The Buffett Bet - The Final Results Are In

Maria Davis, Maycrest Capital – February 26, 2018

What was the bet about? Mr. Buffett bet that over a ten-year time frame – from the beginning of 2008 to the end of 2017 – a simple S&P 500 index fund would beat the average of five funds of funds selected by an investment advisory firm. An outspoken critic of the level of fees charged by hedge funds and funds of funds, Mr. Buffett predicted that over time a low-cost index fund would beat the funds of funds, simply because of the fees involved.

Could it really be that over a ten-year period five top notch funds of funds would not be able to achieve a higher return than a simple plain-vanilla index fund?

The Results Are In

Warren Buffett just released the final scorecard in his letter to shareholders. The results are not pretty – for the counterparty to the bet that is, as the Oracle of Omaha handily won the bet.

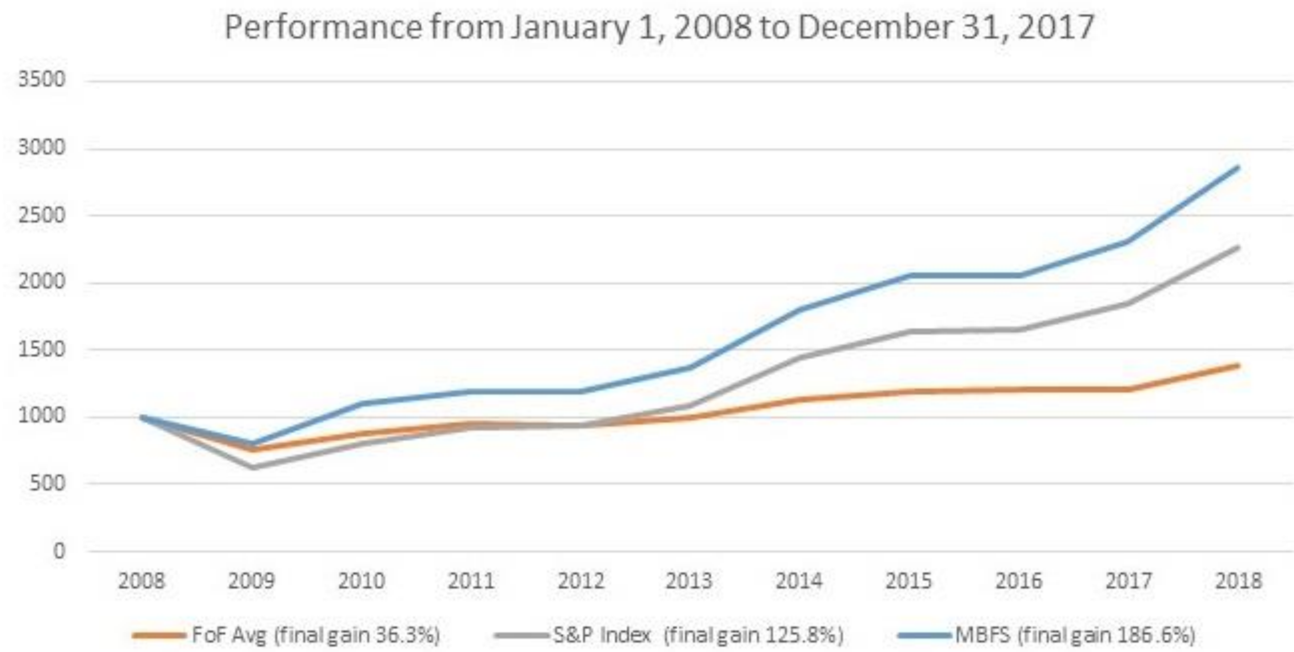
Warren Buffett’s prediction came true: Over the ten-year time frame from the beginning of 2008 to the end of 2017, the Vanguard S&P 500 index fund chosen by Mr. Buffett delivered far better returns than the returns achieved by the five funds of funds selected by Protégé Partners, the counterparty to the bet.

I would like to highlight two points.

1. While *in the aggregate*, asset managers may not outperform the market over an extended period, there are many talented asset managers in the marketplace that have produced outstanding results for their investors. Ray Dalio’s Bridgewater Associates comes to mind as an example of a hedge fund that has been successful over a long time. Our small firm, Maycrest Capital, with its Maycrest Balanced Fund Strategy, also outperformed the S&P 500 Index over the ten-year time frame from 2008 to 2017.
2. We should really look at risk-adjusted returns, rather than focusing solely on the absolute return percentage.

Using the information included in Warren Buffett’s letter to shareholders, I compared

- the average performance of the five funds of funds (FoF Avg);
- the returns of the S&P 500 index fund that Warren Buffett had chosen for the bet (S&P Index); and
- the returns of our firm’s Maycrest Balanced Fund Strategy (MBFS).



Quite a difference over the ten-year time frame.

The ten-year period included the Great Recession, the worst economic decline since the Great Depression, so that's not the typical ten-year period you may say. It is not. You would expect hedge funds to fare better in a down market. The funds of funds in fact did outperform the S&P index fund in 2008 – it was just not enough to overcome the performance lag during the bull market that followed. While the above graph only shows the average of the five funds of funds, it is worth noting that even the best of these funds of funds did not match the 10-year return of the S&P index fund. (Also, one fund of funds was liquidated in 2017. Its results are included for the nine years of its operations.)

As far as risk-adjusted returns are concerned: Given the limited information available, I just compared the maximum annual drawdown over the past ten years as a rough proxy of risk. On a risk-adjusted basis, the results of the S&P 500 index fund don't look quite as impressive: The average of the five funds of funds suffered a maximum annual drawdown of 23.9%, quite a bit less than the drawdown of the S&P 500 index fund (37.0%). The Maycrest Balanced Fund Strategy was the winner with a maximum annual drawdown of 19.7%.

Are Asset Managers Worth Their Fees?

Are asset managers worth their fees? Well, that's up to each investor to decide.

Traditionally, hedge funds have charged a 2% management fee and 20% performance fee – although fees have been coming down in the past few years. Funds of funds layer a fee on top of that, so they come with a hefty price tag. That puts them at a significant disadvantage that they must overcome when competing with a plain vanilla low-cost index fund.

But fees and risk-adjusted returns are only two aspects to consider when deciding whether to use asset managers. Other factors also play a role, for example a desire to achieve diversification or steady returns, or to decrease the correlation to the U.S. stock market, just to name a few. Investors may also turn to asset managers with an expectation that they may do better in bear markets as compared to an index and that they may have a smoother ride maneuvering through the zigs and zags of the market.

Let me end with five tips for researching and choosing asset managers that you may find helpful if you decide not to follow the do-it-yourself route:

- Look for managers that have a good (real, not hypothetical) track record and that have performed well in different market environments;
- Understand the investment philosophy and risks involved;
- Pay attention to the fees and expenses;
- Choose asset managers that co-invest in their funds; and
- Research whether there are any disciplinary actions against the firm (for registered investment advisors, that information is included in Form ADV and accessible to the public at https://adviserinfo.sec.gov).

The author is the chief operating officer of Maycrest Capital. Maycrest Capital may only conduct business in states where it is properly registered to do so. There is no guarantee that the firm's strategy will perform as designed or that the strategy will be profitable. Investors should expect unprofitable periods. Past performance is not indicative of future performance.