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Macro Memo
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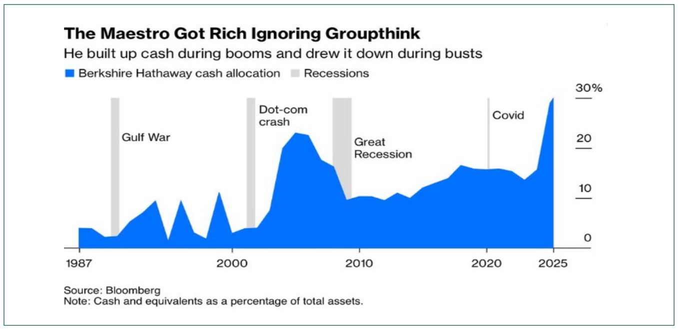
One More Lesson from the Oracle

On May 3 Warren Buffett shocked shareholders of Berkshire Hathaway by announcing his intention to step down as Chief Executive Officer at the end of this year. Buffett's success as an investor is legendary and has earned him the moniker, The Oracle of Omaha. A $100 investment in Berkshire Hathaway at the beginning of Buffett's tenure in 1965 is now worth over $5,500,000. That same $100 in the S&P 500 has grown to $390,540.[1] Buffett's strategy compounded annually at an average of 19.9% vs. 10.4% for the S&P.

Given Buffett's outstanding success over his career as a stock investor, the fact that he is now holding a greater percentage of cash in his portfolio than at any other time during his career is noteworthy. At year-end 2024, Buffett's cash holdings amounted to nearly 30% of his portfolio value.[2] What is even more telling is how he chooses to hold his cash position.

A previous time Berkshire Hathaway held an elevated percentage of cash was during the internet craze of the late 1990s. At that time Buffett chose to hold his cash in long-term zero-coupon Treasury bonds.[3] This was essentially a leveraged bet on the direction of interest rates. Buffett was right on the direction of rates and made a substantial profit on the investment, far outperforming the money market rates at that time while he patiently waited for longer-term opportunities in the stock market to develop. Buffett also raised a substantial percentage of cash in Berkshire's portfolio ahead of the Global Financial Crisis of 2008, giving him plenty of dry powder for future opportunities.



This time around, Buffett seems far less bullish on interest rates as Berkshire is now one of the largest Treasury bill holders in the world, owning over 5% of the entire T-bill market. This is also a bet on the direction of interest rates, but not a bullish one. T-bills offer the shortest duration of all Treasury securities and therefore suggest Buffett is not at all confident about the stability of interest rates in the near term. He specifically addressed his concerns during the shareholder meeting, commenting that annual Federal fiscal deficits of 7% are unsustainable and inflationary. He believes that number needs to be less than 4% for stable prices.

Buffett's concerns have merit. The newly created Department of Government Efficiency (D.O.G.E.) has yet to find the $1 trillion in budget cuts necessary to get deficits to that level. Further, many of the cuts identified and recommended by D.O.G.E. are delayed by court challenges. This increases the likelihood deficits will remain at inflationary levels.

Inflation is kryptonite to financial assets. Stocks and bonds both are claims on future cash flows. However, higher inflation makes the purchasing power of those future cash flows less valuable.[4] As a result, the valuations of financial assets drop. A common metric of a stock's value is its price-to-earnings ratio (P/E). It represents the earnings multiple an investor is willing to pay for the stock. When the future purchasing power of those earnings drops, investors typically reduce the multiple they are willing to pay for those earnings. Currently, P/E ratios are at historically high levels relative to the long-term median of 16.[5]

Shiller PE Ratio

In addition to pressure on earnings multiples investors are willing to pay for stocks, the earnings themselves are also facing headwinds via deglobalization. While globalization (circa 1980-2020) increased the revenues of multinational corporations by giving them new markets into which they could sell their products, it also decreased costs by providing cheaper sources of labor. Deglobalization is the inverse operation of that equation. Companies who've enjoyed a broader global market in which to sell their goods and services may see an impact on their top-line revenues and bottom-line profits as global trade rebalances. Current nationalist movements suggest this trade-off is worthwhile to secure critical supply lines. Regardless of the political sentiments, the economic realities will lead to lower earnings growth, or lower earnings all together. Combined with contracting multiples, these factors could lead to stock prices returning to their long-term averages.[6]

This brings us back to the notion of "one more lesson from the Oracle." Buffett is credited with his "waiting for a fat pitch" approach to value investing. It's an approach he's compared to the great baseball player, Ted Williams, and Ted's approach to hitting. Williams knew the strike zone well and would wait for his pitch. Buffett knows the "wait for the fat pitch" approach doesn't guarantee an investment home run, but he does believe it increases the chance for success, and it dramatically reduces his odds of striking out.

In addition to being an extraordinary picker of stocks, Buffett has demonstrated great prudence as a capital allocator. This simply means he has a knack for being in the right investments at the right time. While Buffett has been raising cash as a net-seller of stocks for the last 10 calendar quarters, one area where he continues to hold, and add to, substantial positions is energy. Hard assets, like energy, tend to hold their value during both inflationary and stagflationary times. Perhaps the Oracle is teaching a lesson well worth learning—maybe it's time to favor hard assets over typical financial assets and have some dry powder in reserve for when that "fat pitch" eventually comes our way.

As always, if you would like to discuss these ideas in more detail, I would welcome the conversation.

1 *https://www.statista.com/chart/34413/how-berkshire-hathaway-out performed-the-market-over-60-years/*

2 *https://www.investmentnews.com/rias/berkshire-hathaway-is-piling-cash-advisors-say-thats-not-such-a-bad-thing/259523#:~:text=The %20report%20 also%20revealed%20that,the%20investment%20company's%20total%20assets.*

3 *https://www.wsj.com/articles/SB890230215616525000*

4 *They will buy fewer things when the holder of the stock or bond receives them.*

5 *https://www.multpl.com/shiller-pe*

6 *An instance of classic mean-reversion*

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DAN CAIRNS,
CFP®, CIMA®, CPWA®, RICP®
Senior Vice President, Financial Advisor
(916) 581-7549
dcairns@dadco.com | cairnswealthmanagement.com

2901 Douglas Blvd., Suite 255 | Roseville, California 95661
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