

Ted Seides Offers Little Real Explanation for Losing Out to Buffett

Editor's note: This article is authored by Jim Roumell, partner and portfolio manager of Roumell Asset Management, based in Chevy Chase, Maryland. The piece was originally written on May 26, 2017 and is published here with permission. Jim's contact information is provided to logged-in members at the conclusion of the article.

Ten years ago, Ted Seides accepted Warren Buffett's challenge (a \$1 million bet with winnings going to charity) to anyone wanting to select a basket of hedge funds to compete in a ten-year contest comparing aggregate returns against the S&P 500 Index. Ted Seides' ["Why I Lost My Bet With Warren Buffett"](#) is an embarrassing exercise in failing to take responsibility for losing in what was an eminently fair fight. In retrospect, Ted seems to suggest he was had by a savvy investor (which is true). Ted lost big, but now whines that it wasn't really a fair fight. Hogwash.

First, Ted laments that history didn't cooperate with his side of the bet. He argues, "...the S&P 500 defied the odds and rewarded investors with a historically normal 7.1% nine-year annualized return," despite starting off at an historically high level that should have resulted in a lower ten-year annualized return. Part of the return came from investors' willingness to pay more for a dollar's worth of earnings, leaving the index trading at an adjusted 29 times its average earnings during the past decade." If investing was as easy as extrapolating historical cycles, and counting on patterns repeating themselves within certain time frames, anyone could do it. Maybe investors are paying up because they believe interest rates will stay low in which case they're acting rationally. In such a world, discount rates result in higher appropriate equity valuations. Ted's argument is analogous to someone who invested in Eastman Kodak ten years ago passing off their ensuing loss by simply noting that consumers stopped taking paper photographs and if they had only not switched to digital, the investment would have worked out.

Second, it should be pointed out that the contest wasn't for ten months but rather ten years. This is a timeframe most investors would agree is a reasonable period to compare the efficacy of two different investment approaches. Moreover, the results of the contest weren't even close. Buffett's S&P 500 Index investment bested Ted's collection of the best and the brightest hedge funds by roughly 3x! Ted seems to want more time until his "historical trends" eventually reassert themselves. It's kind of like a baseball team arguing that if it had a few more innings of play it would have won the game. However, given the deep hole that Ted's team is in (commensurate with a giant opportunity cost never to be returned to his investors), it would take an awful lot of extra innings to (potentially) make up the lost ground. In fact, if the contest were extended for another ten years (not a new game but an extension of the existing one), the odds are high that Warren's S&P 500 team would still win.

Third, Ted cleverly changes the crux of the contest and introduces something not considered for purposes of the contest - risk. To wit, "Our bet focused on returns, casting aside the degree of risk assumed in earning those returns." In retrospect, Ted wishes that he and Warren would have chosen a different contest, i.e., one that included some type of risk assessment. The S&P 500's valuation was quite high at the contest's inception in 2007, an advantage Ted no doubt was mindful of that didn't seem to bother Buffett one bit. Sorry, if you propose a game of chess and lose, you don't get to say that you would have won had the game been checkers.

Fourth, Ted asserts, "Hedge funds tend to significantly outperform in bear markets, as demonstrated in 2008 and 2000-2002. These same risk-mitigating properties tempered hedge-fund returns in the

rally that began in 2009.” One would hope that there would at least be certain discrete periods where hedge funds provided real value given the exorbitant fees they charge. Let’s not forget that the contest period included a period that witnessed a 50% drop in the S&P 500. Even with that wind at Ted’s back, his side still lost big. Are Ted’s investors supposed to take comfort that his super-smart hedge fund managers will likely shine, comparatively speaking, if we enter a long-term bear market? Buffett has noted many times that as a long-term investor, he would prefer a volatile annualized return of 15% over a steady one of 10%. The return premium for accepting volatility is meaningful. And it’s cheaper than Ted’s alternative.

To be clear, adjusting returns to account for risk incurred makes tremendous sense and our firm often puts our returns in the context of risk taken. For instance, since inception (January 1, 1999 through March 31, 2017) our annualized return is 7.9% versus the S&P 500’s return of 5.6%, and we often note that our average cash balance was roughly 25% during this period, i.e. we took significantly less risk exposure while exceeding that benchmark by over 2% per year. I should point out, however, that this long-term outperformance has been marked by periods of significant underperformance – 2014 and 2015 in particular, for us.

Fifth, Ted now conveniently argues, “Comparing hedge funds and the S&P 500 is a little like asking which team is better, the Chicago Bulls or the Chicago Bears. Like the Bulls and the Bears in the Windy City, hedge funds and the S&P 500 play different sports.” This is a statement from someone who in the famous words of Jack Nicholson’s character in a “Few Good Men” – can’t handle the truth. Hedge funds and the S&P 500 do in fact play the same sport – it’s the sport of trying to compound wealth. If Ted really believed the S&P 500 was a different sport, why did agree to play? Certainly, the Bulls would never agree to play the Bears in a game of football.

The S&P 500’s selling point is a simple one. Stock returns are highly dependent on picking the right stocks. Picking such stocks in a world awash in information, coupled with the collective judgment of many players determining price, is very difficult indeed. You might as well buy the best and brightest portfolio of companies and call it a day. And, it’s far cheaper than the alternatives. Believers in such a strategy just received strong evidence underscoring their approach. The New York Times recently reported the results of a new study conducted by Hendrik Bessembinder, a finance professor at Arizona State University, that “...demonstrates persuasively that while investing in the overall stock market makes sense, the obstacles facing individual stock pickers are formidable.”

Some of the study’s findings are stunning and should humble any active money manager. For instance, Bessembinder found that 58 percent of individual stocks since 1926 have failed to outperform one-month Treasury bills over their lifetimes. Moreover, a mere 4 percent of stocks in the entire market accounted for all of the net market returns from 1926 through 2015. The Times reports, “By contrast, the most common single result for an individual stock over the period was a return of nearly negative 100 percent – almost a total loss.” Bessembinder used a database developed at the University of Chicago, known as CRSP (Center of Research in Security Prices), which included virtually every stock listed on the broad American market from July 1926 through December 2015. Buffett, keenly aware of the headwinds faced by active management, was likely never too concerned with losing the contest despite a beginning point where the market’s total capitalization to GDP was the second highest on record in the post-WWII period. Rest assured, if he had lost, he wouldn’t have whined and offered up a smattering of clever, but wholly unsatisfying, reasons as to why he lost.

Finally, Ted tries to make the argument that many investors don’t possess the fortitude to stay invested, and thus don’t enjoy the market’s actual return, while “...hedge fund investors stood a much better chance of staying the course and earning the returns on the rebound, even if those returns were less than those of the index fund.” This point caps off Ted’s analysis which at day’s end is a “heads I win, tails you lose” dissertation on the subject. This last point, which is not buttressed with any data of

the average holding periods of each class of investors, seems to say to potential investors, “Our returns are not as good as the other guy’s, but you don’t have the stomach to stick with the other guy so you might as well settle with us because we’ll lock your capital up and that will save you from yourself.” Again, the S&P 500 didn’t win by a little but by 3x! In other words, an investor could have sold out of the rally that began in 2009 a few years ago and still beaten Ted’s team. Here’s an idea to consider: How about just educating people to stay invested and avoid trying to time the market?

Here’s a not-so-well-kept industry secret – few active managers add value and their clients would be better off just parking their long-term investment dollars in an S&P 500 index fund. Is that so hard to admit? Apparently, the answer is yes.

Active managers of all stripes and disciplines would do well to ponder the results of the Buffett-Seides contest. As active managers, we should recognize the daunting task of adding investment value and not shy away from facing that simple truth. More importantly, we should clearly articulate to our clients the source of our investment edge and why we’re worth the fees we charge. For instance, we recently concluded that we should only manage a small pool of assets (perhaps \$300 to \$400 million absent bear market pricing) in order to add investment value. We have little evidence that we can consistently add value outside of off-the-beaten track, left for dead, micro-cap securities. We believe it’s virtually impossible to add value investing in larger, liquid securities with little opportunity to discover mispricing given the efficiency of liquid markets. The active management industry (hedge fund or otherwise) faces a serious conundrum – it wants to grow AUM but its value proposition most often declines as a result. Thus, the industry, like Ted, is left struggling to find arguments justifying its business model.

There are many strategies that make sense, and are worth the fees charged, particularly in the context where an asset allocator is bringing together disparate strategies in order to accomplish an overall portfolio symphony. Moreover, there are in fact managers who have outperformed relevant benchmarks. Typically, these are highly disciplined investors, adhering faithfully to their strategy, exercised over a long period of time. But too often, hedge funds in particular try make the argument that they’re smarter, and that their alleged cutting-edge smarts lead to superior returns. The world patiently waits for the evidence. And will have to continue to wait given the results of the Buffett-Seides contest.

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