# Investment Wisdom from Buffett's Bets

## Greed and Fear

Back in 2014, Warren Buffett's company, Berkshire Hathaway, insured a Quicken Loans-sponsored NCAA basketball "March Madness" bracket contest, offering $1 billion to anyone correctly picking the winning teams in all of the games. Media excitement around Buffett's offer built for weeks. Then, all 15 million participants were eliminated before the first round was complete. The Berkshire Hathaway insurance premium (profit from winning the bet) was not disclosed but estimated to be in the tens of millions.[1]

Before signing the deal, Buffett himself calculated the approximate odds of a winning entry. If all teams were evenly matched, the odds would be exactly 1 in 9 quintillion (9 followed by 18 zeroes). But, "calculating the exact odds of a perfect bracket is impossible," Buffett explains, "because picking the winner of a game isn't a random event like a coin flip." This is especially true in the first round when the top-seeded teams usually prevail.[1] Duke Professor Ezra Miller estimated the odds of a perfect bracket to be at least 1 in 1 billion, even if each contestant made "intelligent" choices.[1]

While the contest was teasingly interesting, it was an illusion. The odds were stacked like those of a carnival game. Buffett has also won other, similar insurance bets, including ones related to the 2010 World Cup and Pepsi's 2003 "Win a Billion" bottle-cap contest.[1]

They say markets are run by greed and fear. When the public becomes taken with these emotions, Buffett gladly takes the other side of the bet. In 2014, 15 million people took the time to complete a Quicken Loans mortgage survey and NCAA bracket for a nearly impossible shot at $1 billion. Buffett collected the insurance premium, and Quicken Loans received the advertising.

In 2008, it was fear that drove much larger profits for Buffett as many worried that the world's financial system would collapse. That winter, Mohamed El-Erian, CEO of the largest bond investment firm in the world, PIMCO, had his wife "run to the ATM and take out as much cash as possible." [2] Meanwhile, Warren Buffett coolly invested $5 billion in Goldman Sachs, a financial firm in desperate need of capital. Buffett netted an estimated $4 billion on the deal.[3] El-Erian was later released from PIMCO following the sub-par performance of many PIMCO funds.

## Fundamental Investing vs. Hedge Funds and Stock Picking

While many assume that Buffett's success has come from stock selection, in "Buffett's Alpha," Lasse Pedersen of NYU and his co-authors prove that most of Buffett's exceptional returns over time are due instead to basic investment strategies, such as keeping borrowing costs low, not panicking when markets decline, and buying when valuations are favorable.[4] These are financial basics we all can follow.

Buffett preaches investment fundamentals, and in January, 2008, he made a wager to demonstrate. He bet high-profile hedge fund firm Protégé Partners $1 million (to be given to charity) that a simple, low-cost Vanguard index fund would beat their hedge fund's performance over a 10-year span.

Hedge funds have the advantage of operating without regulation. Managers invest as they like, often without set guidelines, asset-class boundaries, or reporting constraints. Hedge funds are also differentiated by their steep fees and tax-inefficiencies, and this is their disadvantage. They typically charge a fee of 20% of the fund's gains. Then they charge an additional 2% per year of the managed assets. High transaction volume often generates more costs and taxes.

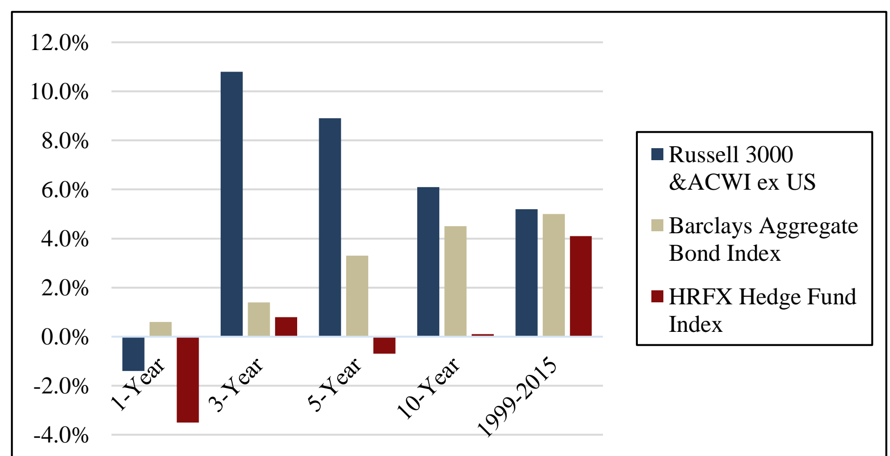
Like the NCAA bracket challenge, the Protégé bet seems an intriguing contest on the surface. It is not. Costs are the single-highest predictive factor of fund returns.[5] Pitting a low-cost index fund against a high-fee hedge fund is like a Ferrari racing a tractor. Through January, 2017, the Vanguard fund had a total return of 85% versus 22% for Protégé.[6]

Today, we have a significant body of research on hedge fund performance over many time periods. A 1999 study by Professors Roger Ibbotson and William Goetzmann of Yale and Stephen Brown of NYU found "most hedge funds had underperformed the S&P 500 Index. There was no evidence of any consistent ability of hedge fund managers in any particular style classification to earn excess returns." [7] In another study Ibbotson showed hedge funds lagged the S&P 500 Index by 2.6% per year from 1995 - 2006. [8] Below is a chart showing the hedge fund index against a global market index (Russell 3000 combined with ACWI except US) and Barclays Bond index from 1999 – 2015.

Hedge fund performance is so poor that they frequently go out of business. Professor Burton Malkiel of Princeton found that less than 25% of the hedge funds in 1996 were still in existence eight years later.[10] In fact, the median lifetime of a hedge fund is just 5.5 years.[11]

The chart to the right bears testimony to this fact. The poor performance and high fees provide for very low returns to the investor. The advent of low cost ETF's like Vanguard's has all but doomed the high fee hedge funds whose fees eat into the returns of the investor.

**Hedge Fund Index vs. Global Market & Bond Indices [9]**



Over the years, Buffett has made several headline-grabbing bets, and he generally wins them. He seems to delight in playing upon the emotions of the masses and the mistakes of other professional investors, like a magician using parlor tricks to take money from unsuspecting bar patrons. But his tricks are not magic. They are based on simple, fundamental investing principles which he is always happy to share.

***"In investing it is not necessary to do extraordinary things to get extraordinary results."***

- Warren Buffett, *1994 Berkshire Hathaway Annual Report*

**Notes and Acknowledgements:**

1. "Buffett Wins NCAA Billion-Dollar Hoops Bet as Brackets Go Bust," Bloomberg, and Professor Ezra Miller, Duke University, March 21, 2014
2. *Fortune*, September, 2009
3. "Buffett Feasts on Goldman Sachs' Famine," *New York Post*, September 30, 2013
4. "Buffett's Alpha" by Andrea Frazzini , David Kabiller of AQR Capital Management, and Professor Lasse Pedersen, NYU, 2013
5. Morningstar
6. "Buffett's Bet with the Hedge Funds: Year Nine," , Investopedia, February 28, 2017
7. "Offshore Hedge Funds: Survival and Performance 1989 – 95," Professor Stephen Brown, NYU, Professor Roger Ibbotson, Yale University, and William Goetzmann, Yale University, 1999
8. "The A, B, C's of Hedge Funds: Alphas, Betas and Costs," Professor Roger Ibbotson, Yale University, 2006
9. "Hedge Funds, What Are They God For?" CFA Institute, February 24, 2016
10. "Hedge Funds: Risk and Return," Professor Burton Malkiel, Princeton University, and Atanu Saha, 2005
11. "Hedge Fund Survival Lifetimes," Professor Greg Gregoriou, State University of New York, 2002

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance. [Spring 2017]