

Weekly Digest

Week ending 4 June 2017

A Long Call: Where do you stand on Buffett's wager?

The end of this year will see the conclusion of a ten year bet made by Warren Buffett, the world's second richest man and undoubtedly a legend amongst investors. The wager has been hosted at longbets.org, which is described as "an arena for competitive, accountable predictions" and was set up as "a way to foster better long-term thinking". There is one million dollars at stake which will go to a charity of the winner's choice.

So what did one of the world's greatest ever (active) investors bet on? Buffett bet that a passive investment in the S&P 500 index would outperform any given portfolio of hedge funds over the ten year period ending December 31st 2017. Anyone could have taken him up on this bet (so long as they had deep enough pockets) but there were very few takers until the eventual counterparty came forward; Protege Partners LLC, an alternatives investments specialist.

Having started the bet just before the global financial crisis struck in 2008 Buffett got off to a rocky start but, like the fabled tortoise, he eventually caught up after five years. There will be no photo finish though - at last count he was sitting on a return of 85.4% (7.1% per annum) compared to an average of just 22% (2.2% per annum) for the five funds selected as his competition.

So what should we take from this?

First and foremost; it is time in the markets that matters, not market timing. Over the very long term the US equity market has delivered a real return (over and above inflation) of nearly 7%. Those that attempt to time markets by dipping in and out often end up destroying value, whilst those who wait patiently can reap the rewards of compounding. Although hedge funds (or other 'alternative' investments) can represent a valuable component in portfolios, for diversification purposes and lower volatility of returns, they are unlikely to match equities over the long run because they generally have neutral or low exposure to equity markets.

Secondly; fees matter. A lot! Although the hedge fund portfolio has delivered gains over the period and has generally displayed

lower volatility - particularly in 2008 when the S&P 500 fell -37.0% - this has come at a steep price. The underlying hedge fund fees include an annual fixed fee, even when returns were bad, as well as substantial participation in profits. This represents a huge headwind to performance and appears to be one of the main drivers behind Buffett creating the bet.

However, what should not be taken from this - but in many places lazy journalists have - is that the bet represents a triumph for passive investing over active (through stock or manager selection). For that to make sense Buffett's competition should be an actively managed equity fund, or collection thereof, whereas what the bet really represents is an "apples to oranges" comparison. Doubtless the US equity market has proved too challenging for many an active manager to beat over the years, but it is possible. Indeed, according to the 'Morningstar Active/Passive Barometer' report (March 2017) 14.0% of actively managed US large cap blend strategies outperformed the market net of fees over the decade ending December 31st 2016. So if Buffett was up against an expertly selected portfolio of actively managed strategies then there might be more excitement in the final months of the bet, especially as many actively managed strategies have seen a strong upturn in results lately.

The managers of the core portfolios would argue there is no right or wrong here. There's no need to make binary choices between equity or alternative strategies, nor between passive or active. Instead the portfolio managers construct portfolios intelligently across these spectrums (and many more) in a way that increases the probability of meeting the goals of the investors. Importantly however, they keep a very keen eye on fees. The managers ensure investments are priced fairly for their expected returns, whilst always maintaining a focus on investing for the long term, which should vastly improve the chances of success. One needs look no further than the latest annual report for Berkshire Hathaway (Buffett's effective investment vehicle) to see the benefits of staying true to these qualities whilst implementing an active investment approach: since 1965 its share price has generated a compounded gain of 20.8% per annum compared to 9.7% for the S&P 500...

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The Marketplace

- Equities higher with volatility falling
- Bond markets rise after muted inflation data
- UK polls indicate tight race ahead of Thursday's election
- US May payrolls report disappoints
- Trump takes US out of Paris Climate Accord

Market Focus

US

- All three US equity indices hit new record highs last week, as US equities rose 1.0%. The VIX volatility index meanwhile entered deeper into historically low levels, falling to 9.9 from 10.8.
- The US dollar index fell 0.5% on Friday after the latest payroll report showed the US economy adding 138,000 jobs in May, falling short of the 182,000 consensus estimate. Net reductions of 66,000 were also made to the previous two months' figures.
- More encouraging was the unemployment rate falling one-tenth to 4.3%, its lowest level since May 2001. This combined with the lower payroll number could point towards a US labour market approaching full employment.
- Global bonds also experienced a strong week, up 0.2%. US Treasury prices rose 0.6%, with some of the rise attributed to lacklustre inflation data, as the core PCE (personal consumption expenditures) price index for May fell for the third consecutive month, to +1.5% year-on-year.
- Finally, on Thursday, President Trump announced that he was withdrawing the US from the Paris Climate Accord – a set of agreements between nearly 200 countries formed to help tackle climate change – claiming that the deal would cost USD 3 trillion in lost

GDP and 6.5 million jobs. Most foreign leaders and many influential figures in the US condemned the decision, with leaders from France, Germany, and Italy rejecting Trump's proposal to renegotiate the terms of the accord.

UK

- Sterling fell 0.6% versus the dollar and 0.2% versus the euro last week, as opinion polls broadly showed the Conservatives' lead over Labour eroding heading into the election this Thursday. On April 18th, when Mrs May called the election, the Tories had a 20-point poll lead over Labour. That lead is now only nine points, according to the FT's most recent poll of polls.
- Some increased investor nervousness ahead of the election was further reflected by UK gilts falling 0.3% over the week, with 10-year Gilt yields rising by 2.5 basis points to 1.04%.

Europe

- Continental European equities rose 0.5% over the week as the Euro Area continued to show signs of strong economic growth. The final composite PMI (Purchasing Managers' Index) reading for May came in at 56.8, unchanged from April, with Germany and France leading from the front in terms of growth according to data compiler IHS Markit.
- Fixed income assets also advanced, with Euro government and corporate bonds rising 0.1% and 0.4% respectively. Similarly to the US, inflation data was a key contributor to moves, with the headline Euro Area CPI (Consumer Prices Index) showing prices rising +1.4% year-on-year for May – below expectations of +1.5% and 0.4% lower than April's CPI reading.

Andrew Hardy (CFA) & Oliver Bickley

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Asset Class/Region	Currency	Currency returns			
		Week ending 2 June 2017	Month to date	YTD 2017	12 months
Developed Market Equities					
United States	USD	1.0%	1.1%	9.6%	17.6%
United Kingdom	GBP	0.4%	0.4%	7.8%	27.0%
Continental Europe	EUR	0.5%	1.0%	12.2%	19.8%
Japan	JPY	2.1%	2.8%	7.2%	23.7%
Asia Pacific (ex Japan)	USD	0.5%	1.0%	18.8%	26.9%
Australia	AUD	0.0%	1.1%	4.1%	14.4%
Global	USD	1.1%	1.2%	11.6%	17.9%
Emerging Market Equities					
Emerging Europe	USD	-2.0%	0.6%	4.9%	21.5%
Emerging Asia	USD	0.6%	1.0%	22.3%	30.3%
Emerging Latin America	USD	-0.2%	0.5%	10.0%	26.5%
BRICs	USD	0.4%	0.7%	16.8%	30.0%
MENA countries	USD	0.2%	0.3%	1.3%	11.3%
South Africa	USD	-2.2%	2.3%	14.9%	24.0%
India	USD	2.1%	0.8%	25.2%	24.5%
Global Emerging Markets	USD	0.1%	1.0%	18.4%	28.4%
Bonds					
US Treasuries	USD	0.6%	0.2%	2.4%	0.0%
US Treasuries (inflation protected)	USD	0.8%	0.2%	2.2%	2.6%
US Corporate (investment grade)	USD	0.7%	0.3%	3.8%	4.4%
US High Yield	USD	0.3%	0.2%	5.0%	13.9%
UK Gilts	GBP	-0.3%	-0.2%	2.1%	5.9%
UK Corporate (investment grade)	GBP	0.0%	-0.1%	3.3%	8.6%
Euro Government Bonds	EUR	0.1%	-0.1%	-0.5%	-0.8%
Euro Corporate (investment grade)	EUR	0.4%	0.1%	1.3%	2.7%
Euro High Yield	EUR	0.3%	0.1%	4.0%	8.9%
Japanese Government	JPY	0.1%	-0.1%	-0.2%	-2.5%
Australian Government	AUD	0.2%	-0.2%	3.4%	1.7%
Global Government Bonds	USD	0.7%	0.1%	4.4%	-1.2%
Global Bonds	USD	0.2%	-0.2%	4.1%	0.0%
Global Convertible Bonds	USD	1.2%	0.9%	8.3%	8.2%
Emerging Market Bonds	USD	0.7%	0.5%	7.2%	8.9%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	0.3%	1.5%	1.6%	2.4%
Australian Property Securities	AUD	1.8%	1.6%	1.9%	-0.2%
Asia Property Securities	USD	3.2%	2.0%	18.6%	20.6%
Global Property Securities	USD	1.4%	1.5%	8.5%	8.3%
Currencies					
Euro	USD	0.5%	0.3%	7.1%	1.1%
UK Pound Sterling	USD	-0.6%	0.0%	4.3%	-10.7%
Japanese Yen	USD	1.2%	0.2%	5.9%	-1.4%
Australian Dollar	USD	-0.4%	0.0%	3.3%	2.9%
South African Rand	USD	0.7%	2.7%	6.9%	21.6%
Swiss Franc	USD	0.8%	0.4%	5.6%	2.7%
Chinese Yuan	USD	0.7%	0.1%	2.1%	-3.3%
Commodities & Alternatives					
Commodities	USD	-1.7%	-0.7%	-6.1%	-2.6%
Agricultural Commodities	USD	-0.6%	-0.2%	-2.1%	-6.8%
Oil	USD	-2.9%	-0.7%	-12.1%	-0.2%
Gold	USD	1.6%	0.5%	10.7%	5.4%
Hedge funds	USD	0.2%	0.2%	2.6%	6.0%

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