April 13, 2022

Banyan's equity composite lost 1.2% in the first quarter of 2022 compared to the S&P 500's loss of 4.6% (click here for more details on our composite performance).

"Macro" economic issues have dominated headlines this year. Stories about high inflation, rising interest rates, and the horrors of war abound. And rightly so. Any one of these issues could alter business conditions. Inflation eats at real returns, higher interest rates pressure asset values, and war destroys a nation's wealth. Plus, news outlets sell a product, and these stories sell.

Despite these "macro" issues, our behavior is unchanged. Banyan's job is to allocate capital to its most productive use. Over the long run, our capital's productivity depends mostly on the "micro" characteristics of the businesses we own and the prices we pay for them. Great businesses can adapt to most any environment, and investing at low prices guards against the poor ones.

Take, for example, our investment in Alleghany (Y), a specialty property and casualty insurer. Banyan first bought the stock for a split-and-spin-adjusted $97.55 in February 1997. We bought more every year thereafter except 1998, 1999, 2005, and 2019. Our last purchase was March 1, 2022, for $649.00 per share. Our firmwide average purchase price is $457.10.

The economy has changed a lot since Banyan first invested in Alleghany. In 1997, the internet was in its infancy, and the iPhone was a decade away. The economy also endured meaningful setbacks over this time, including a stock market bubble in 1999/2000, a financial crisis in 2008/2009, and a pandemic in 2020/2021, not to mention countless other scares we have now forgotten.

All the while, Alleghany kept moseying along. Its accounting net worth, or book value, was $1.4 billion at the end of 1996. Since then, Alleghany has spun off assets, bought back stock, and paid special dividends. Each of these actions created *owner* value but reduced *book* value. Yet, Alleghany's book value still compounded at 7.7% annually through 2021 to reach $9.2 billion.

Better yet, these respectable results were all but inevitable. A well-run insurance company has an uncanny ability to compound book value for decades. The time lag between premiums flowing in and claims flowing out provides a steady pool of "float" to be invested on owners' behalf, and "float" has no maturity date. This sets the stage for *safe* leveraged returns on equity.

Furthermore, the cost of "float" is *negative* if the insurer underwrites profitably. For instance, a 10% underwriting margin (or 90% "combined ratio") is akin to paying *negative* 10% interest on borrowed funds. This is potent in the hands of a savvy investor. With "float" costing negative 10%, an investment offering a 15% return and funded half with "float" produces a 40% return on equity.[1]

Warren Buffett, the savviest investor of all, noticed this potent "micro" characteristic early and made insurance the centerpiece of his masterwork, Berkshire Hathaway. Hence Buffett's all-cash offer on March 21st to buy the whole of Alleghany for $848.02 per share, or 25.3% above the prior day closing price. Buffett is paying 1.26 times yearend book value. The deal should close this year.

A great business can adapt to almost any environment, and sooner or later it will have to. We keep this in mind in times of plenty so we can weather leaner years. It is because of this that our behavior does not change with the economic winds. Our course is steady. Over the long-term, buying great businesses like Alleghany at good prices ***builds permanent wealth*** under all conditions.

Sincerely,

Drew Estes, CFA
Partner & Portfolio Manager

Alek Nabulsi
Partner

[1] Return on Equity = Return on Investment + [(Leverage Ratio – 1) x (Return on Investment – Cost of Leverage)], or

Return on Equity = 15% + [(2 – 1) x (15% + 10%)] = 15% + 25% = 40%