Unwarrented

"Compound interest is the eighth wonder of the world.
He who understands it, earns it.
He who doesn't, pays it."

- Albert Einstein

Or at least we'd like to think Einstein said that. It's unverified, and no one knows for sure, but like many supposed Churchill quotes that just seem more powerful and relevant if he actually spoke them (many, he didn't), we're going to let it slide. Because compound interest, is indeed, truly wonderful.

Evidently, the closest thing we in financial markets have to Albert Einstein or Winston Churchill, is Warren Buffett. Warren's long-term track record is nothing short of incredible. He has a few detractors, but mostly legions of fans that read everything they can about him, quote him on a weekly basis, and fly to Omaha every May for the Berkshire Hathaway annual meeting. We ourselves have reiterated his folksy advice for years, as well as those from his mentor, Ben Graham.

And, as usual, Buffett has some great one-liners in this year's Berkshire Hathaway Annual Letter:

"Once a CEO hungers for a deal, he or she will never lack for forecasts that justify the purchase."

"Investment bankers, smelling huge fees, will be applauding as well."

"If the historical performance of the target falls short of validating its acquisition (price), large 'synergies' will be forecast. Spreadsheets never disappoint."

"At Berkshire, in contrast...we also never factor in, nor do we often find, synergies."

The Oracle of Omaha also makes some of his same old mistakes (e.g. confusing risk with expected returns), but he certainly has given many more pearls of wisdom to the industry than he has taken from it. So, I'm willing to let it slide that his special access to deals means that the playing field hasn't been fair. I'm even willing to let slide his transformation in the late winter of his career. Most stock-pickers grow old and find religion. Warren has seen the light in a different way. After years of minimizing and outright avoiding taxes (legally, mind you, I assume); now that he has money that even Einstein might have trouble comprehending, he is advocating that everyone should pay more taxes.

That's fine. He and Bill Gates can take tricks from each other and state that the US government should be expropriating more and more of its citizens' capital to their heart's content. But when he starts making fun of the people that know the difference between alpha and beta; well, that's a step too far!!!

So we are *not* going to let this perpetuated myth slide that Buffett is continuing to beat the market. Sure, he beat Ted Seides and Protégé Partners in the fund-of-funds bet; but that was apples and oranges, and it did temporary (irreparable?) damage to the industry of "helpers" as Buffett likes to call them. FoFs, OCIOs, consultants and other "helpers" may individually have specific issues (namely fee-layering and/or beta-camouflaging), but they were *never* supposed to be a substitute for the S&P 500, nor did they take 100% equity risks in the process. So, over a ten year period during which the S&P 500 surged 125.8%, yes, the index not only routed the average of the five unnamed FoFs, it trounced each of them individually.[1] This should surprise no one, even the FoFs or their ultimate investors themselves. Yet it still prompted a bit of gloating from St. Warren.

> The bet illuminated another important investment lesson: Though markets are generally rational, they occasionally do crazy things. Seizing the opportunities then offered does *not* require great intelligence, a degree in economics or a familiarity with Wall Street jargon such as alpha and beta. What investors then need instead is an

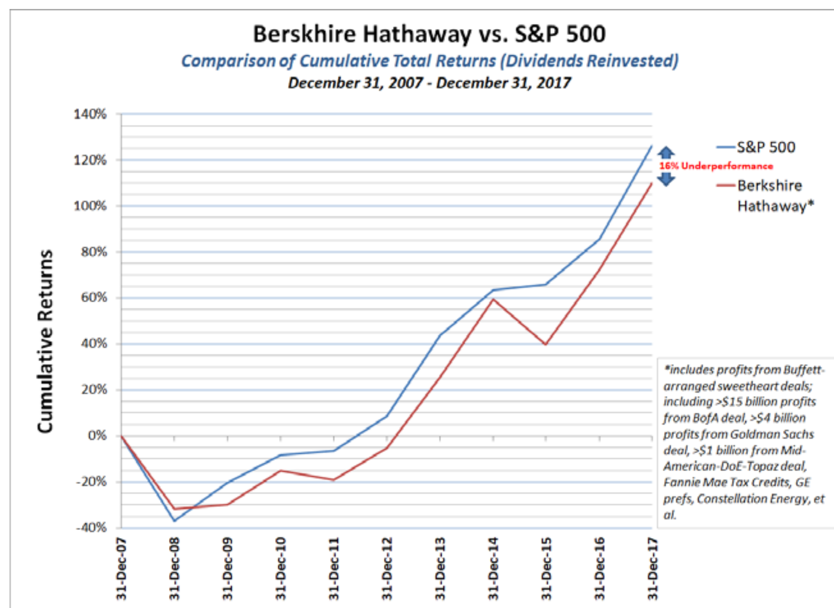
[1] *And I'd like to know who FoF "C" was. Generating 88% returns over those ten years either means that they had a beta of 0.7x or higher, or were doing something special, after fees.*

Buffett then goes on to describe how both he and Protégé financed their bet, at least initially, and used his letter as a forum to state how "risky" it was to have done so (again, his confusion with expected returns). By "risk" here, he means the opportunity cost of not being invested in equities. He highlights that the bonds they purchased were initially yielding a 4.56% annual return but that by 2012 this was down to just 0.88%. Kudos to him (and Ted) for swapping the 10Ys out for shares in Berkshire Hathaway halfway through, but how about mentioning that each of the FoFs appear also to have trounced the 0.88% returns from 2012 to 2017 as well?

In fact, is it remotely possible that investors in those FoF products took their money out of bonds to finance an investment because they wanted a bit more risk, a bit of diversification, a bit of equity exposure, but not full-blown market risk – and that they are actually happy with their returns, especially in the context of the more directional exposure in their portfolios? In other words, would a 35%/65% blend of the SPX and the 10 Year bond have been a more appropriate benchmark?

Maybe. Maybe not. But there is something conspicuous by its absence here. There is an elephant in the room. No one seems to be talking about how well Warren Buffett did *himself* during these same ten years. You know, the Warren Buffett with all the special access and the levered beta bets and the 100% (or more?) equity exposure.

Not so well, it turns out.



He's underperformed by 16% over the last ten years. It's even worse if you exclude GFC in 2008. Over the last nine years, he's underperformed by 51%.[2]

And this is where the trickery starts. Buffett loves discussing his compound returns: "For the last 53 years, the company has built value by reinvesting its earnings and letting compound interest work its magic," he claims. Well, here is the magic. Even though he underperformed the market over the past ten years, his long-term "compounded returns" grew more than those of the S&P 500. That, of course, is just the math as gains from 2008-2017 are applied to previous pools of money that had grown differently. But it does give rise to this strange outcome where cumulative returns for Berkshire increased 144 more times[3] than those of the S&P during a period when Berkshire Hathaway underperformed the S&P.

	BRK	SPX
Compound Returns Sep 30, 1964 through Dec 31, 2007	779145%	4236%
Returns from Dec 31, 2007, through Dec 31, 2017	110%	126%
Compound Returns Sep 30, 1964 through Dec 31, 2017	2398735%	15470%
Absolute Change in Compounded Cumulative Returns from Dec 31, 2007 to Dec 31, 2017	1619590%	11234%

[2] *Berkshire Hathaway shares have actually underperformed since December 31, 2002 (15 years ago) as well. During that period, Berkshire shares are up 308%, while the S&P 500 is up 314%.*
[3] *1,619,590 / 11,234 = 144*

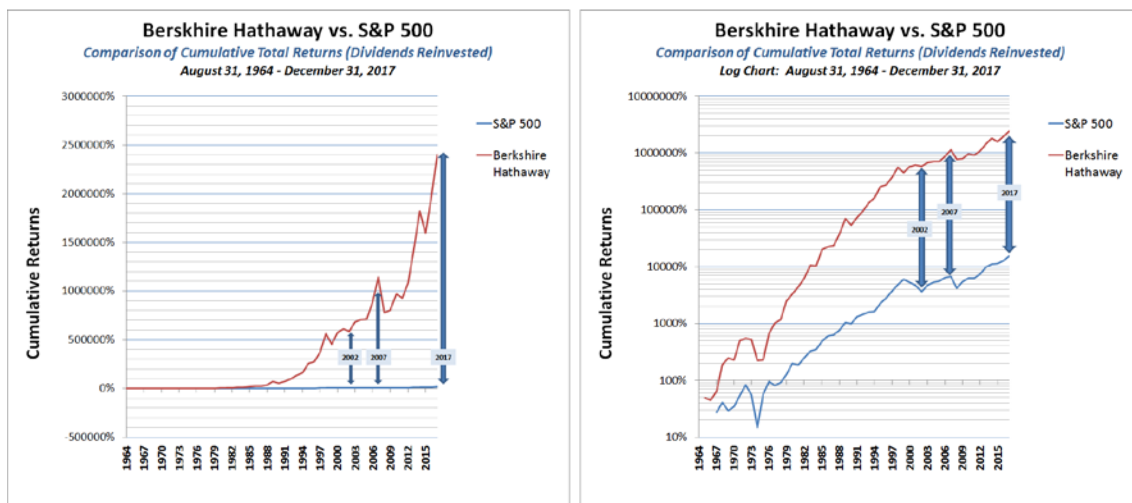
This isn't as mind-altering as scientists (after the fact) impacting a conclusion whether or not light is a particle or a wave (and influencing the decision by how they measure it[4]), but it is something worth considering. If an *investor* (rather than a scientist) had a chance to go back in time and change his outcome (ten years in this case - which isn't a short horizon in the real world) the right decision would have been to sell his Berkshire shares, and use the proceeds to buy a Vanguard Index fund. Not dissimilar to the advice Buffett has given his own wife.[5]

Yet Buffett remains as popular as ever. The first page of the Berkshire Hathaway letter leads with year-by-year changes in the book value and market value of Berkshire Hathaway's shares, and a comparison to the total return of the S&P 500. Naturally, when people see these tables, their eyes gravitate to the 2,404,748% cumulative return of Berkshire shares, and the relatively miniscule 15,508% for the S&P 500.

Berkshire's Performance vs. the S&P 500

	Annual Percentage Change		
Year	in Per-Share Book Value of Berkshire	in Per-Share Market Value of Berkshire	in S&P 500 with Dividends Included
2003	21.0	15.8	28.7
2004	10.5	4.3	10.9
2005	6.4	0.8	4.9
2006	18.4	24.1	15.8
2007	11.0	28.7	5.5
2008	(9.6)	(31.8)	(37.0)
2009	19.8	2.7	26.5
2010	13.0	21.4	15.1
2011	4.6	(4.7)	2.1
2012	14.4	16.8	16.0
2013	18.2	32.7	32.4
2014	8.3	27.0	13.7
2015	6.4	(12.5)	1.4
2016	10.7	23.4	12.0
2017	23.0	21.9	21.8
Compounded Annual Gain – 1965-2017	19.1%	20.9%	9.9%
Overall Gain – 1964-2017	1,088,029%	2,404,748%	15,508%

Our minds want to then envision a chart showing this difference. We human beings like things to be simple, and we consequently will conjure up images in our head of the chart below on the left. While technically accurate, it gives the false impression that Buffett is continuing to outperform. As stated above, he hasn't since 2002. The way to correctly visualise compound returns is to do so using a log scale. Log returns are not as easy to comprehend, but they are relevant and applicable when compounding. That's the chart on the right, and it paints a very different picture.



The bottom line is that Buffett has been underperforming for the last 10-15 years. Given his size, that should be no surprise; but if he wants to compare his apples to the hedge fund industry's oranges, and claim that all the oranges are spoiled, and that his apples are still delicious, we beg to differ. With that, this "helper" believes this steam-rolling canonisation of Buffett is probably unwarrented.[6,7]

[4] *http://www.sciencemag.org/news/2017/10/quantum-experiment-space-confirms-reality-what-you-make-it-0*
[5] *http://www.berkshirehathaway.com/letters/2013ltr.pdf*
[6] *Misspelling intended. I know. Terrible.*
[7] *Yes, we know the Upton Sinclair quote. But we do understand.*

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