantification of the impact that such promotion can have, data from the initial public offering "IPO" market is instructive. The data is in the context that well informed decision making when considering an IPO is critical from the perspective of the corporate – typically the amount of new capital raised is significant – up to of one third of the value of the company on average is raised.

As per Figure 5, the first day performance of post-IPO companies has averaged +20.5% from 1980-2022, with no down year. Additional to this, average IPO fees, payable to the bank conducting the listing, are 7% of the monies raised[14]. The implication is that the cost of an IPO from the perspective of a corporate is 27.5% of the value of the monies raised at the market close on day one (i.e. 20.5% + 7%), relative to the value of those monies had they been invested at the IPO issuance price.

"The biggest money made, you know, in Wall Street in recent years, has not been made by great performance, but it's been made by great promotion."

Warren Buffett, Berkshire Hathaway shareholder meeting, 2001[15]

The alternative transaction to an IPO – which is the corporate raising equity capital by selling an interest to private equity – is a transaction incurring no comparable frictional cost, and in some cases also achieving strategic accretion.

According to McKinsey, the capital available to fund this alternative source of equity financing is vast: in 2022 private equity deal volume was $2.4 trillion, and private market assets under management reached $11.7 trillion[17].

The inference from the significant pool of private equity capital available is that the IPO process is logically conducted primarily because the corporate in question has been persuaded that a public listing for its equity will achieve pricing at least 35% higher (i.e. 1/ [1 – 27.5%]) than a private market buyer would be willing to pay.

Or, to put it more bluntly, when the general public is included in the pool of buyers for an equity participation in a company, price outcomes can be *promoted* to at least 35% beyond that which would be achievable with a sophisticated private buyer of the same equity participation and with superior information resolution.

For almost 90 years, the US Securities Act of 1933 has prohibited deceit and misrepresentations relating to the sale of securities to the general public. And yet, even in the last 40 years, there have been more than 9,000 IPOs in the United States[19].

Of course, there needs to be no breach of the securities laws for promotion to occur – the implication is that promotion occurs by bias, by storytelling, by force of personality, and by media appearances.

Figure 5: The first day performance of post-IPO companies has averaged +20.5% from 1980-1922, with no down year[18]

Year	Number of IPOs	Mean First-day Return: Equal-weighted	Mean First-day Return: Proceeds-weighted
1980	71	14.3%	20.0%
1981	192	5.9%	5.7%
1982	77	11.0%	13.3%
1983	451	9.9%	9.4%
1984	171	3.7%	2.5%
1985	186	6.4%	5.6%
1986	393	6.1%	5.1%
1987	285	5.6%	5.7%
1988	105	5.5%	3.4%
1989	116	8.0%	4.7%
1990	110	10.8%	8.1%
1991	286	11.9%	9.7%
1992	412	10.3%	8.0%
1993	510	12.7%	11.2%
1994	402	9.6%	8.3%
1995	462	21.4%	17.5%
1996	677	17.2%	16.1%
1997	474	14.0%	14.4%
1998	283	21.9%	15.6%
1999	476	71.2%	57.4%
2000	380	56.3%	45.8%
2001	80	14.0%	8.4%
2002	66	9.1%	5.1%
2003	63	11.7%	10.4%
2004	173	12.3%	12.4%
2005	159	10.3%	9.3%
2006	157	12.1%	13.0%
2007	159	14.0%	13.9%
2008	21	5.7%	24.7%
2009	41	9.8%	11.1%
2010	91	9.4%	6.2%
2011	81	13.9%	13.0%
2012	93	17.7%	8.9%
2013	158	20.9%	19.0%
2014	206	15.5%	12.8%
2015	118	19.2%	18.9%
2016	75	14.5%	14.2%
2017	106	12.9%	16.0%
2018	134	18.6%	19.1%
2019	113	23.5%	17.6%
2020	165	41.6%	47.9%
2021	311	32.1%	24.0%
2022	38	48.9%	14.2%
1980-2022	**9,127**	**19.0%**	**20.5%**

"I cannot recall any time in the last 30 years that we've bought a new issue.. the idea that a seller is bringing something to market today, when there is going to be a lot of hoopla connected with it, that is going to be the single cheapest thing to buy out of thousands of businesses in the world, is ridiculous.

And when it carries a 7% commission – or higher – it's ridiculous.

You have thousands of opportunities among stocks in the world, and most of them are not being promoted or being sold with special commissions in them."

Warren Buffett and Charlie Munger explaining their aversion to investing in IPOs[16]

2.3. Herd mentality and gambling mentality in the decision making of market participants

> *"Investors behave in very human ways – which is that they get very excited during bull markets, and they look in the rear-view mirror – I made money last year, I'm going to make money this year, so I will borrow. And when they look in the rear-view mirror, they plough in, and they just push and push and push up prices.*
>
> *And if they look in the rear-view mirror and see no money having been made. They just say this is a lousy place to be – so they don't care what is going on in the underlying business.*
>
> *It is astounding, but that makes for huge opportunity – just huge opportunity."*

Warren Buffett, 2001, lecture at the University of Georgia[20]

The third assumption of the Buffettian approach, that herding and gambling mentalities are present in market participants, is contended as an aspect of human behaviour that not only results in a vulnerability to security price promotion, but also its opposite, vulnerability to security price demotion, such that discounted investment opportunities are available with sufficient frequency in simple and understandable businesses.

Herd mentality in humans

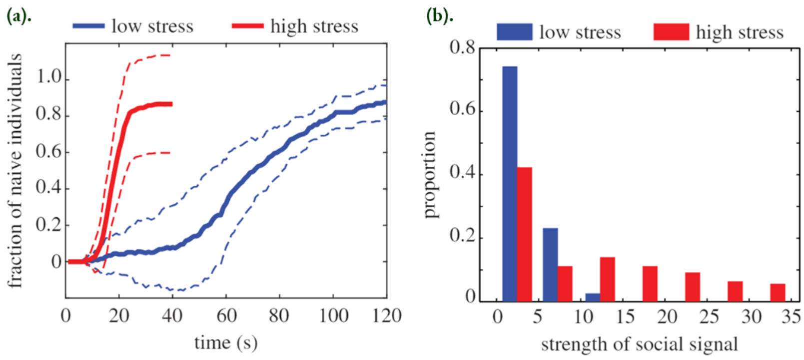
Herd mentality by its nature requires it to be subconscious: if herd following was a conscious decision this would disenfranchise the herd as the primary input to its participants' decision making. As such, if as humans we are subject to herding behaviour we should not necessarily expect to consciously recognise it. Nor to be told it: the social stigma associated with labelling a person as following the herd is one of insult. Nevertheless, it is still the case that, in contending a herding function in humans, an extrapolation from animals could have historically been theorised, as per Figure 6.

Figure 6: Herding behaviour is observable across the animal kingdom, particularly when animals are subjected to unanticipated reward or danger from a confusing or complex series of inputs[21]

It is only in recent years however that the safety and ethical issues relating to testing humans in dynamically changing crowding environments have been resolved, using virtual reality with real human participants. Collaborative studies undertaken by the Max Planck Institute for Human Development in Germany, the Cognitive Science and Computational Social Science departments at ETH Research University in Zurich, and the Computer Science department at Rutgers University in the US have tested human participants in crowds using virtual reality[22]. The research work offers verificatory evidence that multiple dynamics of crowd movements in humans are driven by non-linear stress-based amplification loops that promote the emergence of large-scale behavioural patterns.

As per Figure 7, (a), the percent of humans that are "naïve" in decision making, that is, who make decisions based on following an existing crowd pattern, rises to 80% in high stress conditions, relative to less than 10% in low stress conditions. That is, the work by Max Planck Institute and its collaborators implies that herd behaviour in humans is triggered by high stress conditions. The studies also quantified the strength of this social impulse felt by humans, relative to the stress level of the conditions. As per Figure 7, (b), the social signal is up to 10x stronger under high stress (red) than under low stress (blue).

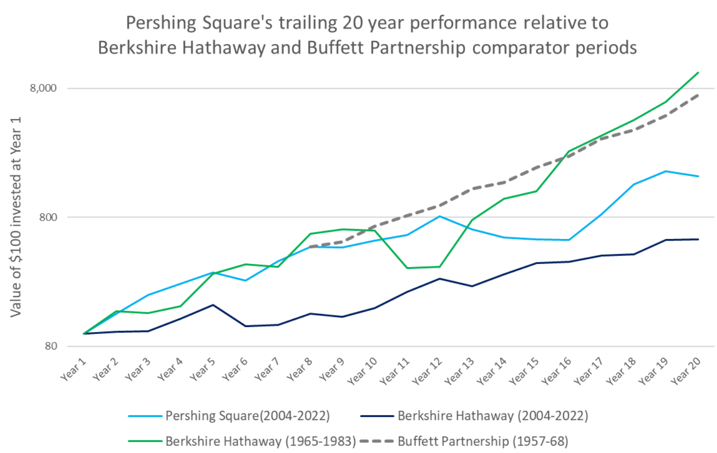
Figure 7: Experiments with human participants in crowds, using virtual reality, confirm herd behaviour in humans is driven by stress-based amplification loops[23]



To the extent that herding behaviour also has significance in terms of the decision inputs of financial market participants, it should be possible to observe recent examples. Indeed this does appear to be the case – a number of large-scale and recent investment opportunities can be contended as having been created by seemingly unintelligent herd behaviour. Examples include in 2016 and 2018 when Apple traded at a PE ratio of 10x (and in both years also had a net cash position of more than 10% of its market capitalisation)[24], in 2020 oil traded below zero[25], and in 2019-2022, the German government 10 year bond had a negative yield[26] – in other words, for a short construct on the bond, the German government was paying market participants to borrow from them.

Indeed, for PSH today which is trading at a 37% discount to NAV[27], despite a peer group leading track record[28] as detailed in Figure 8, combined with public indications of an intent to introduce a US listing to reduce its discount to NAV[29], as well as an active share buyback programme[30], readers may consider whether PSH is a further example of an unintelligently priced outlier in markets currently.

Figure 8: Since 2004, Pershing Square has delivered a 16.0% annualised return, exceeding the 9.3% equivalent by Berkshire Hathaway over the same period. However, for the 20 years following Warren Buffett taking control of Berkshire Hathaway it delivered a 27.8% annualised return; the Buffett Partnership delivered 25.3% annualised[31].



Gambling mentality in humans

The Buffettian approach also links the vulnerability of public market participants to promotion by their susceptibility to gambling. As Warren Buffett noted earlier this year, "*the world is full of foolish gamblers*"[32]. However, for this contention to be robust as underpinning a long-term investment approach, gambling behaviour, like herding behavior, must be an enduring human characteristic, and not simply one which has happened to apply during the period of BH's history.

Whilst, simplistically, gambling appears to be a maladaptive human behaviour, the evolutionary origins of gambling appear to have led to it being innately programmed in many humans. The explanation, according to that stipulated by evolutionary biologists, is that conviction by humans in a certain outcome despite an uncertain reality, particularly when that conviction is led by a strong personality force, can still be an evolutionary advantage. Examples include the aggregation by humans in political interests, as well as well as a form of status display relating to alignment of such interests[33].

Academic studies appraising gambling behaviour in humans observe a correlation to lower income groups[34], and this also rationalises the otherwise counter-intuitive opening up of equity market participation to the general public, rather than solely to well-funded, well-informed private market participants: it is in the former group that gambling behaviour will be more prevalent.

In this context it is notable that the so called "stock-splits" undertaken by publically listed companies, by lowering the economic value of each equity unit (whilst increasing the total number of units) would appear to serve no purpose other than making each stock unit more affordable to the general public. As such, stock splits can be also contended to be a design to incentivise gambling behaviour, and therefore the success with which a security promotion strategy can be conducted.

However, there are other incentives for gambling behaviour, and at the institutional level. Wall Street banks offer preferential IPO allocations, and other "perks" such as research access to institutions with high trading activity[35], in other words to those speculating on short term price outcomes rather than allocating to investments on the basis of Buffettian principles.

> *"My wife — when we got married April 19th, 1952 — we got in my aunt's car, and we started driving west. And we ended up — we drove all over the west — but one night we ended up in Las Vegas. And I walked into this casino, aged — the Flamingo — it was kind of a motel-like arrangement — and I was 21. And my bride was 19.*
>
> *And I looked around the room and there were all these people — and they were better dressed then — it was a more dignified group than, perhaps, you'd get currently — but they had flown thousands of miles in some cases — you know — in planes that weren't as fast as the current ones and were more expensive, probably, on a per-mile basis, adjusted, then.*
>
> *They'd gone to great lengths to come out to do something that was mathematically unintelligent, and they knew it was unintelligent. And, I mean, they couldn't do it fast enough, in terms of rolling the dice, you know, and trying to determine whether they were hot or whatever they may be.*
>
> *And I looked around at that group. And everybody there knew that they were doing something that was mathematically dumb, and they'd come thousands of miles to do it, and they were — and I said to my wife, I said, you know, I'm going to get rich (Laughs). I mean, how can you miss? (Laughs). If people are willing to do this, you know, this is a land of opportunity. And, well, it's the way it still is, you know.."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 2022[36]

3. The Buffettian approach aims to reduce vulnerability to promotion by focusing on the simple and understandable, and on cash generation rather than share price

3.1. Buffettian principle for lowering vulnerability to promotion (1): Focus on simple, understandable businesses

The Buffettian contention that vulnerability to promotion is a result of an innate programming of humans dictates a remedy weighted first toward pre-determined rules, with the analysis carried out by the capital allocator both conditional on and subordinated to the initial rule set. As per Figure 9, rules in favour of this approach are disclosed by both BH and PSH.

> *"Charlie and I have a number of filters that things have to get through very quickly before we are willing to think about them."*
>
> Warren Buffett discussing the nature of auction markets versus negotiated deals[37]

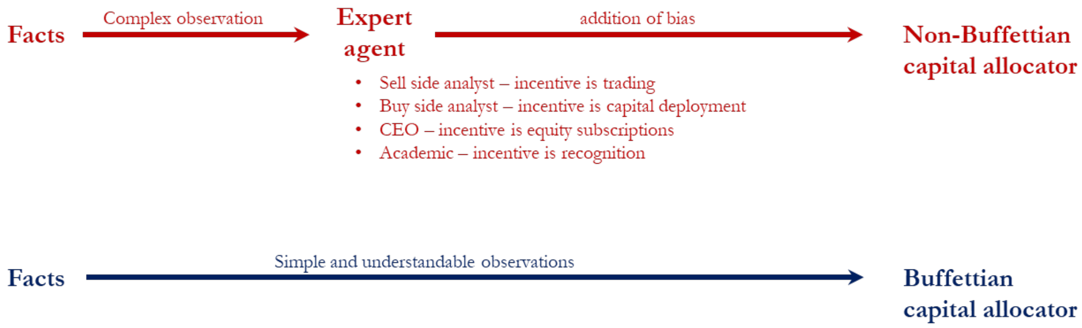
> *"I went back to the core principles – I had a member of the investment team literally engrave them in a stone tablet not dissimilar from Moses's Ten Commandments. I had that stone tablet, what you might call a deal toy, sit on everyone's desk in the office and we've adhered to those principles ever since."*
>
> Bill Ackman interview with David Rubenstein, 2020[38]

Figure 9: The full set of disclosed Buffettian rules, and their comparison to those disclosed by Pershing Square[39]

Berkshire Hathaway principles	**Pershing Square principles**
1a. Focus on simple, understandable businesses whose analysis does not demand "expert agent" assistance	
• *a business we understand*	• *simple, predictable*
1b. The approach to valuing businesses must focus on cash return relative to initial cash outlay	
• *cash return on cash outlay*	• *free cashflow generative*
	• *consideration of relative PE ratios*
2. Attractive long-term economics with defence against competitor entry, recessionary and other risk	
• *favourable long-term economics*	• *dominant companies*
• *long-term competitive advantage*	• *large barriers to entry*
• *a stable industry*	• *earn high returns on capital*
	• *limited exposure to extrinsic risks we can't control*
3. Strong financial position: low risk of the business must be transformed into a low risk to for the equity	
• *businesses capitalized in a way that that low risk of the business is transformed into a low risk to the equity*	• *strong balance sheets*
	• *don't need access to capital to survive*
4. Management competence and good governance	
• *able management*	• *excellent management*
• *trustworthy management*	• *good governance*

The first rule, as per Figure 9, *1a, a focus on simple, understandable businesses whose analysis does not demand "expert agent" assistance*, appears designed to reduce the vulnerability of the capital allocator to promotion by restricting investments to those where the facts and reasoning are directly observable and understandable by the capital allocator without a reliance on biased agents. The rule is illustrated in more detail in Figure 10 below.

Figure 10: The Buffettian approach seeks the blue line, where the facts and reasoning that relate to the investment case are directly observable by the capital allocator without a reliance on biased agents[40]



The figure's contention is that the majority of information relating to securities is represented by the red line, where the underlying facts corresponding to the investment are both complex and in some way obscured from direct observation by the capital allocator. As such, information relating to the investment is only understandable by the capital allocator in some way engaging with an agent – be it a sell side analyst, a buy side analyst, a CEO or an academic – yet all of whom are each incentivised to pass on the information in the context of their own biased appraisal or incentive. By contrast, the Buffettian approach seeks the blue line, where the facts and reasoning that relate to the investment case are both simple, understandable, and directly observable by the capital allocator without a reliance on biased agents.

> *"If, in your thinking, you rely entirely on others, often through purchase of professional advice, whenever outside a small territory of your own, you will suffer much calamity."*
>
> Charlie Munger, Practical Thought about Practical Thought, 1996[41]

> *"You can do very ordinary things, I mean what is complicated about Coca Cola, and yet we are $3 billion better off than we were three years ago because of it. There is nothing that I know about that product, its distribution system, its finances or anything that hundreds or millions of people don't already know.*
>
> *And similarly, if you get into some complicated business, you can get a report that is 1,000 pages thick and you got PhDs working on it, but it doesn't mean anything."*
>
> Warren Buffett, Berkshire Hathaway annual meeting 1994[42]

> *"In high-tech businesses or something like that, we don't have the faintest idea what the coupons are going to be.*
>
> *We get into businesses we think we can understand reasonably well, we are trying to print the coupons out."*
>
> Warren Buffett, Berkshire Hathaway annual meeting 1997[43]

In Buffett's comments on the prior page on Coca-Cola, he emphasises two points. The first is the lack of complexity to the analysis. By rejecting complex business types the need to rely on "expert agents" for advice is removed, along its risk of bias.

Buffett adds that expert advice, even if from PhDs writing reports of 1,000 pages, "*doesn't mean anything*".

Buffett secondly then comments that his analysis relies on no information that "*millions of people don't already know*". In other words, it is not complex information nor is it information gained by access to privileged analysts or corporate executives (whose interests are aligned with the investor understanding facts by way of a certain bias) that the Buffettian approach seeks, but investments that can be appraised with these inputs removed.

For the comparison to PSH, Bill Ackman also expresses a focus on "*simple, predictable*" businesses as per Figure 9, and notes that it has been in cases of compromise on business quality or complexity that PSH has suffered losses.

> *"It really is each case that we've compromised on business quality or complexity we've been harmed."*
>
> Bill Ackman interview with David Rubenstein, 2020[44]

However, our analysis has not identified as clear statements in the public domain from Bill Ackman that his comparable focus on simple predictable business is due to an attempt to remove *bias* from an analysis. Notably, Ackman stated in the context of overseeing an ultimately loss-making investment in Valeant Pharmaceuticals in 2014, as per Figure 11, "*you get a good sense of people.. you have to rely on trust.*" A number of executives from Valeant were ultimately disclosed as having engaged in fraudulent practices at the company[46], and the company itself was forced to pay $45 million to settle legal challenges relating to improper revenue accounting[47].

Figure 11: The PSH investment in Valeant arguably revealed higher trust in both agents and biased information-risk than a strict adherence to Buffettian principles would dictate

"I've been working with Valeant.. you get a good sense of people.. you have to rely on trust," Bill Ackman, 2014[45]

Whilst the overall investment track record of Pershing Square remains very strong, likely in part from the value derived from learning from such experiences, the Valeant allocation arguably provides evidence of an instance of higher trust in both expert agents and biased information-risk than a more strict adherence to Buffettian principles would dictate.

Other publically disclosed comments from both BH and PSH also appear to reveal a greater emphasis at BH that the capital allocator should aim to remove bias from the investment process. For example, at BH, the "buy side analyst" role, which typically seeks sector experts but who also risk susceptibility to bias in their analyses in favour of capital deployment, has not been meaningfully used. Buffett and Munger have disclosed that they make all investment decisions themselves without analyst advice. By contrast, for the PSH business model an analyst investment team approach remains in place.

> *"Charlie and I allocate all the capital ourselves. That is our job. We don't feel we should delegate [to analysts], and I mean, we wouldn't do it anyway."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 1994[48]

> *"The ideal way to run headquarters is to have one man, preferably over 80, sitting in an office by himself. Anything else is pure frippery.."*
>
> Charlie Munger, Becoming Warren Buffett, HBO documentary[49]

> *"Unlike Buffett who you know runs ran at really a one-person operation and has an accountant and a couple of assistants, the way we've built our business is I've hired a lot of super-talented highly compensated people."*
>
> Bill Ackman, Pershing Square Holdings, September 2023[50]

3.2. Buffettian principle for avoiding promotion (2): valuations must focus on cash return relative to cash outlay

The second rule imposed by the Buffettian approach to reduce its vulnerability to promotion is as per Figure 9, *1b, the approach to valuing businesses must focus on cash return relative to initial cash outlay.*

Our observation is that this rule is not necessarily an objective truth of business valuation – for example when independent experts are used to put forward valuations in M&A transaction negotiations, such valuations crystalise value for shareholders in many instances[51] and often use share price multiples of earnings[52], as well as reference to comparable transactions.

As such, Buffett's election to use cash return relative to initial cash outlay as the primary valuation tool may be interpreted as a method designed to further remove the input of promoters from the valuation process: the cash in versus cash out valuation methodology disallows the investor to focus on the short-term variable – share price, and therefore earnings multiple – that a stock promotion agent will typically target.

Buffett, in emphasising that valuation should be based on the cash in cash out measure, refers to share price multiple-based valuations as "*just a game of who beats who*" adding more comprehensively "*the only reason for putting cash into any kind of an investment now is because you expect to take cash out, not by selling it to somebody else, because that's just a game of who beats who, but, by what the asset, itself, produces*[53]".

As per Figure 12, BH in 1998 took its emphasis on the cash in cash out measure a step further with a new corporate logo (since discontinued) at its annual shareholder meeting. The logo depicted the company's mission as a hand "grabbing cash" from stock market opportunities.

Figure 12: The significance with which Warren Buffett focuses on cash return to the investor, relative to cash outlay, was reinforced by the Berkshire Hathaway choice of logo (since discontinued) at the 1998 annual meeting, depicting the company's mission as a hand "grabbing cash" from opportunities in the securities markets[54]

> *"When you look at a bond, say United States government bond, it is very easy to tell how much you are going to get back – it says it right on the bond, it says when you get the interest payments, it says when you are going to get the principal. So it is very easy to figure out the value of the bond. The cashflows are printed on the bond.*
>
> *The cashflows are not printed on a stock certificate. That is the job of the analyst, is to change that stock certificate, which represents an interest in the business, and change that into a bond, and say this is what I think it is going to pay out in the future.*
>
> *The only reason for making an investment and laying out money now is to get more money later on, and that is what investing is all about."*
>
> Warren Buffett, 2001, lecture at the University of Georgia[55]

By comparison, the PSH approach to business valuation appears to consider a wider range of measures beyond the Buffettian focus on cash return relative to initial cash outlay.

The PSH ruleset, as per Figure 9, *1b,* includes that the business must be *free cashflow generative*. However, when PSH goes into greater disclosure as to the valuation premise of its holdings, as per Figure 13 on the following page, valuation approaches are used including cash returns on cash outlay *and* more frequently, recently, a discount of the PE ratio relative to peer group companies, the latter an approach that Buffett shows less favour toward.

As noted, our conclusion is not that the PE multiple approach can be objectively defined as "wrong", but that its rejection by Warren Buffett is most likely because it can potentially make investors more vulnerable to promotion when they embrace the same valuation approaches more commonly also used by promoting agents.

Figure 13: Warren Buffett discourages the use of the PE ratio in valuations "forget it", and instead advocates for valuations on the basis of cash return relative to initial cash outlay. By contrast, whilst Bill Ackman earlier in his career also indicated a preference for valuation as cash return relative to initial cash outlay, more recent Pershing Square Holdings disclosures typically refer to the PE ratio as the primary valuation indicator

"There is a lot more to intrinsic value than book value or PE. Forget it... you have to understand the business... [and] if you attempt to assess intrinsic value, it all relates to cash flows."

Warren Buffett, Berkshire Hathaway shareholder meetings, 1996, 1997[59]

"I would not look for a metric like relative PEs to determine how to invest. Look for things you understand, where you think you can see out for many years, as to the cash that can be generated from the business."

Warren Buffett, Berkshire Hathaway shareholder meeting, 2002[58]

"We don't think really month-to-month or quarter-to-quarter. The value of a business is the present value of the cash you can take out of it over.. say, 50 years. And if the business is worth the present value of the cash you can take out of it over 50 years.. you should think more about what you're paying versus what the business is worth, rather than what you are paying because of what they are going to earn next quarter."

Bill Ackman, CNBC interview, 2008[57]

"Lowe's currently trades at only 13.5x forward earnings, a low valuation for a business of this quality, and a substantial discount to its direct competitor, Home Depot which trades at a price-earnings multiple of 18x."

Bill Ackman, PSH annual report 2022[65]

"Google was way behind in AI, and the stock sold off to 15x PE for one of the greatest businesses in the world."

Bill Ackman, CNBC Delivering Alpha, 2023[56]

4. The demanding set of Buffettian criteria means the great opportunity is rare. The rare opportunity, to have impact, must then be scaled. Scaling demands safety.

4.1. The great opportunity will be rare

The demanding set of criteria that define the Buffettian approach dictate that the great opportunity will be rare, and as such, the optimal investor makes new allocations very seldomly, waiting for what Warren Buffett describes as the "perfect pitch".

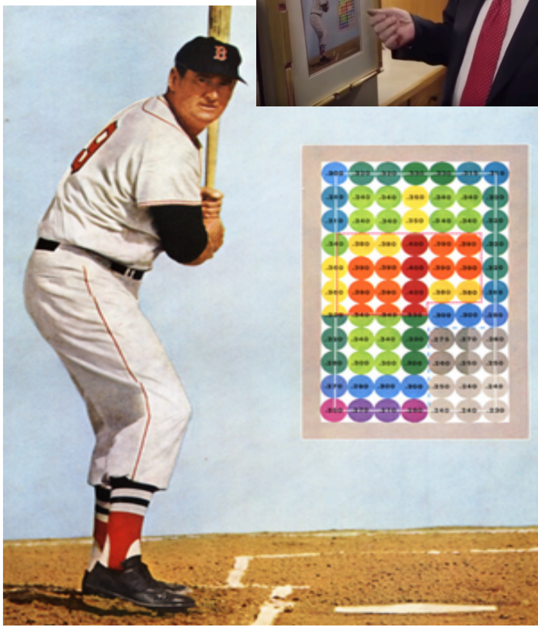
> *"The one thing that all betters in the whole industry of horse racing have who have consistently beaten the pari-mutuel system, what they have in common is quite simple, they bet very seldom. You can get very remarkable investment results if you think more like a winning pari-mutuel player."*
>
> Charlie Munger, A Lesson on Elementary, Worldly Wisdom, 1995[60]

> *"Part of the Berkshire secret is that when there's nothing to do, Warren is very good at doing nothing."*
>
> Charlie Munger, Berkshire Hathaway meeting, 2018[61]

"In his book, The Science of Hitting, Ted Williams explains that he carved the strike zone into 77 cells, each the size of a baseball. Swinging only at balls in his "best" cell, he knew, would allow him to bat 0.400; reaching for balls in his "worst" spot, the low outside corner of the strike zone, would reduce him to 0.230. In other words, waiting for the fat pitch would mean a trip to the Hall of Fame; swinging indiscriminately would mean a ticket to the minors.

We will stick with the approach that got us here and try not to relax our standards. Ted Williams, in The Story of My Life, explains why: "My argument is, to be a good hitter, you've got to get a good ball to hit. It's the first rule in the book."

Warren Buffett, Berkshire Hathaway shareholder letters 1994, 1997[62]



"The market is efficient yes. But it is not perfectly efficient. If you don't trade too actively, you are talking about fairly low transaction costs. So that with enough fanaticism and enough discipline, some of the shrewd people are going to get way better results than average in the nature of things.

It is not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it, who look and sift the world for a mispriced bet – that they can occasionally find one.

And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't bet at all. And yet, in investment management, practically nobody operates that way. We operate that way – I'm talking about Buffett and Munger.

But a huge majority of people have some crazy construct in their heads. And instead of waiting for a near cinch and loading up, they apparently ascribe to the theory that if they work a little harder or hire more business school students, they'll come to know everything about everything all of the time. To me that is totally insane.

The way to win is to work, work, work, work, and hope to have a few insights. You can get very remarkable investment results if you think more like us. And you are not going to be smart enough to find thousands in a lifetime. But when you get a few, you really load up. It's just that simple."

Charlie Munger, A Lesson on Elementary, Worldly Wisdom, 1995[63]

In the context that PSH is evidenced as following the Buffettian approach, Bill Ackman also guides a strategy of targeting a low number of trades in any one year, and as such implying a comparable strategy of waiting for the "perfect pitch".

> *"We do very few transactions maybe one or two a year"*
>
> Bill Ackman, interview with Charlie Rose, 2013[64]

> *"We prefer less rather than more investment-related activity as it is an indication that we have made good decisions about where to invest our capital for the long term. Constant turnover of the portfolio of a so-called long-term investment manager is generally an indication of poor investment decisions that had to be reconsidered."*
>
> Bill Ackman, Pershing Square Holdings Annual Report 2022[65]

The rareness of opportunity also demands an extensive search process as a large part of the fund manager's time allocation, a point that both Warren Buffett and Charlie Munger have made publically.

> *"We have to work extremely hard to find just a very few attractive investment situations."*
>
> Buffett Partnership letter 1965[66]

> *"When I started, I went through the pages of the manuals page by page. I mean, I probably went through 20,000 pages in the Moody's industrial, transportation, banks and finance manuals.*
>
> *And I did it twice.*
>
> *And I actually, you know, looked at every business."*
>
> Warren Buffett, Berkshire Hathaway annual meeting 2001[67]

> *"Work hard at it, look and sift the world for a mispriced bet – and you can occasionally find one.*
>
> *Think of it as heavy odds against game full of falsehoods and craziness and yet with an occasional mispriced something or other."*
>
> Charlie Munger, A Lesson on Elementary, Worldly Wisdom, 1995[68]

4.2. The rare opportunity, to have impact, must be scaled

The second consequence of the Buffettian approach is that to the extent the great opportunity is rare, once it is identified, logic dictates a large capital allocation. In this context both BH and PSH can be observed to be targeting scaled positions.

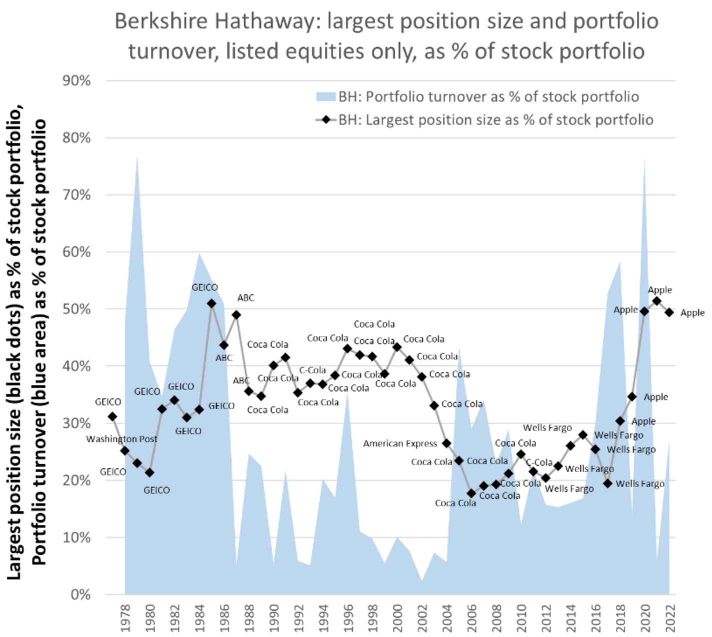
> *"Being prepared, on a few occasions in a lifetime, to act promptly in scale, in doing some simple and logical thing, will dramatically improve the financial results of that lifetime. A few major opportunities, clearly recognisable as such, will usually come to one who continuously searches and waits, with a curious mind that loves diagnosis involving multiple variables."*

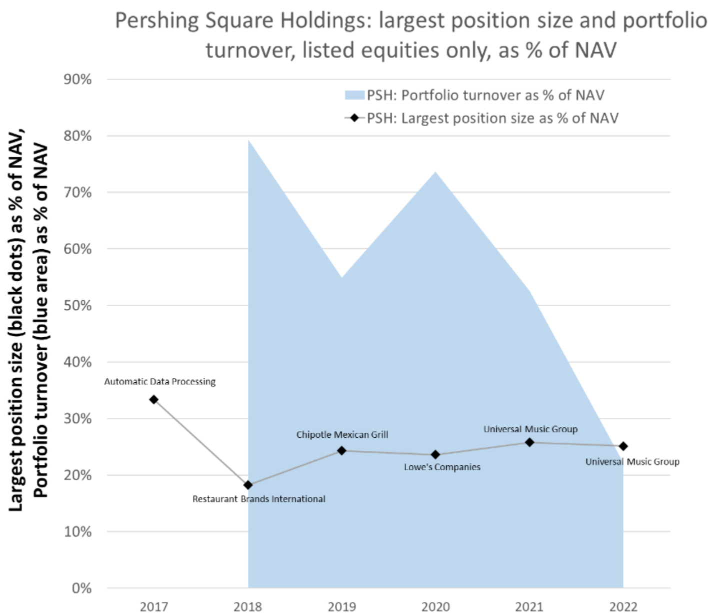
Charlie Munger, Poor Charlie's Almanac[69]

> *"If you look through the Forbes 300, wealthiest people in the world, most of them have made their fortune in one business, or a portfolio of two businesses. Very few of them have made it in a portfolio of 100.*
>
> *So I've always had the view that why not own the best 10 or 11 investments as opposed to ideas 12 through 25 or 100 which is more typical. There are very few great investments at any one time so the ability to concentrate is an enormously valuable asset of a strategy – it leads to bumpier returns and more attention on mistakes, but if you want to make high rates of return over a long period of time it's hard to do that being very diversified."*

Bill Ackman, interview series 100 Years of Financial Wisdom[70]

Figure 14: Whilst both Berkshire Hathaway and Pershing Square Holdings advocate position scaling, Berkshire Hathaway appears to show a higher conviction than Pershing Square Holdings. From 1978-2002, the largest position size of Berkshire Hathaway exceeded 30% of its equity portfolio and reached, in 1985, 50% of its equity portfolio. Today, Berkshire Hathaway again has its largest position at 50% of its equity portfolio – Apple[71]





As per Figure 14, BH appears to have historically imposed both low trading frequency, and the scaling of positions, to a greater degree than PSH. BH has averaged a listed equity portfolio turnover of c. 30% per annum it its period 1980 to 2022 albeit 1995-2005 its turnover was considerably lower averaging below 10% per annum. By comparison, PSH averaged a portfolio turnover of 50% per annum in its publically disclosed period 2017 to 2022, albeit this is including a time point where PSH was coming out of a performance detraction which may have justified the higher turnover period as its strategy re-oriented. In 2022 PSH's stock turnover was 20%.

Similarly, in terms of position sizing, BH appears to reveal a higher conviction in the Buffettian approach than PSH, albeit the comparisons are not like-for-like given the BH portfolio assessed is solely its listed stocks which only represent a proportion of all BH assets. Regardless, from 1978-2002, the largest position size of BH exceeded 30% of its listed equity portfolio and reached, in 1985, 50%. Today, BH again has its largest position – Apple – at more than 50% of its listed equity portfolio. By comparison, the largest position of PSH 2017 to 2022 has not materially deviated from 25% of its equity portfolio and today also corresponds to this proportion.

4.3 Safety: the prioritisation of robust businesses which also deliver attractive long-term returns on equity

The Buffettian approach is well known for demanding a discount to intrinsic value[72]. Its rationale is straightforward: a discount offers both a margin of safety and more upside.

However, the accuracy of the discount calculation also requires the analysis to achieve reasonable precision in the intrinsic value estimate of the business. As such, the Buffettian approach demands opportunities with low conditionality, including to extrinsic risks such as recession, and to the risk of competitive displacement. The result is that the Buffettian approach focuses on recession robust businesses, and market leading companies with durable competitive advantage sufficient to lower the probability of scenarios of competitive harm.

As per Figure 9, *2, attractive long-term economics with defence against competitor entry, recessionary and other risk*, both BH and PSH indicate adherence to this rule.

Whilst this white paper does not comprehensively detail the business models most typically offering these criteria, we illustrate in Figure 15 the businesses currently and historically owned by BH as representative. Typically the business types include a powerful brand which is achieving enduring resonance with the public and/or an infrastructure or fixed asset position which prevents competing companies, without comparable attributes, from taking market share. Headline examples include Coca Cola, McDonald's, the US railroads, Apple and Gilette, and both BH and PSH have had multiple historic stock selections among these names[74].

Figure 15: The stock investments currently and historically made by Berkshire Hathaway[73]

> *"We're not predicting the currents coming, just how some things will swim in them, whatever the currents are."*
>
> Charlie Munger, Berkshire Hathaway annual meeting, 1998[75]

> *"Our approach to investing capital is to find extremely durable, well-capitalised, high-quality growth companies that can survive any storm."*
>
> Bill Ackman, Pershing Square Annual Report 2022[76]

The nature of the Buffettian assessment method – focusing on cash return over the life of the enterprise – compared with the rareness of opportunity that occurs, also demands a long-term holding ideology, and as such, businesses that have attractive long-term compounding rates on their retained equity. This requirement – durable competitive advantage leading to high returns on equity – is also within both the BH and PSH rules as per Figure 9, principle 2.

> *"Over the long term, it is hard for a stock to earn a much better return than the business which underlies its earnings. If the business earns 6% on capital over 40 years and you hold it for 40 years, you are not going to make much different than 6% return. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive price, you end up with one hell of a result. So the trick is in getting into better businesses."*
>
> Charlie Munger, A Lesson on Elementary, Worldly Wisdom[77]

> *"In businesses we are looking for an entity which has durable competitive advantage – one that not only is doing well now but that will be doing well 10, 20 years from now. We're not looking for the best brain surgeon in town, we are looking for the Mayo Clinic, so we want an institution that regardless of the person in charge will maintain that competitive advantage over the decades."*
>
> Warren Buffett, public domain interview, 2018[78]

A sustainably high return on equity also allows the capital allocator to achieve a form of *influence indifference*, and in particular, indifference as to whether the company can be influenced to return cash to shareholders or not. The high return on equity of the business means that a capital hoarding mentality by the company still produces pleasing outcomes, to the extent that its own deployment of capital remains within its core high return activities.

4.4 Safety: low financial risk

Similarly, scaling positions demands the removal of scenarios of equity value transfer to debt holders, as per figure 9, principle *4, strong financial position: low risk of the business must be transformed into a low risk to for the equity*. As detailed, both BH and PSH have comparable rules with regard to low financial risk.

> *"We tend to go into businesses that inherently are low-risk, and are capitalized in a way that that low risk of the business is transformed into a low risk to the equity."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 1997[79]

Interestingly however, both BH and PSH have on rare occasions breached the principle of requiring allocations to possess low financial risk. In 2008, Buffett allowed the attractions of undervaluation and herd-like behaviour in the market to outweigh his disdain for leverage, and allocated to Irish banks, which were levered 48 to 1[80]. His outcome was a 90% loss by year end[81].

Similarly, in 2014 Bill Ackman allocated to Valeant, which was levered, in terms of net debt to EBITDA, at 5.5x to 1[82]. The quality of Valeant's EBITDA also had some opacity – its growth relied on the continuation of an acquisition strategy[83]. PSH realised a loss exceeding 90% on its investment in Valeant[84].

4.5. Safety: deep dive research to verify and stress test the assumptions of the investment case

Whilst the Buffettian approach advocates for a focus on simple, understandable businesses, this does not rule out that industrious deep dive research is also required, and applied.

It is clear from the comments from Warren Buffett and Bill Ackman that they both advocate for the commitment of extraordinary hours to obsessive, focused work on core positions, when required. This includes in Warren Buffett's case reading more than 100 years of the annual reports of Coca Cola, combined with sufficient reading from competitor disclosures for Buffett to be able to recall the market shares of Dr Pepper and Royal Crown Cola across numerous individual US cities. Similarly, Bill Ackman has stated that on multiple occasions the investments of PSH have required the reading of thousands of pages of documents.

> *"I was recently studying the 1896 report of Coke (and you think that you are behind in your reading!)"*
>
> Warren Buffett, Berkshire Hathaway letter to shareholders 1996[85]

> *"The share of Dr. Pepper in Dallas is 18 percent. And in Boston, it's six-tenths of one percent. Whereas Royal Crown Cola has 3 percent in Chicago, and one-tenth of a percent, in Detroit, a couple hundred miles away."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 2000[86]

> *"Roberto Goizueta, Coke's CEO since 1981, had a burning sense of urgency about reaching his goals. An excerpt from one handwritten note he sent to me illustrates his mind-set: "By the way I have told my wife that what she refers to as an obsession, you call focus. I like your term much better."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting 1997[87]

> *"Todd and Ted, they're both terrific assets, and they love Berkshire and they work extraordinary hours."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 2021[88]

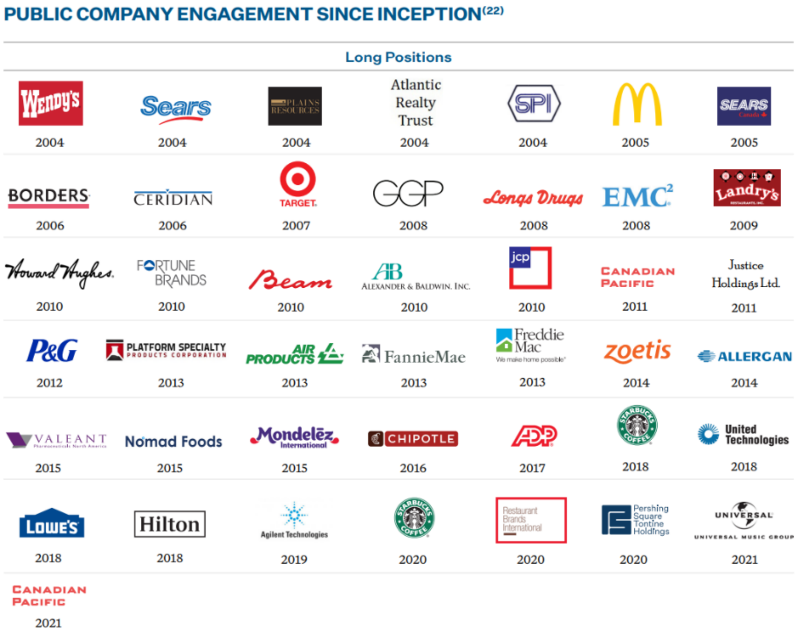
> *"There have been occasions where there was the need to read thousands of pages of documents, it was important for General Growth Properties, that was one of those, MBIA was another. Some of the best things require you to go very very deep."*
>
> Bill Ackman, Pershing Square Holdings, interview September 2023[89]

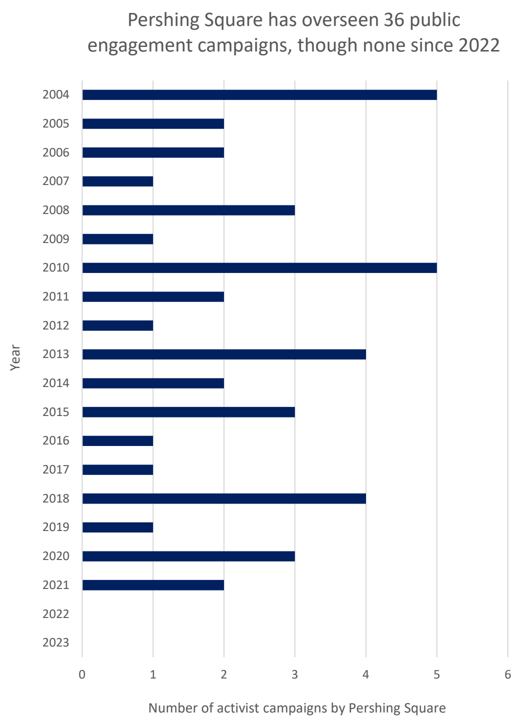
Bill Ackman's industrious approach to investing is also revealed by his activity in opportunity sourcing, including through building the public profile of Pershing Square both through extensive public speaking and on social media. In addition, PSH also employs a team of analysts to further increase the throughput of work achievable. Over the last 20 years, Pershing Square has led 36 campaigns of public company engagement, and for each campaign PSH slide decks have regularly exceeded 150 pages[90], further evidencing the industriousness aspect of the approach used.

However, in this aspect PSH appears to use a differentiation from the Buffettian approach, in that public protagonist activism also adds an element of the investor becoming the stock promoter themselves – both in terms of equity price impact from a publically-facing activist campaign and in terms of its potential synergy in asset raising for the fund manager. In this context, it is notable that since shifting the majority of its assets to PSH, which as a closed-ended structure, relative to the prior majority of assets controlled by Pershing Square Funds which were open ended, Pershing Square has appeared to reduce the frequency of its public protagonist activist approach[91].

Figure 16: Since inception, Pershing Square has led 36 activist campaigns, and as an activist investor, its public-facing slide decks regularly exceeded 150 slides.

However, no public engagement campaigns have been conducted by Pershing Square since 2021[92]





4.6. Safety: removing risk of the manager themselves

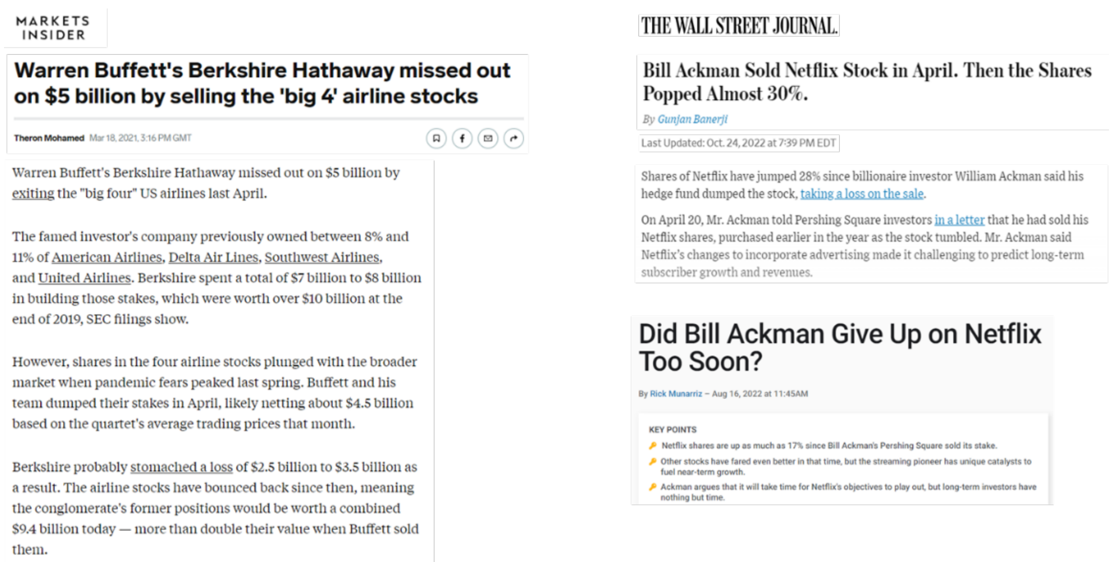
Finally, the confidence in allocation decision that the Buffettian principles provide for are designed to also result in the manager achieving optimisation in allocation behaviour – adding to positions on weakness rather than a loss of confidence and the crystallisation of losses. As Buffett puts it, this outcome avoids a critical risk in investment – the risk of the manager themselves – unable to retain their belief in the core holding during a period of market distress.

> *"The risk then becomes the risk of you yourself. I mean, whether you can retain your belief in the real fundamentals of the business and not get too concerned about the stock market."*
>
> *"Following conservative principles is the key to getting rid of the risk that would otherwise exist in the market."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 1997[93]

> *"Some people are more subject to fear than others. It's like a virus, it strikes some people with much greater ferocity than others. And fear is something I really never really felt financially, and I don't think Charlie's felt it either. Some people can handle it psychologically. If you cant handle it psychologically, then you really shouldn't own stocks because you're going to buy and sell at the wrong time."*
>
> Warren Buffett, Berkshire Hathaway shareholder meeting, 2020[94]

It is notable that when BH and PSH have strayed into investments that fail to comply with the Buffettian principles, in our appraisal by BH in the US airlines (low return on equity, high operating/financial leverage)[95], and by PSH in Netflix (lack of business advantage clarity relative to competitive threat)[96], the personality types of their managers, once Buffettian principles have been breached, has not been sufficient to prevent the suboptimal loss of belief during market dislocation. As per Figure 17, both investors "sold at the bottom" for these investments, only to watch the share prices subsequently rise.

Figure 17: Warren Buffett and Bill Ackman have been susceptible to succumbing to pressure from share price developments, and changing their minds on an investment at suboptimal timing, crystalising losses[97]


MARKETS INSIDER

Warren Buffett's Berkshire Hathaway missed out on $5 billion by selling the 'big 4' airline stocks

Theron Mohamed Mar 18, 2021, 3:16 PM GMT

Warren Buffett's Berkshire Hathaway missed out on $5 billion by exiting the "big four" US airlines last April.

The famed investor's company previously owned between 8% and 11% of American Airlines, Delta Air Lines, Southwest Airlines, and United Airlines. Berkshire spent a total of $7 billion to $8 billion in building those stakes, which were worth over $10 billion at the end of 2019, SEC filings show.

However, shares in the four airline stocks plunged with the broader market when pandemic fears peaked last spring. Buffett and his team dumped their stakes in April, likely netting about $4.5 billion based on the quartet's average trading prices that month.

Berkshire probably stomached a loss of $2.5 billion to $3.5 billion as a result. The airline stocks have bounced back since then, meaning the conglomerate's former positions would be worth a combined $9.4 billion today — more than double their value when Buffett sold them.

THE WALL STREET JOURNAL.

Bill Ackman Sold Netflix Stock in April. Then the Shares Popped Almost 30%.

By Gunjan Banerji

Last Updated: Oct. 24, 2022 at 7:39 PM EDT

Shares of Netflix have jumped 28% since billionaire investor William Ackman said his hedge fund dumped the stock, taking a loss on the sale.

On April 20, Mr. Ackman told Pershing Square investors in a letter that he had sold his Netflix shares, purchased earlier in the year as the stock tumbled. Mr. Ackman said Netflix's changes to incorporate advertising made it challenging to predict long-term subscriber growth and revenues.

Did Bill Ackman Give Up on Netflix Too Soon?

By Rick Munarriz – Aug 16, 2022 at 11:45AM

KEY POINTS

- Netflix shares are up as much as 17% since Bill Ackman's Pershing Square sold its stake.
- Other stocks have fared even better in that time, but the streaming pioneer has unique catalysts to fuel near-term growth.
- Ackman argues that it will take time for Netflix's objectives to play out, but long-term investors have nothing but time.

5. The Buffettian portfolio design: realism as to the implications of leverage

5.1. Modest, non-margin leverage at up to 30% of assets is used, with the mission to optimise financing cost

As detailed further in section 5.3, the Buffettian aversion to margin leverage stems from the risk that it can lead to the investor being forced to sell a holding at precisely the wrong time. However, this does not rule out the modest use of non-margin leverage.

For BH it is float, generated from its insurance business, that is used as a source of debt-equivalent financing. Whilst this float may be called upon by insurance claims, the claimants have no ability to correlate claims corresponding to the mark-to-market position of the BH equity portfolio. As such, float can be considered as funding that has been "borrowed" from insurance policy holders on a non-margined basis.

As at June 30th, BH disclosed float of $166bn, relative to its market capitalisation at the date of this white paper of $800bn. If we assess BH's leverage as that equivalent to treating this insurance float as debt, and its market capitalisation as its gross assets, then BH's current gearing is 21%.

In the case of PSH, as per Figure 18, the company has borrowed $2.3bn of non-margin leverage against its $10.5bn stock portfolio. The debt is long duration with a weighted average 8 year maturity date. The overall gearing ratio is therefore also moderate at 22%.

Figure 18: Pershing Square Holdings currently borrows at 22% of its portfolio value, using long-term debt with no margin recourse[103]

The Company has the following Senior Notes issued and outstanding, which are listed on Euronext Dublin with a symbol of PSHNA:

Bond	Date of Issuance		Bond Face	Price of Bonds at Issuance (of Par)	Fixed Rate Coupon (per annum)	Coupon Payment	Maturity Date
2027 Bonds	October 1, 2021	€	500,000,000	99.869%	1.375%	Annual	October 1, 2027
2030 Bonds	November 2, 2020	$	500,000,000	100%	3.250%	Semi-Annual	November 15, 2030
2031 Bonds	October 1, 2021	$	700,000,000	99.670%	3.250%	Semi-Annual	October 1, 2031
2032 Bonds	August 26, 2020	$	200,000,000	100%	3.000%	Semi-Annual	July 15, 2032
2039 Bonds	July 25, 2019	$	400,000,000	100%	4.950%	Semi-Annual	July 15, 2039

However, in the current environment of rising interest rates, assuming sustained, the approach of BH may reveal a commensurately rising advantage relative to PSH. BH estimates the cost of its insurance float has averaged 3% per annum[104], relative to PSH bonds currently trading at a 7.9% yield[105], and relative to US 30 year rates currently at 4.8%[106], offering a financing advantage in favour of the BH corporate design.

> *"We're looking around for float because we don't want to pay 5 percent for money. And we could have the float entirely in equities. We can have it any place it makes the most sense.*
>
> *So our job at Berkshire is to get the liabilities as cheaply as possible. And then we want all the assets to be employed as intelligently as possible.*
>
> *We have an excellent chance of having very low cost, and perhaps even no-cost or negative cost float over the next five years or so, or really as far as the eye can see."*
>
> *"If you generate float at 3 percent per annum and buy businesses that earn 13 percent per annum with the proceeds of the float, we have figured out that that's a pretty good position to be in."*
>
> Warren Buffett and Charlie Munger, Berkshire Hathaway shareholder meetings, 2001, 2002[107, 108]

5.2. Modest margin leverage (up to 25% of NAV) is tolerated exclusively with regard to merger arbitrage situations

The Buffettian contention that leverage should not be used if it puts the investor in a position where they risk being forced to sell a holding does not rule out the use of modest margin leverage for positions where there is an unusually high degree of safety in mark-to-market pricing resulting in a dramatically lower probability of a forced selling scenario.

As per the quote below, Buffett did allow modest (up to 25% of fund assets) margin leverage for merger arbitrage holdings during the Buffett Partnership period. Merger arbitrages are short duration, binding constructs in which an equity becomes subject to a takeover offer and normally trades at a modest discount to the deal close price to reflect the duration of the anticipated period until the deal is closed. With modest leverage, such constructs can in instances of market inefficiency offer attractive annualised returns.

However, today BH is too large to participate in the arbitrage market with meaningful impact relative to assets and hence why margin leverage is now completely ruled out by BH. By comparison, PSH does not conduct merger arbitrage as part of its deployments.

> *"I believe in using borrowed money to offset a portion of our work-out [arbitrage] portfolio, since there is a high degree of safety in this category in terms of both eventual results and immediate market behavior.*
>
> *My self-imposed standard limit regarding borrowing is 25% of partnership net worth, although something extraordinary could result in modifying this for a limited period of time."*

Buffett Partnership letter, 1963[102]

5.3. Rejection of margin leverage for all other allocation types

The primary assumptions of the Buffettian approach – biased information, price influence through promotion, combined with an enduring market presence of herd and gambling behaviour – introduces scenarios of both irrational and chaotic market pricing. This explains both the more broad Buffettian aversion to leverage, but also why all margin-recourse leverage is rejected outright by both BH and PSH with regard to floating price securities (i.e. outside of merger arbitrages).

> *"Anything can happen in terms of markets. That's why you never want to use margin to buy into investments.*
>
> *When things go bad, all kinds of things correlate that no one ever dreamed correlated.*

Warren Buffett, Berkshire Hathaway annual meeting, 2003, 2017[98]

> *"The problem with margin leverage is, because stock prices can trade at any price in the short term, margin leverage can put you in a position where you're forced to sell something at precisely the wrong time."*

Bill Ackman, Pershing Square Holdings Q1 2016 earnings call[99]

Whilst leverage amplifies the amplitude of financial outcome, it does not per se weight the outcome to a positive result. As such, the Buffettian rejection of, in particular, margin leverage, is subject to the contention, as Ackman notes, that margin leverage "*can put you in a position where you're forced to sell something at precisely the wrong time*" and thereby incurs a cost.

The implicit statement is that the cost of forced selling cannot be offset by the profit from taking advantage of others at their point of forced selling. The lack of surplus capital dictates the accuracy of the conclusion: a forced exit of all levered positions cannot be offset by an opportunistic attempt to capture, with no surplus capital, only a proportion of those available opportunities from other forced sellers.

> *"American business is going to have interruptions, and you're not going to foresee them. You don't want to get yourself in a position where those interruptions can affect you, either because you're leveraged or because you're psychologically unable to handle looking at a bunch of numbers.."*

Warren Buffett, Berkshire Hathaway annual meeting, 2020[101]

> *"I will guarantee you sometime in the next 20 years that people will do some exceptionally stupid things in equity markets. And then the question is, are we in a position to do something about that when that happens?"*

Warren Buffett, Berkshire Hathaway shareholder meeting, 2021[100]

6. The Buffettian portfolio design: realism with regard to macro allocations

6.1. The complexity of the macro system breaches the "simple and understandable" Buffettian rule

The Buffettian portfolio design also contends that investor must be realistic with regard to the low forecast accuracy and therefore low attractiveness of most macro allocations such as government bonds, commodities and currencies. The complexity of the macro, its sheer volume of variables, as well as instances of self-reinforcing feedback loops within the macro, all result in the critical facts not being known robustly, and as such breach the "simple and understandable" rule demanded by the Buffettian approach. Macro variables can also be subject to prospectively dramatic change in the future, disallowing in most cases the long term static and cost efficient positioning that the Buffettian approach also advocates for.

> *"A macro-based commitment never has anything close to 100% probability of being successful. Charlie and I do not really discuss sectors much nor do we let the macro environment enter our decision."*
>
> *"We are not two fellows who think we can predict the price of soybeans or corn or oil or anything else."*

Warren Buffett, Berkshire Hathaway shareholder letter 1997, 2017[118], shareholder meeting, 2016[119]

Buffett further argues that allocation to the macro is not just time wastage, but that its in most cases low accuracy conclusions can also disadvantageously discourage otherwise attractive security selections of great businesses, and as such a macro focus can add a further disadvantage.

> *"Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed it is dangerous because it may blue your vision of the facts that are truly important."*

Warren Buffett, Berkshire Hathaway shareholder letter 2013[120]

6.2. However, macro opportunities can meet some Buffettian criteria and the asymmetry of rare opportunities within the macro can partially substitute for a lack of information resolution

Whilst the complexity of the macro breaches the "simple and understandable" rule in terms of information resolution, macro opportunities can still meet other of the Buffettian requirements.

Activity by promotional agents still influences macro security prices, and gambling and herd like mentalities are present in macro markets as well. Furthermore, a value assessment based on long-term participation in cash receipts relative to initial cash outlay can apply to some macro opportunities, and additionally a wide search can be used to identify opportunities particularly where herd behaviour by market participants and/or gambling has been unintelligent.

Macro constructs can also offer high levels of asymmetry, and as such, the requirement for the facts and reasoning of the situation to be right is lowered, because the cost of being wrong – at maximum asymmetry – is also low. As such, macro constructs can, on rare occasions, have a level of compatibility with the Buffettian principles so long as the allocator substitutes information resolution with asymmetry.

It is in rapidly changing macro conditions, particularly in relation to variables whose attributes may not be subject to market efficient pricing, that PSH has engaged in asymmetrical macro allocations. As Bill Ackman points out in the quote below, the driving variable relating to the highly profitable purchase of credit spreads undertaken by PSH coincident with the early stage of covid developments in 2020 was primarily driven by the asymmetry of the pricing of these spreads.

> *"We were thinking about hedging this [covid] risk, and credit spreads were extremely tight. And we thought it was an interesting asymmetric that even without a virus risk, just the theory that how much tighter could credit spreads get, if you looked at the credit spread indices, they were actually tighter than all-time tights, once you took out a few credits that were substantially wider than the rest of the credits in the indices."*

Bill Ackman, Pershing Square Q1 2020 earnings call transcript[121]

6.3. Both Berkshire Hathaway and Pershing Square Holdings have only rarely made macro allocations, however, the last macro allocation by Berkshire Hathaway was almost 20 years ago, whereas Pershing Square Holdings has continued to allocate to macro opportunities more recently

Whilst the Buffettian principles include the 2013 comment by Buffett that "*forming macro opinions or listening to the macro or market predictions of others is a waste of time,*" BH itself – similar to PSH – has on rare occasions, made scaled macro allocations, and suggesting a further similarity between the BH and PSH approaches.

As per Figure 19, in 1997 BH purchased $4.6bn of long duration US zero-coupon treasuries, a bet that interest rates would fall and representing 10% of the BH market capitalisation at the time. In 1998, BH purchased an oil futures position of 14 million barrels, worth $13bn, and representing 19% of its market capitalisation at the time. Also in 1998, BH purchased 130m ounces of silver, then representing 8% of its market capitalisation. And in 2004, BH held non-US dollar foreign exchange contracts worth $21.4bn, or 24% of its market capitalisation, and as such a bet that the US dollar would devalue.

As Bill Ackman notes, PSH has similarly also found macro opportunities only very rarely, with two identified in the 12 years to 2022, albeit PSH continues to guide that such rare macro allocations may remain a feature of deployments at PSH.

Figure 19: both Warren Buffett and Bill Ackman have made macro allocations, although only in the case of Pershing Square have they continued post 2005[123]

- **1998**: Berkshire Hathaway makes multiple macro allocations, buying silver, long-term zero-coupon treasuries, and oil

The Washington Post
Democracy Dies in Darkness

BUFFETT DISCLOSES BIG SILVER PURCHASES

4 Feb 1998

As silver prices soared to nine-year highs, legendary investor Warren Buffett disclosed today that his company has loaded up on nearly 130 million ounces of the precious metal since July.

In a surprise announcement released after commodities markets closed today, Buffett's Omaha-based investment company, Berkshire Hathaway Inc., said it has been buying silver in anticipation that its price would rise as demand outpaces supply.

THE WALL STREET JOURNAL.

Buffett Admits to Making A Big Bet on Zero-Coupons

By Gregory ZuckermanStaff Reporter of The Wall Street Journal
March 19, 1998 12:01 am ET

Save

Warren Buffett may be celebrating, but the party could be over for zero-coupon bonds.

In Berkshire Hathaway 's BRK.B -0.72% annual report, released over the weekend, Mr. Buffett finally acknowledged what has long been an open secret within the bond market: Over the summer, the Omaha, Neb.-based company made a big bet on long-term bonds. Berkshire Hathaway had a year-end position in long-term, zero-coupon Treasurys valued at a whopping $4.6 billion.

The New York Times

INVESTING IT: THE SUMMER SWOON -- THE MASTER INVESTOR; Is There a Bear on Mr. Buffett's Farm?

By Robert D. Hershey Jr.
Aug. 9, 1998

In recent years, Berkshire took a large position in oil futures, of which contracts for 14 million barrels remained at the end of 1997. And the company stunned the metals market last year by buying 111 million ounces of silver.

- **2004-2005**: Berkshire Hathaway bets on US dollar devaluation by scaling allocation to ex-US currencies

The New York Times

MARKET PLACE

In '05, Buffett Says He's Still Betting Against the Dollar

Share full article

By Floyd Norris
March 7, 2005

When the stock market was soaring in the late 1990's, Warren E. Buffett now says, he should have sold stocks rather than just complain that they were overvalued. Now Mr. Buffett, the billionaire investor, says he is acting on his view that the dollar is still headed down, even though it makes him nervous that so many agree with him.

The annual report showed that of the $3.5 billion in pretax gains on investments Berkshire realized in 2004, well over half came from betting against the dollar. That included $1.8 billion from foreign exchange contracts. A portion of the $730 million in profits on junk bonds came from foreign exchange profits as well. The bonds were purchased in 2001 and 2002, when such bonds traded at relatively high interest rates.

- **2005-2009**: Pershing Square buys credit default swaps on bond insurers
- **2020**: Pershing Square buys credit default swaps on corporate bonds
- **Late 2020 to current**: Pershing Square uses options on government bonds to bet on rising interest rates

Pershing Square's hedging strategy has generated substantial gains across multiple volatile market environments since the firm's inception

Risk Factor	Time Period	Hedging Instrument	Investment / Carrying Costs	Total Proceeds	Multiple of Capital Gross	Multiple of Capital Net[(4)]
Subprime Mortgage Crisis	2005 - 2009	CDS on Bond Insurers (Primarily MBIA)[(1)]	$64 million	$1.1 billion	17.5x	13.8x
COVID-19	2020	Index CDS on Investment Grade & High Yield Bonds[(2)]	$27 million	$2.6 billion	93.4x	77.8x
Rise in Interest Rates	Late 2020 - 2022	Out-of-the-money Interest Rate Swaptions[(3)]	$384 million	$2.7 billion	7.1x	6.7x

"We have only found macro investments that fit our requirements – namely a high degree of asymmetry and a high confidence level in the predicted outcome – to be episodically available.

While we have made large profits hedging the financial crisis in 2008, we made no material macro-related investments after the crisis until February 2020. While we have continued to identify interesting asymmetric macro investments over the past three years, there is no certainty that similar opportunities will present themselves."

Pershing Square Holdings Annual Report 2022[122]

7. The Buffettian portfolio design: a net long cash collecting machine that bets on America

7.1. The Buffettian portfolio construed as a net long equities, cash collecting machine

The Buffettian approach therefore overall dictates that the investor primarily focuses on holding a net long position from equity securities returning cash to their holders, and at the same time as achieving a low cost holding structure including by:

1) the refusal of handicapping long-term returns by imposing equity hedge costs given the unpredictability of near term market moves (with the lack of margin leverage further reducing the rationale for such hedging), and

2) the refusal of tolerating the trading costs associated with high portfolio turnover.

This design matches the portfolios disclosed by both BH and PSH, with Bill Ackman noting in the 2022 PSH annual report that a permanent retirement from equity short selling activities has been imposed.

> *"I don't believe anybody knows what the market is going to do tomorrow, next week, next month, next year. I always kept at least 80% of my net worth in equities. My favoured status was 100% – and still is."*

Warren Buffett, Berkshire Hathaway shareholder letters 2020, 2021[109]

> *"We have on a few rare occasions engaged in the "noisiest" form of activism, activist short selling. Importantly for our reputation as a supportive constructive owner, we have permanently retired from this line of work."*

Bill Ackman, Pershing Square Holdings annual report 2022[110]

7.2. The Buffettian portfolio also prioritises US market exposure above other markets

There is an additional stance however taken by Warren Buffett – and matched by Bill Ackman – that the optimal portfolio should be positioned to benefit from the American economic tailwind enduring over the long term.

> *"Just remember, the overriding question is how American business is going to do over your investing lifetime.*
>
> *I was convinced of this on World War II, I was convinced of it during the Cuban Missile Crisis, 9/11, the financial crisis, that nothing can basically stop America.*
>
> *If you bet on America, and sustain that position for decades, you're going to do far better than, in my view, owning Treasury securities or far better than following people who tell you what the farmer ["Mr Market"] is going to yell out next.*
>
> *This country really, really works. [And] I have yet to see a time when it made sense to make a long-term bet against America. I doubt very much that any reader of this letter will have a different experience in the future."*

Warren Buffett, Berkshire Hathaway shareholder meetings, 2018, 2019, 2020, 2022[111]

> *"The substantial majority of the Company's portfolio is typically allocated to 8 or 12 core holdings, usually listed large capitalisation North American companies."*

Bill Ackman, Pershing Square Interim Report 2021[112]

Buffett and Munger have given some context as to *why* the investor should bet on America. Their statements include that American citizens have a "*real advantage*", "*way higher than are indicated by the GDP figures*". Munger adds: "*capitalism is the golden goose that we all live in.*" Buffett thereon notes that American citizens "*like to make money, but they really like – they like to be inventive.*"

As such, the Buffettian argument is that the American advantage is capitalism, and second, the American advantage is its citizens. In terms of the first statement, it is not that capitalism is unique to America but it is true that capitalism at unmatched scale, and therefore unmatched efficiency, is unique to America. As such, Buffettian principles argue that *America has a unique position for corporates to both efficiently raise capital but also co-incident with allowing corporates to raise scaled capital.*

"Capitalism is the golden goose that we all live on."

"The GDP figures greatly underestimate the real advantage that our system has given its citizens. It under weighs a lot of huge achievements because they don't translate right into money in a way that the economists can handle.

The real achievements over the last centuries are way higher than are indicated by the GDP figures, and the GDP figures are good. The future isn't necessarily going to be quite as good as the past, but it doesn't have to be."

Charlie Munger, Berkshire Hathaway shareholder meeting, 2016, 2017[113]

"We find ways in this economy to employ more and more people, and we've got now more people employed than ever in the history of the country even in heavy industry, which means turning out the same number of goods with fewer people or turning out more goods with the same number. That's capitalism.

I don't think you need to worry about American ingenuity running out. I mean, you look at the people in all kinds of American businesses and they like to make money, but they really like – they like to be inventive. They like to do things. And this economy, it works. It will continue to work."

Warren Buffett, Berkshire Hathaway shareholder meeting, 2019[114]

Figure 20: the US significantly leads all countries by share of total world equity market value as of January 2023[115]

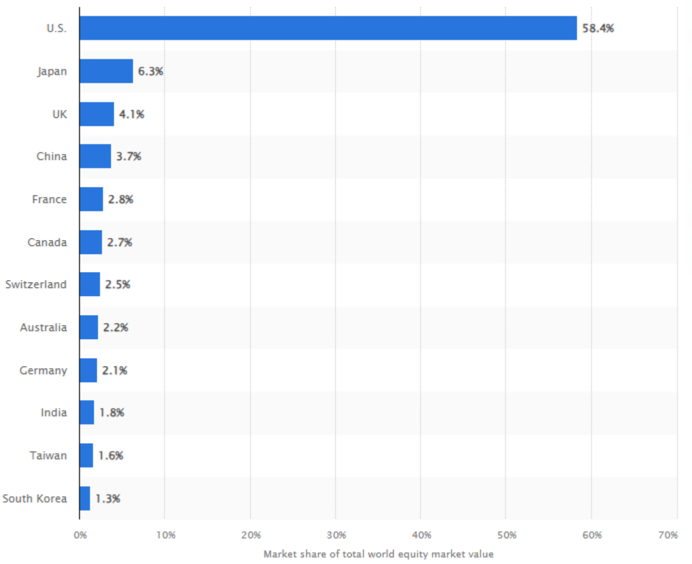


Figure 21: America's capitalism advantage contextualised as a *business* – capitalism per se may be a commodity – but America's capital markets offer corporates the only route to *both* efficiently raise capital and raise extremely large, scaled capital

"I have always been attracted to the low cost operator in any business and, when you can find a combination of (i) an extremely large business, (ii) a more or less homogenous product and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, then you have a really attractive investment situation."

Warren Buffett, discussing the business advantage of GEICO, 1976[116]

The second contention by Buffett and Munger is that the American advantage is also its citizens. Buffett's statement, "*I don't think you need to worry about American ingenuity running out*," is almost identical to the comment on the following page from Elon Musk "*I don't think we have to worry about some other country out there out-innovating us*" and it is perhaps simply an inevitable conclusion that is being made: outsize ingenuity is downstream from scale leadership in capitalism.

America's long-term status is also as a country that has both been reasonably open to immigration at the same time as embracing scaled capitalism. Therefore America can be theorised as having attracted, from around the world, innovative minds. Elon Musk, himself an immigrant from South Africa, has argued that America "*becomes somewhat of a self-fulfilling prophecy, in that, because the US was open to new ideas, it attracted people from around the world who liked new ideas, so now it is filled with people who like new ideas.*" Musk's observation is similar to Buffett's comments, "*you look at the people in all kinds of American businesses and they like to make money, but they really like – they like to be inventive.*"

> *I think the US is more open to new ideas than any country in the world, and it becomes somewhat of a self-fulfilling prophecy, in that, because the US was open to new ideas, it attracted people from around the world who liked new ideas, so now it is filled with people who like new ideas.*
>
> *And it's a country which tends to encourage success. Someone that did extremely well – generally the reaction in the US is good for that person, whereas in most countries people think oh that person did well because they try to rise beyond their station.*
>
> *I don't think we have to worry about some other country out there out-innovating us – almost all innovation in the world comes from the US, it's a ridiculous percentage. It's like the statement about democracy – it's a bad system but it's the least bad, well the US is the least bad at encouraging innovation.*
>
> *The US is a nation of explorers – people came here from other parts of the world by choosing to give up the known in favour of the unknown – the US is a distillation of the human spirit of exploration.*
>
> Elon Musk, public comments, 2021[117]

(white paper continues on next page)

8. Vehicle design considerations for the Buffettian approach: fees and incentives

8.1. Low ongoing management fee charges

Perhaps the most straightforward attribute that a long-term investor should seek in an investment vehicle following the Buffettian approach is low ongoing management fees. Whilst Buffett's own salary at $100,000 per annum[124] is low, BH does hire highly compensated managers for pools of its capital, including fund managers Todd Coombs and Ted Weschler, as well as those managers of its wholly owned business subsidiaries who will also have competitive compensation. As such, clearly BH has "management fees", albeit absent other information we would contend they are likely reasonable in line with Buffett's generally conservative approach.

In the case of PSH, a management fee of 1.5% of net assets is charged[125], modestly above the 0.5% to 1.0% management fee of most mutual funds[126], albeit still within the range of reasonableness given the superior track record of PSH to the vast majority of its peer group[127].

However, when the Buffettian approach is deployed by *listed* investment vehicles such as BH and PSH a further advantage, relative to mutual funds, can occur. To the extent the listed vehicle trades at an enduring discount to either its intrinsic value in the case of BH, or to its net asset value in the case of PSH, a consistent stock repurchase program can accrete returns to offset the amount that the ongoing management charges would otherwise deplete returns.

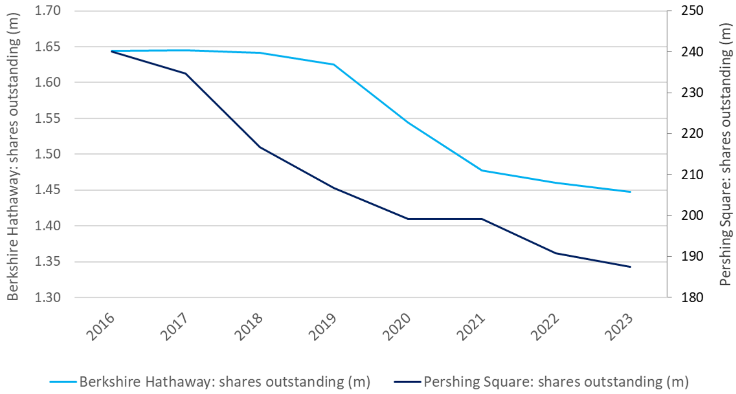
> *"We relish the opportunity to buy back shares at 30+% discounts to NAV – since we began our share repurchase program on May 1, 2017, we have acquired 59.8 million shares or 25% of our shares outstanding at an average price of $18.80 and discount of 28%, which has added 1.2% per annum to our annual NAV returns since inception of the program."*
>
> Pershing Square Holdings Annual Report 2022[128]

Over the last seven years, discounted share repurchases by PSH have had exactly this effect, adding 1.2% percent per annum to NAV returns and as such can be contextualised as reducing the annual management fee to just 30 basis points per annum.

BH has over this period also begun to repurchase shares, following historic comments by Warren Buffett that earnings will be reaching in the current period a level that will not allow management to otherwise intelligently reinvest all of the company's earnings. Buffett added that so long as Berkshire shares are welling sell below intrinsic value, "*massive repurchases will almost certainly be the best choice*". As per Figure 22, BH has commenced this path over the last 7 years purchasing 12% of its shares, and suggesting that in Buffett's appraisal its valuation has also met the test of selling well below intrinsic value.

> *"Eventually, probably between ten and twenty years from now – Berkshire's earnings and capital resources will reach a level that will not allow management to intelligently reinvest all of the company's earnings. If Berkshire shares are selling well below intrinsic value, massive repurchases will almost certainly be the best choice. You can be comfortable that your directors will make the right decision."*
>
> Warren Buffett, Berkshire Hathaway shareholder letter 2014[129]

Figure 22: Over the last 7 years, Berkshire Hathaway has repurchased 12% of its shares, and Pershing Square Holdings has repurchased 25% of its shares[130]



A listed Buffettian corporate entity can therefore consistently reduce its net annual management charges so long as its shares trade at a good discount to value on an enduring basis and this is combined with a consistent share buyback programme.

As such the listed Buffettian vehicle is optimised when an oddity in its design raises the probability of undervaluation and the consequent ability to make enduring share repurchases at a discounted valuation.

In the case of PSH, the fund structure is straightforward and therefore it is not clear that its equity security will enjoy such a large discount to NAV over future periods. As such, the prospective accretion from share buybacks at PSH may decrease. Furthermore, Bill Ackman's statement revealing an intent to seek a US listing for PSH[131], specifically to reduce the discount to NAV, would appear to prospectively handicap the use of share buybacks as a future tool to accrete PSH's performance further. Considered as a variable in isolation, it is notable that this would also handicap Ackman's longer term ambition, as detailed on the front page of this white paper, to achieve a superior long term record than Warren Buffett.

> *"We have not given up on addressing the wide discount at which our shares trade. We are continuing to consider potential transformational transactions that would enable PSH to become part of a U.S. listed company."*
>
> Pershing Square Holdings Annual Report 2022[132]

In contrast to PSH, there is arguably clearer logic as to why BH may trade at a discounted value on an enduring basis. The company is a conglomerate, and as such, may suffer on an enduring basis from the so called "conglomerate discount" – a perception by market participants that a diversified collection of businesses is less attractive than pure play alternatives.

Secondly, an accounting quirk means that the profits reported by BH only include the dividends from its vast stock portfolio, rather than BH's share of the earnings of its holdings[133]. Assuming most market participants use PE ratios to value BH and at no more than the market average multiple, a long-term undervaluation of BH equity is a consequence, and therefore, long term above average accretion from share buybacks.

As at the date of this white paper, the stock portfolio of BH is valued at $352bn and it has look-through earnings of $16bn, relative to its dividend payout of $5.7bn[134]. As such, the earnings of BH are currently under reported by approximately $10bn. For FY2024, the consensus estimates for BH earnings is $38bn, implying valuation of 20x PE[135]. Adjusting for the look through earnings of BH's stock portfolio, its look through PE ratio cheapens to 15.8x. By comparison, the S&P500 trades at a PE ratio of 19x[136].

8.2. An optimised performance-incentive fee design

> *"The basic rule of incentives is that you get what you reward for."*
>
> Charlie Munger, Berkshire Hathaway annual meeting 2020[137]

> *"When I ran a partnership in the 1960s, I took a quarter of the profit over 6 percent a year. And I didn't get paid any salary, but I could make a lot of money doing that. And that thought occurred to me as I ran the place from day to day, and I think it probably helped a little. (Laughter)*
>
> *So I don't think it's a terrible thing to have somebody get paid for making money for the shareholders."*
>
> Warren Buffett, Berkshire Hathaway annual meeting 1997[138]

As per their quotes above, Buffett and Munger contend that reasonably structured performance-incentive fees can influence investment results so long as combined with a Buffettian approach. The assertion can be viewed in line with the contention from the Buffettian principles that an industrious approach to work, both in terms of new opportunity search and deep dive research, also accretes results, and as such an incentive system should be designed to reward such work.

BH is unusual in that Buffett is remunerated with a salary of just $100,000 per year, which, combined with the absence of dividend and the trajectory of gifting of his stock in BH to charity, results in his salary being his sole income from BH. However, BH does make performance-related payments to the managers of its subsidiaries, and as such the contention that BH is free of performance fees would be too simplistic. By contrast, PSH charges a performance fee of 16% [139].

> *"We pay Tod Combs and Ted Weschler a salary of a million dollars a year, and we give them 10 percent of the amount by which their portfolios beat the S&P500. We do it on a three-year rolling basis so you don't get the seesaw effect. And each one gets paid 80% based on their own efforts and 20% based on the other person's, so that they have every incentive to operate in a collaborative way. It's the same structure on pay that we had with Lou Simpson for 20-some years, except he did not have a partner."*
>
> Warren Buffett, Berkshire Hathaway annual meeting 2012[140]

However, the tax free aspect of the structure at PSH appears to provide for a higher efficiency than BH, even including the PSH performance fees. BH pays capital gains tax on the crystalised performance from its stock portfolio to the US government at a 21% rate[141]. Reductively therefore, it can be argued that BH has a 5% higher "performance fee" (i.e. 21% less 16%) than PSH with regard to its stock investments, and yet the structure of PSH has preferable incentivisation given the fee is paid to the manager in comparison to BH where the fee is paid to the US government.

> *"If we just owned stocks, our performance would be significantly worse than the S&P because we would be incurring a corporate tax, which would now be 21% on capital gains, plus possible some state income taxes.*
>
> *And this problem would be intensified if corporate tax rates were to rise. This is a structural disadvantage we simply have to live with; there is no antidote for it."*
>
> Warren Buffett, Berkshire Hathaway shareholder meetings, 1992, 2019[142]

8.3. Manager is fully invested in the product

Whilst performance-based incentives align a manager with the upside delivered to shareholders, it is only when this is combined by the manager's by full economic participation in the investment vehicle that the manager's downside expense is made close to that of their upside.

In this regard it is notable that it has been the consistent policy of Warren Buffett for more than 60 years to have his entire net worth invested in, first, the Buffett Partnership, and thereon, in BH.

> *"My wife, children and I have virtually our entire net worth invested in the partnership."*

Warren Buffett, Buffett Partnership letter 1960[143]

> *"I did have all money in after 1962, so the downside would equal the upside."*

Warren Buffett, Berkshire Hathaway shareholder meeting, 2003[58]

> *"The five foundations have received Berkshire B shares that had a value when received of about $50 billion, substantially more than my entire net worth in 2006," Buffett said, referring to the year he first made the pledge. "My remaining A shares are worth about $112 billion, well over 99% of my net worth."*

Warren Buffett, commenting on the continuation of his charitable giving pledge, 2022[144]

With regard to PSH, it is disclosed that Bill Ackman and affiliates own 26% of the common stock of PSH, representing a commitment valued at $1.7bn as at the date of this white paper. Bill Ackman's statement is that he is "well-aligned", however, the exact proportion of his total wealth that this alignment represents is less clear.

> *"PSH now represents 87% of our assets under management, 26% of which is owned by affiliates of the investment manager. Our private funds, which comprise 13% of our assets under management, also have highly stable capital as affiliates of the investment manager comprise 40% of their capital.*
>
> *With more than $3.2bn of equity capital invested alongside our shareholders and other investors, we are well-aligned and highly incentivised to generate high long-term rates of return while carefully managing the risk of a permanent loss of capital."*

Pershing Square Holdings Annual Report 2022[145]

9. Vehicle design considerations for the Buffettian approach: maximising the pool size from which opportunities that can be captured

9.1. The vehicle design should not restrict the opportunity set

Warren Buffett refers to his search process and the capital deployment competency of BH as "two-pronged", that is, minority stake buying in businesses (listed shares) and outright purchases of businesses.

> *"Our two-pronged approach to huge scale capital allocation is rare in corporate America and, at times, gives us an important advantage."*
>
> Warren Buffett, Berkshire Hathaway shareholder letter 2018[146]

On a trailing basis this advantage has not been matched by PSH in that Bill Ackman has stated that PSH will not buy 100% of an operating business, although he has indicated that PSH would consider retaining an interest acquired in a listed security that was subsequently taken private.

> *"Can Pershing Square buy operating businesses outright? I think the question really is, will we own 100% of an operating business? We won't buy 100% of an operating business.*
>
> *We do have the ability to retain an interest of the business that's taken private.."*
>
> Bill Ackman, Pershing Square Q3 2019 conference call[147]

However, Pershing Square has developed an expertise in the use of Special Purpose Acquisition Corporations or "SPACs". In 2011, Pershing Square Funds invested $458m in the Justice Holdings SPAC[148]. Then, in 2012, Justice Holdings negotiated a merger transaction with Burger King. By 2017, Pershing Square's shareholding was worth $2.1bn, a 4.6x return[149] . More recently, in July 2021, PSH, in a private-to-public transaction negotiated at €18.58 per share an investment of 10% in the equity of the then privately held Universal Music Group "UMG"[150], initially targeting deployment from a Pershing Square SPAC, named Tontine[151]. Today, UMG equity is listed and priced at €24.30, a 31% uplift in valuation[152]. UMG remains the largest holding of PSH at 25% of NAV, as per Figure 14.

In September 2023, Pershing Square Holdings achieved SEC clearance for an innovation to the traditional SPAC design, named Special Purpose Acquisition Rights or "SPAR"[153]. The SPAR structure differs from the SPAC structure in that its capital is sourced, after announcing a transaction, by offering SPAR holders participation through an "opt-in" election rather than the SPAC's process of raising capital upfront, and then, upon announcing a transaction, allowing holders to "opt-out".

By the use a of variable strike for the subscription amount, SPAR can within reason target any deal size, and as such, addresses the deal size rigidity handicap that is a property of SPACs. The SPAR also provides a path for Pershing Square Holdings to target successive private-to-public company transactions, albeit each time by merging them with a listed trust in which Pershing Square participates, rather than acquiring privately held companies outright.

The SPAR offers PSH an important advantage above that achieved by BH in the past. Pershing Square can vary its proportionate participation in each transaction: in other words PSH can invest 20% of its NAV in a deal whether it is $10bn or $100bn, by correspondingly varying the total percentage of the transaction that PSH funds represents[154]. By comparison, BH could not consider large deals in its earlier years, and in its current years smaller deals would not make a meaningful impact to the much larger scale of BH.

There are only 40 listed companies with a market capitalisation at 20% or above of that of BH, and therefore whilst BH can afford to buy almost any business, only a handful of businesses remain large enough to allow for a significant accretion of BH's returns. By comparison, by varying the strike on the SPAR, PSH can achieve economic participation in the purchase of any business (within reason), and yet all transactions that allow a $2bn participation for PSH (20% of NAV) would be significant in terms of the impact on the returns of PSH.

> *"One advantage we have versus Berkshire Hathaway is just relative scale. Berkshire has the problem, if you will, of deploying $130bn of capital or some fraction of that number which is still a very large number, relative to the liquidity available in buying one equity at a time.*
>
> *Whereas, by virtue of our much, much smaller size, today, we have $10bn of capital to invest, we can be much more nimble."*
>
> Bill Ackman, Pershing Square Holdings Q1 2020 earnings call[155]

9.2. Allocator indifference to whether a business retains, or distributes, surplus cashflow

The SPAR structure however does not allow PSH a control shareholding in an outright business purchase unless the transaction value is below $7bn, at which the maximum disclosed $3.5bn contribution by PSH and affiliates would be 51%.

This does commensurately leave BH with an advantage in structure over PSH, which is a greater dollar volume of potential business purchase candidates exist for control shareholdings. Control shareholdings allow the allocator to direct the cashflow distribution decision at the business in question, and therefore if the business does not have opportunities to redeploy its capital, it can still be a highly successful allocation for the control investor.

By comparison, for a non-control investment, if the business does not have opportunities to redeploy its capital and yet management elects not to redistribute surplus capital to shareholders, a hoarding mentality which is not uncommon to observe, the capital can remain locked in a non-productive way at the level of the business. As Buffett notes, that there are very few business that can redeploy all of the capital that they generate at their underlying rate of return on equity, and as such a lack of control on redistribution can be a handicap from the perspective of the investor.

> *"The ideal business is one that earns very high returns on capital and can keep using lots of capital at those returns. If you could put $100m into a business that earns 20%, on that capital, say $20m – ideally it would be able to earn 20% on $120m the following year, and 20% on $144m the following year and so on. You could keep redeploying capital at these same returns. But there are very very very few businesses like that.*
>
> *"So we would love the business that could keep deploying, if fact even well beyond the earnings, I mean we would love to have a business that could earn 20% on $100m now, and if we put a $1bn more it in, it would earn 20% more on that $1bn. But like I say, those businesses are so rare, there are a lot of promises on those businesses, but we've practically never seen one."*
>
> Warren Buffett Berkshire Hathaway shareholder meeting, 2003[156]

10. Conclusion

10.1. Functional comparison between Pershing Square Holdings and Berkshire Hathaway

In conclusion, as per Figure 23 on the following page, there are some modest differences in the deployment of the Buffettian approach of BH and PSH, and some larger differences in the opportunity set and operating structure of each entity.

The differences primarily favouring PSH relate to its smaller scale increasing the number of prospective allocation opportunities, and the SPAR competency of PSH now allowing similar advantage in relation to private-to-public transactions. The net rate of shareholder profit retention due to tax and performance fee differences is modestly also in favour of PSH.

By comparison, BH has a lower cost of leverage from the use of insurance float, and as well as arguably the strongest adaptation of the Buffettian principles in terms of allocating to new opportunities. Finally, whilst BH has a low volume of opportunities to choose from, there may be a far lower level of competition (or none) for each super-scaled deal, whereas at the smaller deal sizes likely targeted by PSH, higher levels of competition may remain.

> *"I worry more about the things I do than the things I don't do – I have missed all kinds of opportunities, but that's... you just want to make sure that you are on the side of the house when you bet rather than betting against the house.."*
>
> Warren Buffett, CNBC interview, 2019[157]

As Buffett notes, the contentions of the Buffettian approach can be simplified to being on the side of the house, used as colloquialism for casino, rather than against. The casino business model increases wealth collecting cash coupons by the maintenance of its static position and right to commission, and these coupons are collected by the casino over-promoting the odds of success to the casino's customer base, which correspondingly loses wealth by a naïve maintenance of disadvantageous levels of activity through the repeated payment of commission to engage in player-versus-player contests.

Whilst BH aims for its allocations to remain on the *side of the house*, it is notable that PSH has historically appeared more willing *to act as the house*, conducting corporate engagement combined with extensive public-facing presentations which inevitably results in some promotional outcomes in relation to the equities targeted.

Adding to its promoter competency, the recent launch of the SPAR by PSH now allows the company to achieve a role similar to an investment bank conducting an IPO, that is, in an additional promoter role facilitating the listing process onto the public markets of a previously private company in return for fees (in PSH's case, warrants based on valuation achieved).

Finally, PSH appears to have a superior one-off opportunity to pursue a more transformational transaction in terms of the valuation implications for PSH, than does BH.

As per page 33 of this white paper, PSH has stated in its 2022 annual report "*we are continuing to consider potential transformational transactions that would enable PSH to become part of a U.S. listed company.*"

Whilst the type of transaction under consideration is not disclosed it is notable that BH possesses an investment portfolio comparable to PSH (in terms of stock selection rather than scale), combined with insurance operations and a number of businesses owned outright, and is valued by the market at 1.3x book value. This compares to PSH, which is currently solely an investment portfolio, trading at 0.63x book value. As such, PSH may have the potential to design a transaction with valuation uplift implications that do not appear to be matched by the type of transaction that would be available to BH.

Figure 23: Pershing Square Holdings' advantages over Berkshire Hathaway – larger capital allocation universe of targets, a promotion competency increases effectiveness in "sell high" outcomes and a moderately higher shareholder capture of profits. By comparison the Berkshire Hathaway advantages may remain as greater dedication to the Buffettian ruleset for capital allocation, combined with a lower financing rate from its gearing (insurance float) competency

	Pershing Square Holdings (Amsterdam-listed investment trust)	**Pershing Square Holdings** (Amsterdam-listed investment trust, with SPAR acquisition competency)	**Berkshire Hathaway** (US-listed corporation)
SIZE OF CAPITAL ALLOCATION UNIVERSE			
Listed domain			
Percent of S&P500 companies in which 20% of capital could be deployed (assume limit is 49% stake)	• **98%**	• **98%**	• **5%**
Private domain			
Minimum investment at 10% of assets	• **N/A**	• **$2bn** • assume 49% stake	• **$75bn** • assume 100% stake
Maximum investment at 25% of assets	• **N/A**	• **unlimited** • within reason – • $1 trillion would be $8,200 strike per SPAR stock unit	• **$190bn** • assume 100% stake
BUY LOW, SELL HIGH, COMPETENCY			
BUY LOW: Buffettian approach to value at business purchase	• **Attractive**	• **Attractive**	• **Best in class**
SELL HIGH: Promoter competency in advocating full pricing case for security in question	• **Moderate**	• **High**	• **Will not engage**
Non-margined gearing and financing rate	• **Gearing: 22%** • **Financing rate: 8%**	• **Gearing: 22%** • **Financing rate: 8%**	• **Gearing: 21%** • **Financing rate: 3%**
SHAREHOLDER CAPTURE OF PROFITS			
Tax on profits	• 0%	• 0%	• 21%
Performance fee on profits	• 16%	• 16%	• 0%
Shareholder profit capture	• **84%**	• **84%**	• **79%**

10.2. Pershing Square Holdings is also observed as a forward thinking innovator, uniquely combining the intelligence of the Buffettian approach with the recent launch of the SPAR, enhancing its future opportunity set with regard to privately held company transactions

More generally, because BH is now a relatively mature company, the success of PSH in matching or exceeding the long-term returns that BH has delivered also relies on the Buffettian approach that is also used by PSH continuing to deliver accretive returns far into the future.

In this context we would argue that the future success of the Buffettian approach – still in our appraisal rarely seen operated with as much skill as by either BH or PSH – rests on the correctness on an enduring basis of the input assumptions in section 1.1 of this white paper. However, we also note that these assumptions do stand up to both the evidence and reasoning investigations detailed in section 2.

Nevertheless, a challenge with the Buffettian approach can be that its focus on simple and understandable businesses does potentially lead an investor to fall into a "backward looking" mindset, both with regard to not taking the time to develop a sophisticated understanding of more modern business models (because they are more frequently subject to promotion), as well as potentially not optimising the corporate structure of their investment vehicle with designs that have benefitted from truly innovative thinking. As such, when the Buffettian approach is used combined with an absence by its practitioner continuing to determinedly embrace new learning, and related action, there can be the potential risk of suboptimal outcomes.

> *"Buffett's first priority is the reservation of much time for quiet reading and thinking, particularly that which might advance his determined learning, no matter how old he became."*
>
> Charlie Munger, Berkshire Hathaway shareholder letter 2014[158]

> *"Keep learning. That's the secret. Keep learning."*
>
> Charlie Munger, Berkshire Hathaway shareholder meeting, 2022[160]

As such, a final principle of the Buffettian approach, and therefore for PSH with regard to its longer term trajectory, will be the requirement to continue with its path of determined learning and consequent action including both with regard to capital allocations and the corporate structure of the investment vehicle itself.

Our observation is that PSH continues to evidence this ability well, and we would particularly note the SPAR design as an example of a not only a recent strong innovation, but one that now ensures PSH should always be able to act when pricing events create an opening for productive for capital allocation regardless as to whether the opportunity is present on either the listed or the private markets.

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