# A Bird's Eye View
# Sparrows Newsletter

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## The Bet

Warren Buffett is considered by many to be the greatest investor of our age. Yet he is famously sceptical of the value added by active investment managers. He has even gone so far as to advise his own trustees to invest his legacy after his death 90% into passive funds and 10% into short-term government bonds.

Buffett's position is not new, and does not signal a change of heart. He has publicly challenged the skills of active equity managers for many years, telling the world that the fees these managers charge will erode any outperformance over the long run. As long ago as 2005, in Berkshire Hathaway's annual report[1], he expressed the view that, in aggregate, the returns achieved by professional managers over time will fall short of the returns available to rank amateurs who simply harvest market returns.

Later, he laid down the gauntlet, and personally challenged active managers to beat the S&P 500 over a ten-year period. Specifically, he bet that: "Over a ten-year period commencing on January 1, 2008, and ending on December 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs and expenses".

Eventually Protégé Partners, a specialised asset manager focused on hedge funds, stepped up to the plate and accepted a formal $1mm wager via Long Bets (www.longbets.org). "The Bet" was on!

Buffett backed a low cost, passive Vanguard S&P index fund, while Protégé's Tom Seides selected five funds-of-funds, which had collectively invested in over 100 hedge funds. Long Bets will measure the net performance of the two portfolios on December 31st this year, and the proceeds of a pot containing the stakes will go to a charity nominated by the winner.

[1] http://www.berkshirehathaway.com/2005ar/2005ar.pdf

In his original argument, Seides accepts that, "on average, active management in a narrowly defined universe like the S&P 500 is destined to underperform market indexes". But he asserts that "through a cycle…..top hedge fund managers have surpassed market returns net of all fees, while assuming less risk as well. We believe such results will continue" [2].

Initially the bet didn't look so good for Buffett across the stock market falls of 2008. By 2012, however, the S&P had started to outstrip the hedge funds, and hasn't looked back since. Interestingly both participants point to performance through the full cycle, and after nine years it is becoming increasingly clear who is right. Not one of the five funds of hedge funds has managed to keep up with the S&P 500. Seides' active portfolio shows a meagre 2.2% annualised return to date, while Buffett's passive portfolio has produced a respectable, inflation-beating 7.1%. To put this in perspective, $1mm invested in the hedge fund portfolio would have gained $220,000 over the life of the bet, versus $864,000 for the Vanguard passive fund.

After costs, *the active portfolio has only produced around a quarter of the underlying market return*, despite the best efforts of a large number of skilled managers selected by a very motivated party.

Protégé Partners is a powerful manager with the ability to negotiate the best terms and select the best managers. It is to be expected that a smaller investor would fare significantly worse.

Buffett's reasoning is clear. The hedge fund of funds portfolio is burdened by layers of fees and costs, heavily skewed to the disadvantage of the investor. The effect of these costs over the cycle puts the strategy in an impossible position relative to the market. He states in Berkshire Hathaway's 2016 annual report[3], "I estimate that over the nine year period roughly 60% - gulp! – of all gains achieved by the five funds of funds were diverted to the two levels of managers".

Buffett goes on to comment on the investment consultants. He poses the question: "Can you imagine an investment consultant telling clients, year after year, to keep adding to an index fund replicating the S&P 500? That would be career suicide. Large fees flow to these hyper-helpers, however, if they recommend small managerial shifts every year or so. That advice is often delivered in esoteric gibberish that explains why fashionable investment "styles" or current economic trends make the shift appropriate".

[2] http://longbets.org/362/
[3] http://www.berkshirehathaway.com/2016ar/2016ar.pdf

What can we conclude from all of this? Buffett's position, and the compelling empirical evidence provided by The Bet, underline several of the fundamental premises behind passive and factor investing:

- Alpha is highly elusive
- Stock picking and market timing seldom add value
- Active decisions can significantly erode market returns
- The only return that matters is the market return through the full cycle
- Cost efficiency is absolutely critical to portfolio returns
- Much of the professional advice available to investors is fundamentally conflicted

These findings in turn support the contention that, for most investors, it is important to select and maintain an appropriate risk position throughout the full investment cycle, and to do so as efficiently and cost effectively as possible.

Buffett's own conclusion:

"The bottom line: When trillions of dollars are managed by Wall Streeters charging high fees, it will usually be the managers who reap outsized profits, not the clients. Both large and small investors should stick with low cost index funds."

As always, we would love to hear your views and comments.

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