# Warren Buffett's Wager

## The Equities vs Hedge Funds Stand-off

Elmien Wagenaar & Kobus Jansen van Vuuren


Warren Buffett, the CEO of Berkshire Hathaway is widely considered as one of the world's most successful investors and resultingly has become the world's third wealthiest person with over $85 billion *(www.forbes.com)* to his name. In the Berkshire Hathaway Inc 2017 Annual Report he discussed the outcome of a decade long wager that ended in December 2017 and, as the winner, the $2.2 million donation he was able to make to a charity of his choice. Mr Buffett's winning claim was that an investment in a US equity index, namely the Standard & Poor 500, would outperform a group of hedge funds selected by Protégé Partners, the counterparty in the wager.

## A Stand-off ?

To some market participants hedge fund investing remains a foreign concept, as they are often unsure of the expected returns, sources of return and the role hedge fund exposure plays in portfolio construction. These individuals would most likely see the result of this wager as evidence of hedge fund inefficiency and they would thus steer clear of such investments. Hedge fund investing is however substantially different to equity investing. Instead of forcing a stand-off between the two strategies, it is more appropriate to consider when a standalone investment in equities is possible. Should this not be the case, a subsequent investigation of the potential benefits the inclusion of hedge funds can have on a portfolio, becomes necessary.

## A Standalone Equity Investment

But first, let's consider Mr Buffett's side of the wager – an investment made purely in equities. The following was stated in the 2017 Annual Report of Berkshire Hathaway Inc:

***"I want to quickly acknowledge that in any upcoming day, week or even year, stocks will be riskier – far riskier – than short-term U.S. bonds. As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates."***

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An investment in equity is volatile and can be exposed to countless market shocks, any one of which can result in a significant loss of invested capital. As mentioned by Mr Buffett, a long investment horizon is key to such an investment. If one enters into such a position at a reasonable valuation there is a general assumption that in the long run markets will move upward. It might be a rollercoaster ride, but equities are generally seen as an inflation beating asset. However, there are very specific requirements for an investor to be able to make such an investment:

1. ***They have the emotional fortitude not to disinvest in the interim***
   In equities, one can expect to see significant capital losses at times. Just one year after the bet was made, the S&P 500 had already incurred a loss of 37%. If any investor responded emotionally by disinvesting at this point, most likely investing the remaining capital in a more conservative instrument, their net financial position at the end of the decade would have looked vastly different, even if they did eventually re-enter equities.

2. ***Their financial position is such that they will not need to withdraw any invested capital for any expected or unexpected eventuality***
   High volatility means that the value of one's investment fluctuates significantly, and as a result a withdrawal at an undesirable time significantly hampers capital recovery.

3. ***Their net wealth is able to suffer a negative return over a 10-year period***
   In equities, it is possible that one's return over a 10-year period is negative. This is a potential outcome that needs to be considered during the financial planning process.

4. ***They are free from any regulatory constraints prohibiting a full equity allocation***

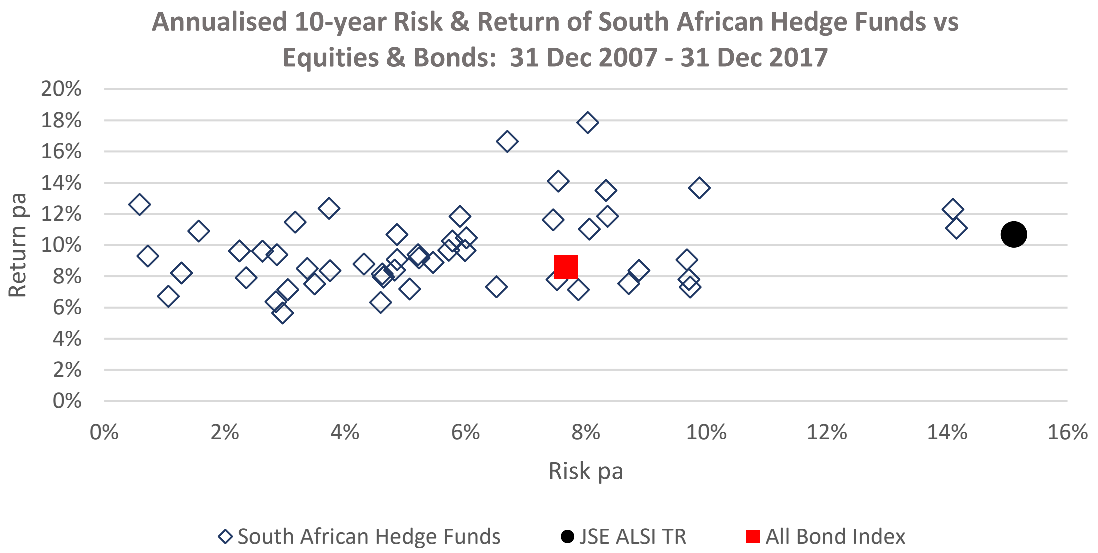
We are fairly certain that Mr Buffett's financial position is such that he satisfies all the points above, and therefore we have sympathy for his "equities above everything else" stance. However, the majority of investors are not in the privileged position where they not only have the luxury of time and emotional fortitude, but also sufficient excess capital to be able to fully invest in a risky asset class that should deliver sufficient reward over time. If any of the four points mentioned above prevents an investor from fully investing in equities, portfolio construction becomes of vital importance. They must ensure that their exposures are sufficiently diversified in order to maximise the likelihood of achieving their expected return, given their financial circumstances.

## The Role of Hedge Funds

In our minds, hedge funds are very seldom a stand-alone solution. But when combined with a traditional portfolio of equity, bonds and cash they are able to provide additional diversification benefits. As an alternative investment with a return stream that can beat inflation over time while also being largely complementary to that of equities due to shorting, hedge funds are able to reduce uncertainty in a portfolio by protecting capital when equities are down, and acting as a strong return generating centre when the opportunity arises. New regulation in the South African hedge fund industry has made these alternative investments accessible to investors of all sizes in a well-regulated, liquid environment. Still, due to the wide range of strategies available, the fund of hedge fund approach is a useful way to access a sufficiently diverse spread.

## The Wager in a South African Context

It is worthwhile to consider how the outcome of the wager might have differed had it occurred in a South African context. The JSE All Share Index TR is a suitable South African equivalent to the S&P 500. A passive 10-year investment in the index is compared to South African hedge funds over the same 10-year period in the graph below.




The annualised risk and return of South African hedge funds (blue), South African equities (JSE All Share TR in black) and bonds (All Bond Index in red) are shown in the graph. Firstly, it should be noted that every South African hedge fund generated returns at a lower volatility than equities, and over 30% of hedge funds outperformed the index (after fees). However, the fact remains that hedge funds are not intended as a substitute, but rather a complement to equities when a full equity allocation is not possible. Therefore, in comparing hedge fund returns to a more traditional complement to equities, it is noted that 58.82% of hedge funds outperformed an investment in bonds. Of these, 73.33% achieved the outperformance at a volatility lower than that of bonds. This goes to show that hedge funds are a very useful asset class that should strongly be considered in portfolio construction to help create a well-diversified portfolio providing any investor with the greatest likelihood of achieving their expected investment outcome.

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