SERVO

FACTORS IN FOCUS

"The Bet," Berkshire, and Better Value

by Eric D. Nelson, CFA

In late February, billionaire investor Warren Buffett released the Berkshire Hathaway Annual Report. This year, Buffett included an update to a popular bet he made nine years ago, the details of which have important ties to Servo's investment philosophy.

"The Bet"

In 2007, Buffet publicly wagered $500,000 that no investment pro could select a portfolio of hedge funds ("alternative" investment strategies sometimes favored by ultra-wealthy and institutional investors) that would, over a 10-year period, match the returns of the S&P 500 Index net of costs. The premise of his bet was twofold—first, the extraordinary fees charged by hedge funds (often 2% management fees and 20% of profits) would seriously erode any pre-cost return advantage. Secondly, he doubted that even the presence of a historical record of (net-of-fee) outperformance on the part of the hedge funds would be predictive of future results.

If this is beginning to sound like general principles espoused by Servo—that active managers don't justify their costs and that historical track records are largely irrelevant—then you're starting to see the point.

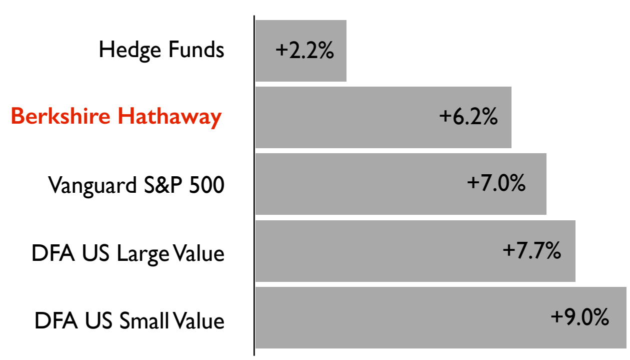
Ted Seides, then a co-manager at Protege Partners, took the bet and relative performance has been tracked for nine years beginning in 2008. If you've been reading *Factors In Focus* for any length of time, the result will not surprise you. Through 2016, the Vanguard S&P 500 fund has compounded at +7% per year, the hedge funds, only +2.2%.

And…What About Berkshire?

Empowered, no doubt, by the resounding victory he'll likely celebrate in just 10 months unless the hedge funds can overcome about a 5% annual deficit in a few quarters, Buffett spent the next few pages of his report excoriating active management and their undeserved fees. Therein lies the irony. Warren Buffet is himself an active manager, so it seems odd to see him attack his own ilk.

At the very least, shouldn't we ask how he, as an active manager, has performed these nine years? That wasn't the bet, of course, but wouldn't you like to know? However, it never comes up and I think I know why. While his long-term track record since the 1960s is second to none, Buffet has been unable to skipper Berkshire Hathaway to a result that exceeds the S&P 500 since 2008 either. The +6.2% per year return on Berkshire is 0.8% per year less than the result of the Vanguard S&P 500 fund. Is this a case of "do what I say, not what I do" if there ever was one in investing?

Chart 1: Returns of the Buffett Bet (2008 to 2016)



Vanguard S&P 500 = VFINX, DFA US Large Value = DFLVX, DFA US Small Value = DFSVX. Source of data: DFA Returns Web, morningstar.com

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Maybe, you're thinking, comparing Berkshire to the S&P 500 over this period is unfair. After all, Buffett was mentored by the famous Benjamin Graham, widely considered the father of "value investing." Could it be that a value approach was simply out of favor over this nine-year period, unfairly penalizing Buffett?

Alas, no such proof of this handicap exists. When we look at the returns in Chart 1 on the previous page for the DFA US Large Value and US Small Cap Value mutual funds—broadly-diversified portfolios that eschew traditional active management and instead target the entire universe of value companies in the large and small cap asset classes—we see S&P 500-beating returns in each case.

So Buffett resembles one of the underperforming active managers of whom he is (rightfully) so critical.

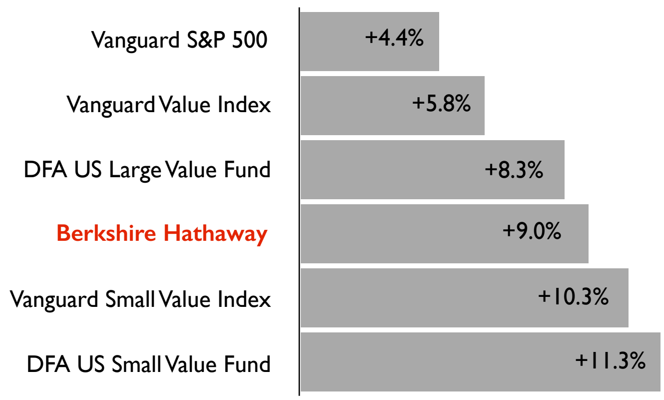
Better Value

If you thought Buffett's support of an S&P 500 Index was limited to his bet, you'd be wrong. Instead, Buffett spends another entire page extolling the virtues of the large cap dominated, growth-oriented S&P 500 Index for investors of all wealth cohorts. He calls out Vanguard founder John Bogle by name as a hero. Sadly, no mention of Eugene Fama or Ken French.

Of course, if the choices are narrowed down to hedge funds or basic index funds, one could certainly do worse than to get behind Buffett and Bogle's beliefs. But wouldn't you expect the value-investing legend, of all people, to broaden his menu of personal recommendations to include index funds focused on *value* stocks? After all, Vanguard, his chosen manager for the S&P 500, manages large and small cap value indexes as well. Since 2000, we find that Vanguard's Value Indexes compare favorably to the S&P 500 and come in only slightly behind Berkshire Hathaway.

Raising the bar even further, we can also observe DFA's US Large Cap and Small Cap Value funds over this same period. DFA's value "asset class" strategies sport Vanguard-like diversification and low costs, but seek out the deepest and most distressed segment of the value stock universe and rebalance more regularly to achieve greater value-style purity. This nuanced portfolio construction and additional management effort aims to outperform traditional index funds by 1% to 2% a year over time. Since 2000 (and over longer periods), DFA's asset class approach has achieved their intended results and even outperformed Berkshire Hathaway when averaged across large and small cap asset classes (a 60/40 mix returned +9.5% annually).

Chart 2: "Traditional" vs. "Better" Value (2000-2016)



Vanguard S&P 500 = VFINX, Vanguard Value Index = VIVAX, DFA US Large Value Fund = DFLVX, Vanguard Small Value Index = VISVX, DFA US Small Value Fund = DFSVX. Source of data = DFA Returns Web

Better Outcomes

There was a time when investors saw the benefit of trying to hire a skilled active manager like Buffett or any number of other Benjamin Graham disciples who managed mutual funds according to classic value-investing principles to beat the market. But today, despite Buffett's reluctance to endorse them, there's a better value approach, as evidenced by Vanguard's traditional index funds and DFA's more highly structured value asset class funds.

With significantly greater diversification (a true "margin of safety"), much lower costs, enhanced tax efficiency and far greater predictability, these strategies represent a natural evolution of traditional "active" value investing. When employed within the context of a goals-based investment plan, the *better value strategies* of today represent a significant step forward in investment management and improve the odds that serious investors can achieve *better financial outcomes*.

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your own personal financial situation.