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Buffett Brings Out the Victory Cigar

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Game Over

This weekend, Warren Buffett declared victory on his 2007 bet that Vanguard 500 Index Fund (VFIAX) would beat a pool of hedge funds over the ensuing decade. The wager has one year remaining, but given that the index fund has gained a cumulative 85% for nine years, while the five challengers have averaged 22%, Buffett will likely retain his statuette.

As Buffett writes, the stock market generously provided the contestants with a fair test. Had stocks been unusually poor over the time period, hedge funds (which do indeed hedge, although not as much as their name suggests) would have held an advantage. The reverse would have been true in a roaring bull market. Instead, stocks landed in the middle, with the index fund appreciating by annualized 7.1%. A Goldilocks' result for the trail, if not for investors.

It's impossible to know what went wrong for the actively managed contestants. The names of the challengers have not been publicly released. Even if they had been, the names of their holdings--in this case other hedge funds, as the five contestants are each hedge funds of funds (HFOFs)--would be unavailable. And if those positions were somehow obtained, their underlying portfolios would be unavailable. One time, two times, three times opaque.

By the Numbers

So much, therefore, for any attempt at performance attribution. We can't know what went wrong with the HFOFs. From Buffett's perspective, however, such work is unnecessary. What matters is the underlying math of the funds' expense structures:

"The underlying hedge fund managers in our bet received payments from their limited partners that likely averaged a bit under the prevailing hedge fund standard of '2 and 20,' meaning a 2% annual fixed fee, payable even when losses are huge, and 20% of profits. ... Still, we're not through with fees. Remember, there were the fund-of-funds managers to be fed as well. These managers received an additional fixed amount that was usually set at 1% of assets."

From there, the logic is straightforward.

It is true that some managers possess superior skill. Buffett states that during his lifetime, he has pegged 10 winning managers "early on" in their careers. Further, he states, he has met only a small percentage of investment managers. "There are no doubt many hundreds of people--perhaps thousands--whom I have never met and whose abilities would equal those of the people I've identified."

That would seem to be great news! Hundreds or even thousands of active investment managers who can beat a relevant index, and who can be known before the fact.

Two (Big) Problems

Unfortunately, there are the twin woes of costs and false positives. Buffett writes that he believed in 10 young portfolio managers who subsequently justified his faith. How many did not? How many times did Mr. Buffett say to himself, "Hey, this manager looks to be something special," and then the fund did not shine.

Buffett does not provide that answer in this year's shareholder letter, but it surely is greater than zero. Even the Oracle of Omaha cannot forecast with perfect accuracy.

And each miss counts, very much, against the successes. With enough false signals, manager selection becomes as useless as those economic forecasts that predict 11 of the next two recessions. Yes, the expert has skill; (s)he can accomplish what few others can, which is to identify winning portfolio managers before the fact. The problem is, getting some of them right is not enough. When fund expenses are high, the person in charge of manager selection must be correct far more often than not.

Consider Buffett's opponents: HFOFs that have 3% annual expense ratios. If a HFOF finds 10 managers who later beat their benchmarks by an annualized 4 percentage points (a mean feat indeed) and 10 who appear to be talented but instead prove to be average, then the HFOF has lost while winning. That is, after paying their costs, half of the HFOF's funds will beat their benchmarks by 1 percentage point per year, and the other half will trail by 3. The overall portfolio is a loser; the HFOF is beaten by the index fund.

That example neatly demonstrates the power of Buffett's position. Despite the industry's suggestion to the contrary, most hedge fund managers are not extraordinary. The laws of investment don't suddenly fail with hedge funds, such that everywhere else even highly skilled and intelligent professionals struggle to beat the averages, but success becomes the norm for hedge funds. Not so; with hedge funds as with other types of investments, significant winners are rare. Most funds do not significantly beat their benchmarks before costs are considered.

Which means that picking 10 winners out of 20 is a major achievement. Yet, using this column's assumptions, landing 10 winners *loses* the bet. With a 3% expense hurdle, the premise that a successful manager delivers an extra 4 percentage points per year, and the very generous assumption that none of the unsuccessful managers will be outright bad (merely average), Buffett's opponents must get 15 managers right out of 20, just to keep pace. That was, shall we say, highly improbable.

Rigging the Odds

In other words, Buffett set up a bet that worked very much in his favor. (He didn't accumulate $70 billion by being the sucker at the table.) He didn't take on big U.S. stock mutual funds, which typically run expense ratios of less than 1%. Had he done that, his odds would have been weaker, because with a lower expense hurdle to overcome, the person selecting the opposing funds wouldn't have been forced to have an extremely high hit rate. Nor did Buffett challenge a single fund. Instead, he insisted on facing a pool of funds. It's one thing to challenge an expert to find one outstanding fund; it's another to demand several such discoveries, without many attendant mistakes.

Almost 10 years ago, the most successful investor on earth bet against HFOFs--and, implicitly, any other variety of high-cost investing. He will win that bet, resoundingly, for exactly the reasons that he prophesied at the time of the wager. That won't put an end to HFOFs; product providers will continue to sell, and those with assets will continue to buy. But surely, it should. Very publicly, their math was shown to fail.

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