RAILROAD WEEK IN REVIEW

December 15, 2023

"We'e reverting back to a stock-picking environment like it was in the 1980s and 1990s — before the whole ETF boom started. So, bottom line, Peter Lynch can come out of retirement. We need him again right now." — Jim Bianco, president of Bianco Research, Real Vision, December 11

"In the corporate world, if you have analysts, due diligence, and no horse sense, you've just described hell… Ben Graham had a lot to learn as an investor. His ideas of how to value companies were all shaped by how the Great Crash and the Depression almost destroyed him. . . . It left him with an aftermath of fear for the rest of his life, and all his methods were designed to keep that at bay." — Charlie Munger

"BNSF operating teams continue to generate strong overall performance as we move into December. Car velocity has improved, with crews achieving the highest velocity week of the year for the week ending December 5th. Average terminal dwell was reduced by more than four percent from last week, and our local service compliance measure remains above 91 percent." — BNSF Industrial Products Network Update, Dec 8

Stock pickers are waking up in institutional investing circles — and it's going to bring some reason to railroad share prices. Here's where I'm coming from.

As a long time Berkshire shareholder (my first shares came when Berkshire bought Burlington Northern and I was holding the railroad's shares), I have become a great fan of Charlie Munger, RIP. He always had the right quip at the right time and the consensus is his viewpoint on companies helped steer Buffett and Berkshire to the right acquisitions at the right time.

One of my favorite Mungerisms is, "It is always better to buy a good business at a fair price than a fair business at a good price." To Munger, a "fair price" was a number less than the intrinsic value of the company under discussion. Couldn't agree with him more. In all my stock purchases, I use the Morningstar "fair value" number as the start point. I always want the share price to be a fraction of that fair value. A good measure is the "margin of safety"— one minus the share price percentage of what's being paid at the moment.

At this particular moment, share prices for all five publicly traded North American railroad are right at fair value. I use the Berkshire B share price as a proxy for BNSF.

Here we have a bargain. Fair value for BRK.B is $400. Those shares are trading right around $350 for a margin of safety of 12 1/2%. I call that a fair price for a good business.

What amazes me is how railroads can continue to earn premium pricing when their actual financial performance isn't all that great if you strip out share buybacks and adhere strictly to GAAP numbers. Two thirds of the total revenue units are manifest carloads — hardly a growth business. Intermodal volumes have shown some growth but one has to question the all-in margins. Operating ratios have gone down mostly because revenues including fuel surcharge have gone up faster than operating expenses have gone down.

George Soros may have gotten it right in his "reflexivity" argument. The analyst says nice things about an account. Others act on it and push up the price and nobody objects. Seems to me some of them could well be shorts.

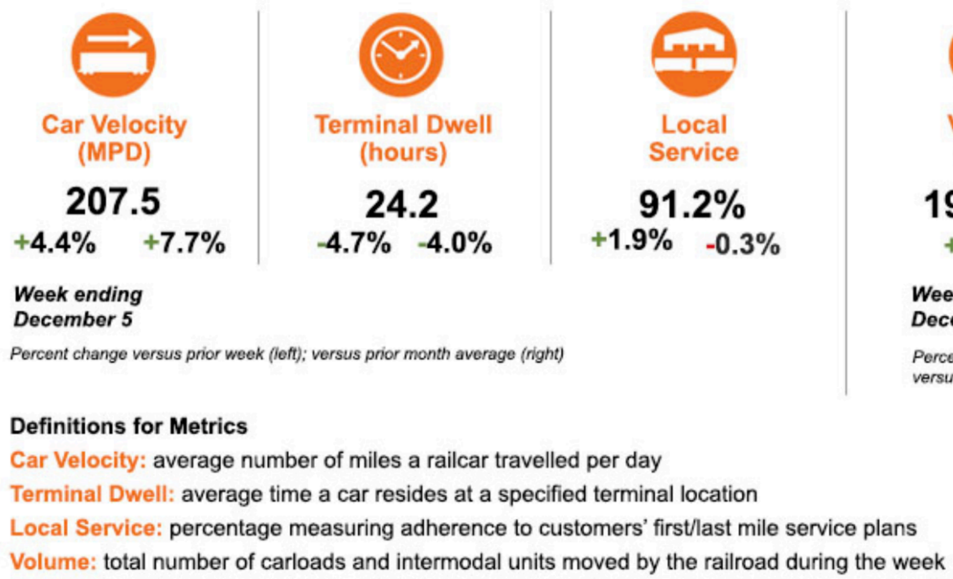
A reader who's been around this business even longer than I have writes, "The two Canadian railroads have some growth prospects (Mexico in one case, Prince Rupert in another), but the U.S. railroads are still digesting the loss of coal and the stagnation in their commodity base. Autos, nah; grain, nah; chemicals, a little. The intermodal dream? A long shot.

"In financial terms, where's the beef? The short lines are mainly overvalued, and the cannibalization card has been well played. When I finished cashing in on KCS, I looked elsewhere. The U. S. railroads can be nice cash returners, but growth?"

Here's where stock-picking gets interesting. Buying ETFs gives you sector averages. But the stock-picker who wants to outperform will eschew the averages and look for the sector's top performer. Now fundamental valuation metrics really count. Ergo the railroads are forced to play to the numbers to keep share prices up. Merch carloads are going to be more important than ever.

Moreover, three quarters of all the shares of all the railroads are owned by institutions — everything from insurance companies to mutual funds to hedge funds — and they make their purchases as much on fundamentals as they do on forward estimates from the analyst community. So as they sharpen their stock-picking pencils to improve returns, they are going to look more closely at the actual numbers generating the prices. The ghost of Charlie Munger will be very much with us.

Among the Class I websites, the BNSF Network Updates page is particularly accessible and useful. This particular page is for industrial products, but there are separate breakouts for intermodal, agricultural products, and coal as well. Below this chart is the present "Service Expectations for the Week Ahead" for industrial commodities:



Earlier in the week, select interchange traffic to/from Canada experienced delays due to heavy rainfall that brought flooding and landslides to the Pacific Northwest. Another storm is expected to bring more rain and snow to the area on Saturday. Winter weather advisories are in place in parts of Montana, the Dakotas and Western Minnesota, as a cold front brings cold wind and snow to these areas before moving east over the weekend. High wind advisories are in place along parts of Southern Transcon, in Eastern New Mexico, West Texas and Southern California; winds expected to decrease soon..

A continuing Week in Review theme is the importance of keeping close tabs on your connecting class I's operating performance. Over the past year there has been a disturbing trend of the Class Is' irregular performance at short line in changes. This can wreak havoc with short line operations, and their customers' supply chains. Happily, short lines can absorb some irregularities. But they have to be prepared.