HOW MUCH MONEY WOULD WARREN BUFFETT HAVE IF HE HAD PAID TAX ON UNREALISED GAINS

The US presidential election is just around the corner. During the election campaign, one of the presidential candidates raised the idea of taxing unrealised capital gains of wealthy people with assets exceeding USD 100 million. Today, taxes are normally paid on realised capital gains. This means that tax liability arises only upon the sale of assets. A tax on unrealised gains would mean that even without selling anything a person could still be liable to taxation. One would simply compare how much assets had grown in value during the year and tax that difference. The plan, as proposed, is for a tax rate of 25%. Let us look at a simple example of what the impact would have been on Warren Buffett's wealth if he had paid such a tax on unrealised gains all his life. Buffett is a relatively easy case to quantify. He has held almost all of his wealth for most of his life in shares of Berkshire Hathaway. Although he does not buy and sell them personally, the shares are publicly traded and so their price is always known.

Here are the starting assumptions:

1. Warren Buffett once wrote in a text entitled "Berkshire – Past, Present and Future" that he held 392,633 shares in April 1965 when he took the helm of Berkshire Hathaway.
2. Buffett has not traded Berkshire stock during his lifetime and, had he not given some of it away to charity in the past two decades, he would very likely still hold all of it today.
3. Beginning in 1965, we will compare for each year the price of Berkshire stock at the end of the year to the price a year earlier. If the price is higher, we will calculate the unrealised capital gain. Of this, 25% will represent tax liability. Buffett will therefore have to sell enough shares each year so that, even after paying tax on the realised gain (also at 25%), he would have just enough cash to pay the tax on the unrealised gain.
4. If Berkshire's share price should fall in any given year, the tax liability would be zero and only start to arise when the share price would exceed the original taxed maximum (the high-water mark principle).

So, what will be the outcome? Had Warren Buffett not paid tax on his unrealised gains, that is, had the current tax regime remained in place, his 392,633 Berkshire shares would be worth USD 271 billion today. If he had been required to pay tax on unrealised gains since 1965, he would own just 22,648 shares today, worth a total of USD 15.6 billion after the forced share sales. The tax on unrealised gains would have deprived him of nearly 95% of his wealth, and that without selling a single share voluntarily for his own benefit. How much would the government have gained in taxes? Only USD 5.7 billion. Instead of the USD 271 billion in wealth created, all of which Buffett has given or intends to give to charity, only USD 15.6 billion would have been generated for charitable purposes and USD 5.7 billion in revenue for the state. About USD 250 billion of wealth would simply not have been created at all due to this pay-as-you-go taxation.

Another question is whether Buffett would even be at the helm of Berkshire today at all.

Today, he holds a controlling stake that has allowed him to run Berkshire for 60 years and think for the long term without fear of losing his position. Berkshire shareholders have benefited immensely from this stability over the long term. Had Buffett needed to sell off a significant chunk of stock each year, however, he might have lost control sometime in the 1980s, and who knows what the company would look like today, what it would be worth, or whether it would even exist at all.

The more one ponders the idea of a tax on unrealised capital gains, the sillier it must seem. Imagine a situation where a wealthy person does not hold publicly traded stocks but owns a company that is not publicly traded. It has no market price. What does this mean? That once a year someone would officially establish its price? I cannot even begin to imagine that. I also cannot imagine how partial divestitures of assets would occur in private companies for which there is no liquid market and that are often tied to the person who is the owner and/or founder. Would he or she in most cases be forced to sell? What should people do who are rich (at least on paper) but have almost no cash? What to do with undivided and illiquid ownership interests in land or property? What motivation should people have to embark on building large companies if they know from the start that if they fail, they will have nothing, and if they succeed the state will take almost everything away from them? What would happen in situations where the prices and values of wealthy people's assets would fall? Would the state give them back the tax they had paid earlier? How would investment and business be affected in an environment where it would be virtually impossible to accumulate large amounts of capital? It is just a silly idea, the application of which would, in the aggregate, be a major negative for human society. Therefore, I think that this will be quickly forgotten after the elections and will never come to pass. (Nevertheless, I would certainly not underestimate the ability of politicians to make irrational and populist decisions with altogether very negative consequences.)

So why am I writing about this if I believe it is just inconsequential posturing ahead of the election in an attempt to please a segment of the electorate? I am writing about it because I consider it to be the tip of an iceberg, a certain symptom of the times we live in today. In the spring of 2020, I wrote a letter to shareholders entitled "The Dam Has Broken". In it, I argued that we were living in those days through "a time of ideological revolution insofar as monetary and fiscal policies of the world's key countries are concerned. There are some things that one might perhaps have believed heretofore to be temporary but that will apparently become permanent aspects of the financial world while having great long-term impacts on the values of the main asset classes. Although for investors there is no escape, there nevertheless does exist a defence."

While the Chinese virus was raging, politicians in many countries lost their last inhibitions when it came to spending money, and just four years later we are seeing the consequences very clearly. We have experienced a period of very high inflation, albeit still with predominantly negative real interest rates, which has brought about a large real devaluation of savings. Budget deficits in various countries have grown to previously unimaginable proportions and, predictably so, no one is making any real attempt to remedy this. I have also written before that a return to

sensible and frugal management of public finances would require two things: politicians willing to take that risk and voters willing to vote for those politicians repeatedly. In the world around me today, I see neither of these.

I do not want to burden you with all sorts of economic statistics to back this up with numbers, so I will just cite a few anecdotal examples. Economic growth among the major global economic powers is slow. Neither the US, nor the EU, nor China, nor Japan can boast rapid GDP growth. What they can "boast" about, however, are gigantic and record budget deficits. By their very definition, budget deficits constitute a very powerful pro-growth economic stimulus, and, if even huge deficits were not enough to make economies grow faster, it is not good. The interest costs to states of servicing growing debts are climbing sharply. Indeed, higher interest rates have added even more to the rising debt levels. When one imagines that in the US the annual cost of debt has already exceeded USD 1 trillion, it is enough to make one's head spin. In a few years' time, even USD 1 trillion in interest costs will very likely seem like a small number in retrospect. Long-term budget projections call for another USD 20 trillion of debt over the next ten years. And these projections do not take into account a possible recession. Meanwhile, in the EU, former ECB chief Mario Draghi's report on EU competitiveness has been released. He proposes to address its long-term decline by even more devolution of powers to Brussels and even greater central borrowing. In other words, still more of what is at the heart of the problem. Nassim Nicholas Taleb commented in a tweet on 11 September that "It is similar to giving protein to people in nursing homes hoping they will grow a few additional inches."

Four years ago, I also wrote, "There are only three possibilities for settling sovereign debt. The first and best one is rapid economic growth. If an economy grows fast enough and is not burdened by a too-large debt, that debt may decrease as a percentage of GDP. For most of the big countries, however, this solution is outside the realm of reality. Their combination of slow growth and large debt practically excludes this, regardless of what politicians and central banks might say.

"The second way of reducing the debt is to cancel it. This is a very common way of resolving the issue, and countries having their own currencies will continue to use it. The latest big such case is the recent default by Argentina. This, however, is quite a drastic solution that is accompanied by great costs and difficulties and is politically unpopular.

"The third way to diminish the debt is to let inflation wipe it away or, generally speaking, to repay it in depreciated currency. History knows many such examples dating back to Ancient Rome. This is and will remain the preferred manner of resolving debts in most countries having their own currencies. This is nothing new, but the extent to which this solution is applied will probably accelerate."

The idea of introducing a tax on unrealised capital gains may not be put into practice, but we will almost certainly hear more and more similar half-mad proposals for new forms of taxation. Some politicians believe that low taxes are the root of the world's problems today, some don't believe it but nevertheless know the suggestion can win them votes, and some know that more taxes mean greater power in their hands. Raising taxes and introducing new taxes is very likely, but doing

so cannot provide a long-term solution. That lies on the spending side. However, no one is rushing to come up with a solution there, so, in the end, the path of letting debts erode over time through inflation and the declining value of money must prevail in any case. I have written more than once before that the best defence against this inevitable development is in productive property assets, and I do not want to repeat myself again.

Vltava Fund is an equity fund and so the question of choosing an underlying asset class is not something we need to address. Rather, it is a question for individual investors when deciding how to allocate their own investments. An issue that is starting to enter into our decision process in selecting individual stocks, however, relates to the existing and expected tax instability in individual countries. Indeed, this development will certainly not be everywhere the same. Various countries will approach tax measures differently both in form and over time. Capital, companies, and individuals will naturally react to this by shifting their activities. We already are seeing companies and individuals move their headquarters from California and New York to Texas and Florida. A wealth tax has forced some rich Norwegians to leave their country and move to a certain unnamed mountainous European country. The exodus of rich people is also facing the formerly popular UK. We are seeing European companies, under the weight of regulation, taxes, and high energy prices, shutting down their operations in EU countries or moving them elsewhere. Massive illegal migration, particularly to EU countries, and a changing demographic, cultural, and security environment, too, are increasingly impacting upon the decisions of some companies and individuals. All these changes and movements can create losers and winners. At the corporate level, the winners will be those companies that can best adapt to the changes, and among countries it will be those that can create or maintain the most favourable and competitive environments. It is very important that both tax and regulatory competition be maintained in the world. However, there will be great pressure to “level the playing field”, which is just another expression for tightening regulation and raising taxes.

From a macroeconomic point of view, things are also changing in the sense that a period of so-called fiscal dominance is coming or, better said, already is upon us. Budget deficits are so large that their impacts on the economy often outweighs impacts of central bank actions. The latter are becoming more and more within the grip of politicians’ decision-making, and their room for manoeuvre is narrowing. So, if we look at inflation as one of the greatest threats to investors and one of their main motivations for investing, then it is good to remember that inflation is much more influenced by fiscal policy than it used to be. That policy has been and probably will remain strongly inflationary in many countries. The paradox is that, while there is often talk of how irreconcilably divided is the political scene, no one is getting serious about tackling budget deficits and sovereign debt. A rare consensus favouring inaction reigns there.

Changes in the portfolio

Our portfolio had a surprisingly positive July and a surprisingly negative September. Overall, stocks saw big moves during the past quarter. The greatest volatility in the markets was in early August. At the centre of activity were

steps to reduce positions in the Japanese yen-backed "carry trade". Carry trades are operations in which an investor borrows in a currency with low interest rates, such as the Japanese yen, and reinvests the funds in higher-yielding assets elsewhere. Interest rates in the Japanese yen have been zero or slightly negative for a very long time. This has prompted many investors to borrow yen, exchange them for dollars, then use those funds to buy dollar-denominated assets. The falling yen exchange rate made it a financial "risk-free money machine" for a long time. Over the summer, however, there occurred a significant reassessment in expectations for interest rate developments in both Japan and the US, and the attractiveness of this carry trade deteriorated significantly. The reduction in positions brought a significant rise in the yen exchange rate and panic set in among some investors, who felt they were in a burning theatre full of people but with only one narrow exit. Equity markets saw one of history's largest one-day leaps upward in the volatility gauge. While the period of greatest volatility lasted only a few days, it allowed us to make some good trades.

At the time of the biggest drop, we significantly increased our position in Japan's Nikkei 225 index, which had fallen by 25% almost overnight. Three weeks later, we sold it more than 20% higher. We have retained our original investment in the Nikkei 225 and intend to hold it going forward. The big price moves allowed us profitably to sell the rest of our position in Humana shares and build a large new position in Brookfield Corporation (more on that below). We bought back at almost half the price part of the Stellantis position that we had sold in January. We significantly boosted our position in OSB Group at a very attractive price. Taking advantage of investor optimism about AI, which has carried upwards a number of stocks in various industries, we sold shares in KLA Corporation at a large profit. We later returned to them at a lower price. If the markets had not fluctuated at all over the past three months, we would not have been able to complete these transactions. Many, mostly academically grounded investors regard stock price volatility as a risk. We see it as an opportunity and define risk, as you well know, quite differently.

Our new position is in shares of Brookfield Corporation (BN). We have been indirect shareholders of BN for more than a decade through our investment in Markel Group. Its stock portfolio is managed by legendary investor Tom Gayner, and throughout that time BN has been one of the largest positions within it. For a time, it was even the largest position, replacing Markel's otherwise long-term largest investment in Berkshire Hathaway. We have been following and analysing BN for more than a decade and have seriously considered including it into the Vltava Fund portfolio on several occasions. It has always come down to our not being able to determine an intrinsic value for the stock in a way that we were satisfied with. That changed the year before last, when BN reorganised the structure of its business and its subsidiaries a bit and we were able to find a relatively simple but at the same time conservative way to value the shares.

BN's management regularly and over the long term publishes its own estimate of the company's value. Its latest estimate speaks of USD 84 per share. We find this number overly optimistic. We think management is assigning overly generous valuation multiples to the

various parts of BN. Our own value estimate is significantly lower, but at the same time still much higher than the price at which we started buying BN (USD 41.50). Nevertheless, we do agree with BN management on one point. Their estimate of long-term shareholder value growth of 15% per year is the same as our estimate.

What does BN do? BN is a leading global investment firm based in Canada and specialising in long-term management of its clients' assets. It has approximately USD 1 trillion under management and is one of just a handful of companies in the world that is able to raise USD 100 billion of new money from its clients annually. These numbers are awe-inspiring. Standing at the top of Brookfield's organisational structure is Brookfield Corporation. BN holds stakes in several additional subsidiaries. It holds 75% of Brookfield Asset Management, a company that manages client assets. It also has a 91% stake in Brookfield Reinsurance and 27% to 100% stakes in four large Brookfield exchange-traded funds. BN's income is derived from management fees, performance fees, ownership interests in subsidiaries, and from the proceeds of its own investments in situations where BN invests its own capital into various investment cases together with client capital. We consider BN to be one of the best companies in its industry and to have a very strong position in infrastructure investments. It is precisely this form of BN's investments that partly underpins our investment thesis.

Over the summer, we devoted a lot of time to studying the AI-related investment wave. This spans a wide range of sectors and our view could be very briefly summarised as follows: The first-tier beneficiaries are primarily companies in the semiconductor sector, NVIDIA perhaps the most. That company is benefiting from the huge increase in investment by large technology companies to build enormous data centres. We know who NVIDIA's customers are. They are companies like Meta, Alphabet, Amazon, and Microsoft. They are investing hundreds of billions of dollars into their AI capabilities. What is not entirely clear, however, is who are and will be the customers of NVIDIA's customers, and, more importantly, when, and if, they will be able to come up with such huge demand for AI services that the profits from AI will justify and pay for the enormous investments all these companies have been making. The further we move away from the starting point that NVIDIA represents in our more broadly-reaching estimates, the less reliable those estimates are. So far, we know just one thing for sure, and that is that investments in AI capabilities are ongoing and they are huge. They are not only bringing large demand to chipmakers and the semiconductor sector but to some other sectors as well. Indeed, building AI clusters also requires the construction of new semiconductor factories, new energy sources, and all the associated infrastructure. The numbers under consideration are incredibly high. It is possible that over the next decade the construction of AI centres will necessitate a 20% increase in US energy consumption. The investment required will be measured not in the hundreds of billions of dollars, but in an order of magnitude higher. Maybe two orders of magnitude.

BN has a lot of experience in financing these and similar infrastructure projects, and the AI boom represents huge potential for BN to grow further. BN is already investing in AI development and we expect the amount of

money it has invested here to multiply several-fold over time. Alongside our investment in KLA Corporation, BN is the second stock that will benefit significantly from the AI boom without having to take large unknown risks.

You probably have not missed the news that Warren Buffett has already sold half the stock from his largest public markets investment, Apple. It was a phenomenal investment for Berkshire. Over the course of seven years or so, it brought a profit of well over USD 100 billion. Apple comprised a very large position within Berkshire's public portfolio, and this was the reason we avoided Apple stock outright during that time. We considered our exposure to Apple through our holdings of Berkshire stock to be sufficient, and we ended up making a lot of money on it. There has been a great deal of speculation in the market about what Buffett's sale of Apple signals regarding his view of the stock market. I think the reason for the sale is much simpler. Buffett probably considers Apple stock so expensive that he prefers to cash in at 20% less (after all, Berkshire must pay tax on its profits). He started selling in the first quarter of the year. When I was in Omaha for the general meeting in May, Buffett said he was still selling, and I expect he continued to do so in the third quarter. I have to say that, as a Berkshire shareholder, I am happy about the Apple sale. I think Berkshire's management will find a better use for this money, as they always have in the past. It is quite likely that they already have a very specific idea about this. If that takes two or three years, it does not matter at all. This is not a race and, in the meantime, the risk of holding Berkshire Hathaway stock itself has been greatly reduced.

For the first time in a long time, the major stock markets now find themselves in a period when they will be operating within an environment of interest rate cuts. I myself am curious to see how quickly and for how long rates will be moving downwards. I do not dare to guess. Nonetheless, already today we are seeing one effect on investor behaviour. We have seen a greater shift of money from bank deposits into equities. Interest rates on deposits, which for a time were strongly competitive with other investments, already are losing that appeal.

Daniel Gladiš, October 2024

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