M&G Investments

M&G Insights

Simple but not easy

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“It’s not supposed to be easy. Anyone who finds it easy is stupid.”-Charlie Munger

In 2007, Warren Buffett made a famous bet that an unmanaged, low-cost S&P 500 stock index fund (the “S&P”) would outperform a group of high-cost, actively managed hedge funds over a ten-year period from 2008 to 2017. The performance would be measured net of fees, costs, and expenses. You can read all about this bet in Berkshire Hathaway’s 2017 shareholder letter, dated February 24, 2018 (https://www.berkshirehathaway.com/letters/2017ltr.pdf).

Protégé Partners, Buffett’s counterparty in the bet, selected five “fund-of-funds” that they believed would outperform the S&P. These five fund-of-funds, in turn, owned interests in more than 200 hedge funds. The table below, excerpted from the letter, reflects the results of these five fund-of-funds against the S&P:

Year	Fund-of-funds A	Fund-of-funds B	Fund-of-funds C	Fund-of-funds D	Fund-of-funds E	S&P Index Fund
2008	-16.5%	-22.3%	-21.3%	-29.3%	-30.1%	-37.0%
2009	11.3%	14.5%	21.4%	16.5%	16.8%	26.6%
2010	5.9%	6.8%	13.3%	4.9%	11.9%	15.1%
2011	-6.3%	-1.3%	5.9%	-6.3%	-2.8%	2.1%
2012	3.4%	9.6%	5.7%	6.2%	9.1%	16.0%
2013	10.5%	15.2%	8.8%	14.2%	14.4%	32.3%
2014	4.7%	4.0%	18.9%	0.7%	-2.1%	13.6%
2015	1.6%	2.5%	5.4%	1.4%	-5.0%	1.4%
2016	-3.2%	1.9%	-1.7%	2.5%	4.4%	11.9%
2017	12.2%	10.6%	15.6%	N/A	18.0%	21.8%
Final Gain Average	21.7%	42.3%	87.7%	2.8%	27.0%	125.8%
Annual Gain	2.0%	3.6%	6.5%	0.3%	2.4%	8.5%

Unsurprisingly, Buffett was right and won the bet by a comfortable margin. What’s counterintuitive is the outcome of the bet considering the starting conditions. Protégé Partners, a premier advisory firm, selected five investment experts who, in turn, employed several hundred other investment experts, each managing their own hedge fund. In Buffett’s own words, “This assemblage was an elite crew, loaded with brains, adrenaline, and confidence. The managers of the five fund-of-funds possessed a further advantage: They could—and did—rearrange their portfolios of hedge funds during the ten years, investing with new ‘stars’ while exiting their positions in hedge funds whose managers had lost their touch.”

Source: M&G Investments, Bloomberg, data to 31 March 2024

So, why did they lose so spectacularly, and how was Buffett so confident from the very beginning?

Dynamic Games

Super Mario Brothers is a fantastic game. If you had a Nintendo or were into computer games in the 90's, you're no doubt familiar with Mario and Luigi navigating the Mushroom Kingdom to rescue Princess Toadstool. Many readers likely honed impressive directional pad controller skills and have fond memories of playing just one more game before they needed to get to bed. However, I'm willing to wager that almost nobody reading this still plays the game.

Super Mario Brothers is a skill-based game that requires practice to develop the reflexive responsiveness needed to master it. Once you've mastered your way around the Goombas, Piranha Plants, and Warp Zones, the game becomes quite mechanical—a linear progression through levels where although it becomes more difficult, the game remains one-dimensional. Players are then forced to compete for high scores by honing their skills or finding hacks.

Contrast this with a game like Scrabble, where the game's fundamentals are not as easily mastered. Every game of Scrabble reveals a different board, and the tiles in your rack are unique in every round. Add to that the competitiveness of going up against live opponents, and Scrabble becomes multi-layered in a way that Super Mario Brothers cannot. Scrabble still sells 1.5 million boards a year, whereas the Super Mario Brothers game that kids of the '90s grew up with has been discontinued. Surprisingly, despite being an archaic board game, I'd say Scrabble is a more dynamic game than Super Mario Brothers.

Dynamic games are challenging to master. They have layers that make it nearly impossible for a single opponent to remain indefinitely undefeated — there's always something to be discovered or some nuance yet to be exploited. Another example of a dynamic game is chess, where the permutations of the game are so numerous that players can spend their entire lives trying to master the game, with varying degrees of success.

A dynamic game embeds an element of the unknown (or unknowable) as part of its make-up. This could arise because there are random variables present in the game (like dice in a board game) or because there are simply too many paths the game could follow for any player to master all of them. Beating the market is an endeavour that embeds both. Unlike traditional games, investing deals with an unknowable future.

Perhaps this is what Buffett was relying on when he made the bet — even though you have a vast and capable army of money managers trying their level best, dynamic games are not beaten with tenacity or intent. It requires patience.

The Lost Virtue in a World of Busyness

Buffett concludes the section on the bet (in the Berkshire Hathaway 2017 letter) with the following:

"A final lesson from our bet: Stick with big, 'easy' decisions and eschew activity. During the ten-year bet, the 200-plus hedge-fund managers that were involved almost certainly made tens of thousands of buy and sell decisions. Most of those managers undoubtedly thought hard about their decisions, each of which they believed would prove advantageous. In the process of investing, they studied 10-Ks, interviewed managements, read trade journals, and conferred with Wall Street analysts."

Markets are generally rational, and I subscribe to the notion that they're mostly efficient — mostly being the operative word. On occasion, however, the market loses its sense of rationality, and inefficiencies manifest. It is during these moments that one should seize the opportunities offered. This doesn't require great intelligence or sophisticated degrees in economics but rather the sensibility not to be swept up by mob fears or enthusiasm and to focus on a few simple fundamentals. Once again, the Buffett formula is instructive: focus on high-quality businesses and buy them when the market presents an obvious opportunity.

Wisdom often hides behind simplicity and on that measure alone, the oracle of Omaha and now late partner, Charlie Munger, are nothing if not wise. The pair have emphasised the importance of patience and keeping to a simple strategy on more occasions than I can recall. In a world cluttered with busyness and driven by constant activity, embracing a simple approach might be our only antidote, though simple but far from easy.