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Warren Buffet's Market Confidence

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Berkshire Hathaway, with roots tracing back to the mid-1800s, has become an icon of successful investing. With Warren Buffet—the "Oracle of Omaha"—at the helm since 1970, the holding company has achieved an average annual return in excess of 21%. From insurance to candy to vacuum cleaners, Berkshire Hathaway has continued to strike gold amid a cry from investors of "Long live Warren Buffet!"

Not owning any of the stock, I have a different reason for sounding the cry. The 77-year-old legend recently made a bet with a prominent hedge fund manager, the results of which won't be known for a decade; nonetheless, I want to see Buffet collect.

Summary: Buffet Put His Trust in the Markets

From a wager with a $1 million outcome to an investment with a $50 billion risk, Warren Buffet—Berkshire Hathaway's "Oracle of Omaha"—puts his dollars into low-cost index funds or their equivalent.

Historically, this strategy has been "on the money." Buffet believes it will continue to be a winner—should you take stock in it, too?

The Wager

In a June article in *Fortune* Magazine, senior editor and Buffet confidante Carol Loomis revealed the wager. Buffet bet that ten years from January 1, 2008 the total return of Vanguard's S & P 500 index fund—a passive vehicle designed to produce the average return of the U.S. stock market—would beat the aggregate return of five "funds of hedge funds" chosen by Protégé Partners, LLC. Buffet has had no takers on the wager since proposing it at Berkshire's 2006 annual love-fest—the stockholder's meeting.

Read the details of the wager, including each party's rationale for its position at www.longbets.org.

Each side put up $320,000 (a total of $640,000) in a zero-coupon treasury bond—worth $1,000,000 to the winner's charity of choice at maturity. The bond is held in escrow by Long Bets, a foundation that facilitates these kinds of wagers.

Hamburger Helper

Buffet often warns of the scourge of investment expenses charged by "helpers": active portfolio managers who charge large fees to clients seeking above market returns.

Funds of hedge funds represent towering layers of fees—"hyper-helpers." Here's a typical breakdown:

- The hedge funds itself charges 1.5–2% in annual fees—plus 20% of profits; and
- A fund of funds charges an additional 1% annually, plus 5% of profits.

The result? Only 75% of the managers' actual performance works for the investor. Or, as my favorite definition of hedge funds states it: "A compensation scheme masquerading as an asset class."

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The Vanguard fund charges seven basis points (0.07%) in management fees for its Admiral shares. How does that impact the portfolio? Let's take a $100,000 investment with a $10,000 gain: the "fund of funds" would leave you with $5,000 out the $10,000 gain, whereas the Vanguard fund would leave you $9,923.

Hedge funds invest in multiple strategies, including selling stocks "short," which benefits the fund when they go down. Buffet contends, however, that it will be extraordinarily difficult for even the smartest hedge fund managers to overcome the enormous cost disadvantage. Excessive fees, will turn a Gorat's steak (his favorite) into a DQ (owned by Berkshire) hamburger.

A Much, Much Bigger Bet

For Mr. Buffet, the $1,000,000 personal wager with Protégé amounts to pocket change. However, a similar, more substantial trade was recently made by Buffet on behalf of Berkshire Hathaway's shareholders.

Over the past year, Berkshire has sold put options on the S & P 500—as well as three foreign indexes—to certain insurance companies. The expiration dates average 15 years out. Being European-style options, they may be exercised only *at* expiration. (American options may be exercised at any time up to expiration.)

For selling these options, Berkshire received $4.5 billion in premiums—covering approximately $50 billion in potential losses—for annuities containing guarantees protecting their customers against market losses. While fearful investors pour billions of dollars into such annuities, the insurance companies are laying off their risk to Berkshire.

Simply put, if the market has a negative cumulative return over the next 15 years—which has never happened—Berkshire will have to pay the $50 billion. If not, the premiums could be assumed to return at least 10% annually—nearly $20 billion after 15 years—making a tidy profit for Berkshire shareholders.

The lesson? If recent market gyrations tempt you to abandon your long-term investment strategy for a guaranteed annuity product, remember this: the odds of benefiting from the cost of such guarantees are quite low. Knowing that Warren Buffet is on the other side of that trade should make you think twice.

Don't Bet On Me, Either

Should you invest in Berkshire Hathaway? Despite his successes, the boss suggests not. When asked by a shareholder at this May's annual meeting for his single best specific investment idea, Buffet responded, "I would just have it all in a very low-cost index fund…and go back and get on with my work."

Buffet's enduring message, in both his words and deeds, is to have confidence in the world's capital markets, even with all their ups and downs.

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