



Warren Buffett bets on an index
Can the S&P 500 beat handpicked hedge funds?

When Warren Buffett takes a stand, investors take notice. His latest move, a \$1 million wager with Protégé Partners LP that the S&P 500 return will beat hedge funds over the next ten years, is no exception. The bet illuminates an important debate: Can the carefully chosen investments of highly educated (and highly paid) experts beat the essentially unmanaged random walk of a broad market index? Our money is on Mr. Buffett and here's why.

At first glance, it doesn't seem like a fair fight. The owners of Protégé Partners, which runs funds of hedge funds, handpicked five funds of funds for its side of the bet (which began January 1, 2008). These funds have at their disposal all the tools of active management, including state-of-the-art fundamental and technical analysis, the freedom to buy and sell at any time, and the opportunity to modify strategies as markets evolve over time. And as hedge funds, they have the added flexibility of using leverage and short-selling to amplify returns, even when security prices are falling.

Mr. Buffett's horse, on the other hand, is a buy-and-hold basket of 500 large cap stocks, specifically Vanguard's S&P 500 tracking index. The managers of this fund manage very little, just keeping holdings in line with the Standard & Poor's index. Buffett's stake will remain fully invested in the index – without the potential benefit of market timing or other strategic maneuvering.

It's the fees

So what is Mr. Buffett thinking? How can a simple index beat the brainpower and strategy of the hedge funds? Ultimately the Buffett bet comes down to fees and expenses. His holding, Admiral class shares of Vanguard's S&P index, had an expense ratio of 7 basis points last year, about as close to zero as one could hope to attain. For fees on the Protégé side, you'll need a calculator. It starts with a 1% annual fee for the fund of funds, on top of the 1.5% management fees that the individual hedge funds collect. Furthermore, the hedge funds keep 20% of any positive return. The funds of funds then take 5% of the remaining 80%.

It's a lot of math, none of it favorable to the hedge fund investor. In a nutshell, 2.5% of asset value goes to management fees, plus about a quarter of all earnings. For Protégé to win this bet, its selections must outperform the index by about 30%. If the S&P makes a 10% annual return over the decade, Protégé needs 13%. That's a very big difference. Mr. Buffet has long railed against the onerous fees charged by the various "helpers" in the investment industry. This wager brings their impact to the fore.

3 reasons to bet with Warren

Mr. Buffett is a smart, rational and cautious man. I expect he considered these factors when he made the wager:



- **Expenses:** As described above, it's hard to win a footrace carrying a twenty pound backpack. That's exactly what non-index investors do – starting 100 basis points or more behind indexes as soon as the starter's gun sounds. The new, second edition of “The Art of Asset Allocation” by David Darst, demonstrates the huge impact of seemingly small fees. He states that over only ten years investors can sacrifice between 11% and 31% of their return to higher annual expenses. Take off the backpack!
- **History:** Empirical evidence supports Mr. Buffett. As Yale endowment manager David Swensen describes, only 22% of actively managed mutual funds beat the Vanguard 500 Index Fund over a 20 year period spanning the 80's and 90's. Burton Malkiel and Mark Hulbert indicate even lower success rates for actively managed funds over other time periods. And recent history tells the same story: the majority of active pooled fund managers failed to achieve an out performance of their respective indices in 2007, according to BNY Mellon Asset Servicing.
- **Taxes:** Although the Buffett-Protégé bet is measured in pre-tax terms, individuals pay taxes on capital gains. When actively managed funds sell stocks at a profit, the tax register rings. The minimal turnover of well constructed indexes avoids almost all capital gains taxes. Consider a \$10 million portfolio earning 9% pre-tax annually. According to Bernstein Global Wealth Management, taxes generated by active management will reduce total return over a ten year period by \$7-\$12 million versus a low cost index.

“Average” is far above average

With the strong historical performance by low expense indexes, why do so many investors still flock to actively managed funds? I expect the answer largely hinges on one word: “average.” Because indexes seek to match rather than outsmart markets, index performance is often described as average. (And, of course, the famous Dow Jones Industrial Average includes the word in its name.)

For better or worse, many wealthy investors bristle at the idea of settling for average, preferring instead to hand select funds or managers that will outperform the average...even if they must pay fees to do so. After all, an investor has about a 50% chance of picking funds or managers that will do better than the “average” return delivered by an index, right? No, as noted earlier, index funds routinely fall in the upper quartile of performance, thanks to their low expense ratios. And after taxes, indexes typically do even better, thanks to low turnover. Indexing and average are not synonymous. Not even close.

Warren Buffett is willing to make a million dollar bet on the idea that average is above average, that an ordinary, low cost, no frills index can beat Wall Street's best and brightest over a 10 year period. We agree. The portfolios of our clients are composed almost exclusively of ETF index investments.



Where professional guidance pays off

So, if investors can earn above average returns through indexes, does professional investment guidance make sense at all? In my opinion, investors reap the greatest benefit from professional guidance in three important tasks:

- **Allocate:** Mr. Buffett is a vocal supporter of index funds for individuals, but I have never heard him suggest that owning the S&P or any other single index is a sound investment strategy. His company, Berkshire Hathaway owns stakes in many companies in many industries around the world. Diversification is critical for any portfolio. In my view, setting allocations across disparate asset classes – in proportions that match one’s individual financial situation and appetite for risk – is the most important element in investment management.
- **Check the correlations:** Today’s turbulent market highlights this important aspect of asset allocation – not all asset classes move together. Owning asset classes with low or negative correlations means that some portion of one’s portfolio can be moving up in any market environment.
- **Index selection:** All indexes are not equal. Differences in weighting formulas, rules for adding and removing securities and sector definitions can result in very different performance characteristics. Choosing among indexes that seem similar on the surface can yield significantly different returns over time.

The OCM advantage – We call OCM ‘the index boutiqueSM’ because it is the first, and so far only, firm whose sole business is indexing global investments via ETFs for individuals. As a private firm for private people, it is built for personal service.

I look forward to the annual updates promised by Mr. Buffett on the status of his wager. Watching this contest unfold provides valuable lessons in investment strategy, cost control, and the true meaning of “average.”

Links:

- For more on the structure of the Buffett-Protégé bet, visit http://money.cnn.com/2008/06/04/news/newsmakers/buffett_bet.fortune/
- Bernstein Global Wealth Management has the best after-tax analysis I have seen: <https://www.bernstein.com/public/story.aspx?cid=1222&nid=185>.
- “The Art of Asset Allocation, Second Edition” by David M. Darst – Table 5.1, page 176, for the impact of annual expenses on return http://www.amazon.com/gp/reader/0071592946/ref=sib_dp_pt#reader-link



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