Warren Buffett wins $1M bet made a decade ago that the S&P 500 stock index would outperform hedge funds

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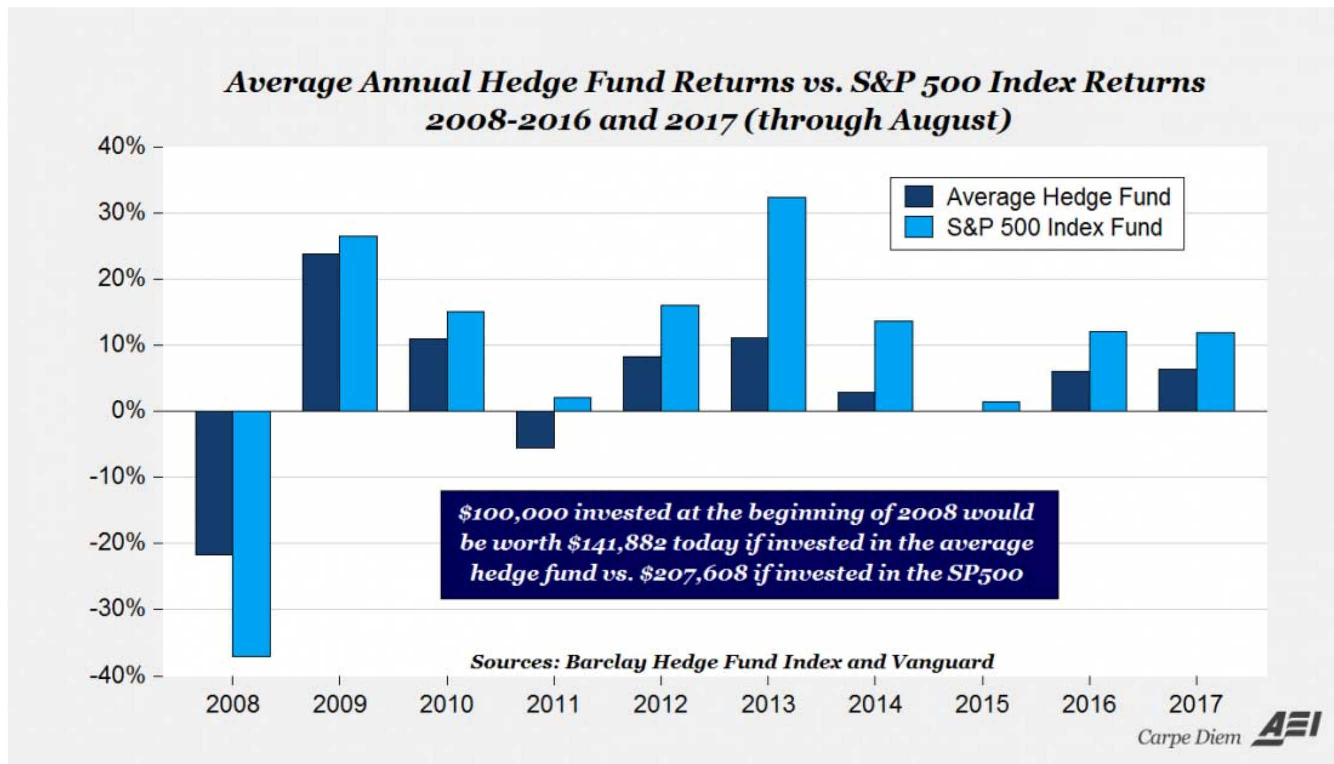
September 16, 2017 6:54 pm | *AEIdeas*



(http://www.aei.org/wp-content/uploads/2017/09/sp.png)

In 2007, Warren Buffett challenged finance professionals in the hedge fund industry to accept a bet that Buffett described in his 2016 letter to shareholders of Berkshire-Hathaway (http://www.berkshirehathaway.com/letters/2016ltr.pdf) (see p. 21-21):

> In Berkshire's 2005 annual report, I argued that active investment management by professionals – in aggregate – would over a period of years underperform the returns achieved by rank amateurs who simply sat still. I explained that the massive fees levied by a variety of "helpers" would leave their clients – again in aggregate – worse off than if the amateurs simply invested in an unmanaged low-cost index fund.
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> Subsequently, I publicly offered to wager $500,000 that no investment pro could select a set of at least five hedge funds – wildly-popular and high-fee investing vehicles – that would over an extended period match the performance of an unmanaged S&P-500 index fund charging only token fees. I suggested a ten-year bet and named a low-cost Vanguard S&P fund as my contender. I then sat back and waited expectantly for a parade of fund managers – who could include their own fund as one of the five – to come forth and defend their occupation. After all, these managers urged others to bet billions on their abilities. Why should they fear putting a little of their own money on the line?

MP: Specifically, Buffett offered to bet that over a ten-year period from January 1, 2008 to December 31, 2017, the S&P 500 index would outperform a portfolio of funds of hedge funds when performance is measured on a basis net of fees, costs and all expenses.

> What followed was the sound of silence. Though there are thousands of professional investment managers who have amassed staggering fortunes by touting their stock-selecting prowess, only one man – Ted Seides – stepped up to my challenge. Ted was a co-manager of Protégé Partners, an asset manager that had raised money from limited partners to form a fund-of-funds – in other words, a fund that invests in multiple hedge funds.
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> I hadn't known Ted before our wager, but I like him and admire his willingness to put his money where his mouth was. He has been both straight-forward with me and meticulous in supplying all the data that both he and I have needed to monitor the bet.
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> For Protégé Partners' side of our ten-year bet, Ted picked five funds-of-funds whose results were to be averaged and compared against my

Vanguard S&P index fund. The five he selected had invested their money in more than 100 hedge funds, which meant that the overall performance of the funds-of-funds would not be distorted by the good or poor results of a single manager.

Each fund-of-funds, of course, operated with a layer of fees that sat above the fees charged by the hedge funds in which it had invested. In this doubling-up arrangement, the larger fees were levied by the underlying hedge funds; each of the fund-of-funds imposed an additional fee for its presumed skills in selecting hedge-fund managers.

Here are the results for the first nine years of the bet – figures leaving no doubt that Girls Inc. of Omaha, the charitable beneficiary I designated to get any bet winnings I earned, will be the organization eagerly opening the mail next January.

Year	Fund of Funds A	Fund of Funds B	Fund of Funds C	Fund of Funds D	Fund of Funds E	S&P Index Fund
2008	-16.5%	-22.3%	-21.3%	-29.3%	-30.1%	-37.0%
2009	11.3%	14.5%	21.4%	16.5%	16.8%	26.6%
2010	5.9%	6.8%	13.3%	4.9%	11.9%	15.1%
2011	-6.3%	-1.3%	5.9%	-6.3%	-2.8%	2.1%
2012	3.4%	9.6%	5.7%	6.2%	9.1%	16.0%
2013	10.5%	15.2%	8.8%	14.2%	14.4%	32.3%
2014	4.7%	4.0%	18.9%	0.7%	-2.1%	13.6%
2015	1.6%	2.5%	5.4%	1.4%	-5.0%	1.4%
2016	-2.9%	1.7%	-1.4%	2.5%	4.4%	11.9%
Gain to Date	8.7%	28.3%	62.8%	2.9%	7.5%	85.4%

Footnote: Under my agreement with Protégé Partners, the names of these funds-of-funds have never been publicly disclosed. I, however, see their annual audits.

The compounded annual increase to date for the index fund is 7.1%, which is a return that could easily prove typical for the stock market over time. That's an important fact: A particularly weak nine years for the market over the lifetime of this bet would have probably helped the relative performance of the hedge funds, because many hold large "short" positions. Conversely, nine years of exceptionally high returns from stocks would have provided a tailwind for index funds.

Instead we operated in what I would call a "neutral" environment. In it, the five funds-of-funds delivered, through 2016, an average of only 2.2%, compounded annually. That means $1 million invested in those funds would have gained $220,000. The index fund would meanwhile have

> gained $854,000.

And here's an [update on Buffett's now-famous bet](http://nypost.com/2017/09/09/warren-buffett-wins-1m-bet-made-with-hedgie-a-decade-ago/) (http://nypost.com/2017/09/09/warren-buffett-wins-1m-bet-made-with-hedgie-a-decade-ago/), which was just settled early ahead of schedule, because the outcome is so one-sided in favor of the S&P 500 index over hedge funds:

> The Oracle of Omaha once again has proven that Wall Street's pricey investments are often a lousy deal. Warren Buffett made a $1 million bet at end of 2007 [with hedge fund manager Ted Seides of Protégé Partners](http://nypost.com/2008/06/10/buffett-finds-rival-in-a-protege/) (http://nypost.com/2008/06/10/buffett-finds-rival-in-a-protege/). Buffett wagered that a low-cost S&P 500 index fund would perform better than a group of Protégé's hedge funds.
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> Buffett's index investment bet is so far ahead that Seides concedes the match, although it doesn't officially end until Dec. 31.
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> The problem for Seides is his five funds through the middle of this year have been only able to gain 2.2% a year since 2008, compared with more than 7% a year for the S&P 500 — a huge difference. That means Seides' $1 million hedge fund investments have only earned $220,000 [through 2016] in the same period that Buffett's low-fee investment gained $854,000.
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> "For all intents and purposes, the game is over. I lost," Seides wrote. The $1 million will go to a Buffett charity, Girls Inc. of Omaha.
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> In conceding defeat, Seides said the high investor fees charged by hedge funds was a critical factor. Hedge funds tend to be a good deal for the people who run the funds, who pass on big bills to the investors.
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> "Is running a hedge fund profitable? Yes. Hedge fund managers typically demand management fees of 2 percent of assets under management," according to Capital Management Services Group (CMSG), which tracks the hedge fund industry. "Performance fees for managers can be 20 percent to 50 percent of trading profits," CMSG adds.
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> By contrast, the costs of an average index fund are minimal. A fund that tracks the S&P 500 fund might have an expense ratio of as little as 0.02%.

MP: The chart above shows the annual returns on the S&P 500 index and the average annual returns on a comprehensive index of thousands of hedge funds maintained by Barclay (https://www.barclayhedge.com/research/indices/ghs/Hedge_Fund_Index.html) over the period of Buffett's bet: From 2008 through August of this year. A $100,000 investment at the beginning of 2008 would have more than doubled to about $208,000 at the end of August this year, compared to only about $142,000 invested in the average hedge fund. The average annual return for the S&P 500 index over that period was 7.8%, or more than double the average return on the Barclay Hedge Fund index since January 2008. And except for 2008, the S&P 500 index outperformed the Hedge Fund index in every other year: 2009 (26.4% vs. 23.7%), 2010 (15% vs. 11%), 2011 (2% vs. –5%), 2012 (16% vs. 8.25%), 2013 (33% vs. 11%), 2014 (13.7% vs. 2.9%), 2015 (1.38% vs. 0%), 2016 (12% vs. 6%), and 2017 (through August, 12% vs. 6.3%). Not. Even. Close.

At least over the most recent ten-year period, Buffett's investment advice (also from the 2016 letter to shareholders) has convincingly prevailed (emphasis added):

> A lot of very smart people set out to do better than average in securities markets. Call them active investors. Their opposites, passive investors, will by definition do about average. In aggregate their positions will more or less approximate those of an index fund. **Therefore, the balance of the universe—the active investors—must do about average as well. However, these investors will incur far greater costs. So, on balance, their aggregate results after these costs will be worse than those of the passive investors.**
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> Costs skyrocket when large annual fees, large performance fees, and active trading costs are all added to the active investor's equation. Funds of hedge funds accentuate this cost problem because their fees are superimposed on the large fees charged by the hedge funds in which the funds of funds are invested.
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> A number of smart people are involved in running hedge funds. But to a great extent their efforts are self-neutralizing, and their IQ will not overcome the costs they impose on investors. **Investors, on average and over time, will do better with a low-cost index fund than with a group of funds of funds.**

This article was found online at:
http://www.aei.org/publication/warren-buffett-wins-1m-bet-made-a-decade-ago-that-the-sp-500-stock-index-would-outperform-hedge-funds/