KIM: Being on opposite side of Buffett trade or bet costly proposition

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While the “active” (i.e. picking individual stocks) vs. “passive” (i.e. index investing) management debate has reached a fever pitch recently, there has been a passionate conversation ongoing for well over a decade.

Warren Buffett’s annual letters to shareholders of Berkshire Hathaway are legendary for explaining concepts in an easy-to-understand manner. In Buffett’s 2005 letter (February 2006), he told of the fictional “Gotrocks” family, which owned all corporations in America (think passive, index investors). Fast talking “Helpers” whispered to individual family members how they could outsmart their relatives by buying and selling certain holdings (think active investors), which these Helpers could broker, for a fee.

Buying and selling individual holdings led to the need for Helpers to pick which holdings to buy and sell (i.e. investment managers), which in turn led to the need for Helpers to pick investment managers (i.e. consultants). All of these Helpers needed to be paid, but none as much as the newest hyper-Helpers (i.e. hedge funds) to appear, which promised the real key to success was paying even steeper fees (2% of assets under management plus 20% of gains, together known as “2 and 20”).

Hedge funds generally operate in secrecy and many utilize investment strategies you need to be a Nobel prizewinner to understand. Part of their attraction is many investors prefer to invest in things they don’t understand and equate higher price to better quality.

Finally, hedge funds are a great way for the manager/general partner to get rich, not the investors/limited partners. Forbes estimated the 25 highest-earning hedge fund managers personally made a combined ***$10.9 billion*** in 2016, even though many of their funds underperformed. Watch “Billions” on Showtime!

At Berkshire’s May 2006 annual meeting, Buffett talked about the impact of fees paid to Helpers on performance and offered to wager $500,000 that over 10-years, the performance of a S&P 500 index fund would beat any five hedge funds the opponent would choose (after fees). For over a year, Buffett heard nothing but crickets from the hedge fund Masters of the Universe, who urged Gotrocks to bet billions on their skill, but were shy about putting up their own dough.

Only Ted Seide, co-manager of Protégé Partners (which manages a “fund of funds” investing in other hedge funds, charging its own fees in addition to the underlying funds’ fees) stepped forward. Seide picked five “fund of funds” (never identified), containing a total of 100+ individual hedge funds. The bet covered January 1, 02008 (no typo) to December 31, 02017. You can still see the bet posted to Long Bets (www.Longbets.org), a non-profit seeded by Amazon’s Jeff Bezos to administer long-term bets for the benefit of charity. Buffett’s designated charity was Girls Inc. of Omaha and Seide’s was Friends of Absolute Return for Kids, Inc.

The results were predictable. Buffett said the compound annual return through the end of 2016 was 7.1% for the S&P 500 index fund, but averaged only 2.2% for the five funds of funds. In dollar terms, $1 million invested in S&P 500 index fund gained $854,000, while $1 million invested in the funds of funds gained only $220,000.

Seide has conceded defeat. Don’t bet against Buffett or buy when he’s selling or sell when he’s buying.
