WALKING THE WALK
THE CRITIC OF HIGH INVESTMENT FEES HAS PUT HIS MONEY WHERE HIS MOUTH IS.

BUFFETT'S BIG BET

The celebrated investor wagers a tidy sum that even carefully chosen hedge funds won't return more than the market over time. **BY CAROL J. LOOMIS**

PHOTOGRAPH BY BEN BAKER

ILL A COLLECTION OF HEDGE FUNDS, carefully selected by experts, return more to investors over the next ten years than the S&P 500? That question is now the subject of a bet between Warren Buffett, the CEO of Berkshire Hathaway, and Protégé Partners LLC, a New York City money-management firm that runs funds of hedge funds—in other words, a firm whose existence rests on its ability to put its clients' money into the best hedge funds and keep it out of the underperformers. You can guess which party is taking which side. Protégé has placed its bet on five funds of hedge funds—specifically, the averaged returns that those vehicles deliver net of all fees, costs, and expenses. On the other side, Buffett, who has long argued that the fees that such "helpers" as hedge funds and funds of funds command are onerous and to be avoided ("Cut Your Gains!" *Fortune*, March 20, 2006), has bet that the returns from a low-cost S&P 500 index fund sold by Vanguard will beat the results delivered by the five funds that Protégé has selected.

We're way past theory here. This bet, being reported for the first time in this article (whose author is both a longtime friend of Buffett's and editor of his chairman's letter in the Berkshire annual report), has been in existence since Jan. 1 of this year. It's between Buffett (not Berkshire) and Protégé (the firm, not its funds). And there's serious money at stake. Each side put up roughly $320,000. The total funds of about $640,000 were used to buy a zero-coupon Treasury bond that will be worth $1 million at the bet's conclusion. That $1 million will then go to charity. If Protégé wins, it has asked that the money be given to Absolute Return for Kids (ARK), an international philanthropy based in London. If Buffett wins, the intended recipient is Girls Inc. of Omaha, whose board includes his daughter, Susan Buffett.

And who's holding the money, by way of owning the zero-coupon bond? That's an esoteric institution most readers of this article will never have heard of, the Long Now Foundation, of San Francisco, which exists to encourage long-term thinking and combat what one of its founders, Stewart Brand (of the *Whole Earth Catalog*), calls the "pathologically short attention span" that seems to afflict the world. Six years ago the foundation set up a mechanism for—what else?—Long Bets. The foundation receives wagers as donations, oversees the bets until they are decided, and then pays

THE PROVOCATEURS SEIDES (RIGHT) INITIATED THE BET, AND HIS PARTNERS BESSENT (LEFT) AND TARRANT JOINED THE ACTION.

ANDREANNA LYNN SEYMORE

off the winner's designated charity. For this work, the foundation normally gets a $50 fee from each side and then shares fifty-fifty with the charitable winner-to-be in the returns earned on the funds being held. In the Buffett-Protégé bet, however, there will be no such sharing; each side simply made a $20,000 charitable gift to the Long Now Foundation.

To see today's Long Bets listings (to which, following publication of this article, the Buffett-Protégé bet will be added), go to www.longbets.org. Some bets catalogued there sound as though they were made in sports bars: Actor Ted Danson garnered $2,000 for a charity when the Red Sox won the World Series before a U.S. men's soccer team won the World Cup. On a more cosmic front, Lotus founder Mitchell Kapor and inventor and futurist Ray Kurzweil have a $20,000 bet on the proposition that "by 2029 no computer—or 'machine intelligence'—will have passed the Turing Test," meaning that a computer won't have successfully impersonated a human. Kapor made that prediction; Kurzweil disagrees with it. Each man, following the rules of Long Bets, has supported his point of view with a brief statement that is posted on the website. Buffett's and Protégé's arguments will appear there as well (and are in the box below).

Through 2007 the Kapor-Kurzweil bet of $20,000 was the largest on Long Bets. The Buffett-Protégé bet obviously vaults the stakes to the stratosphere. And to that there is a certain history, which began at Berkshire's May 2006 annual meeting. Expounding that weekend on the transaction and management costs borne by investors, Buffett offered to bet any taker $1 million that over ten years and after fees, the performance of an S&P index fund would beat ten hedge funds that any opponent might choose. Some time later he repeated the offer, adding that since he hadn't been taken up on the bet, he must be right in his thinking.

But in July 2007, Ted Seides, a principal of Protégé but speaking for himself at that point, wrote Buffett to say he'd like to make the bet—or at least some version of it. Months of sporadic negotiation ensued. The two sides eventually agreed that Seides would bet on five funds of funds rather than ten hedge funds. Seides, stepping way beyond his usual stakes—say, the cost of a meal—suggested that he and Buffett make the bet for $100,000 (which, he noted, was Buffett's annual salary). Buffett, not knowing then that Long Bets even existed, said that considering his age—he's now 77—and the complications that a ten-year bet might add to his estate's being settled, he'd only be interested in wagering at least $500,000. Even then, he wrote Seides, "my estate attorney is going to think I'm out of my mind for complicating things."

If $500,000 seemed too steep to Seides, Buffett (for whom it's obviously more of a trifle) had no problem with Seides recruiting partners to help out. And that's what in effect happened, by way of Protégé Partners LLC making the bet rather than Seides. Protégé, which manages around $3.5 billion, is principally owned by Seides, 37, and two other men, CEO Jeffrey Tarrant, 52, and Scott Bessent, 45. Each has a strong investment background, and two of the three have worked with well-known market practitioners: Seides learned the world of alternative investments under Yale's David Swensen; Bessent worked with both George Soros and short-seller Jim Chanos.

UPON ITS FOUNDING IN 2002 by Tarrant and Seides, Protégé set up a fund of funds and began recruiting the kind of sophisticated investors—both institu-

THE PREDICTION AND THE ARGUMENTS

Prediction: Over a ten-year period commencing Jan. 1, 2008, and ending Dec. 31, 2017, the S&P 500 will outperform a portfolio of funds of hedge funds, when performance is measured on a basis net of fees, costs, and expenses.

Warren Buffett: AGREE

A lot of very smart people set out to do better than average in securities markets. Call them active investors.

Their opposites, passive investors, will by definition do about average. In aggregate their positions will more or less approximate those of an index fund. Therefore the balance of the universe—the active investors—must do about average as well. However, these investors will incur far greater costs. So, on balance, their aggregate results after these costs will be worse than those of the passive investors.

Costs skyrocket when large annual fees, large performance fees, and active trading costs are all added to the active investor's equation. Funds of hedge funds accentuate this cost problem because their fees are superimposed on the large fees charged by the hedge funds in which the funds of funds are invested.

A number of smart people are involved in running hedge funds. But to a great extent their efforts are self-neutralizing, and their IQ will not overcome the costs they impose on investors. Investors, on average and over time, will do better with a low-cost index fund than with a group of funds of funds.

Protégé Partners LLC: DISAGREE

Mr. Buffett is correct in his assertion that, on average, active management in a narrowly defined universe like the S&P 500 is destined to underperform market indexes. But applying that argument to hedge funds is a bit of an apples-to-oranges comparison.

Having the flexibility to invest both long and short, hedge funds do not set out to beat the market. Rather, they seek to generate positive returns over time regardless of the market environment. For hedge funds, success can mean outperforming the market in lean times, while underperforming in the best of times. Through a cycle, nevertheless, top hedge fund managers have surpassed market returns net of all fees, while assuming less risk as well. We believe such results will continue.

There is a wide gap between the returns of the best hedge funds and the average ones. This differential affords sophisticated institutional investors, among them funds of funds, an opportunity to pick strategies and managers that these investors think will outperform the averages. Funds of funds with the ability to sort the wheat from the chaff will earn returns that amply compensate for the extra layer of fees their clients pay.

Who'll win? Take our online poll. Join in a discussion about the bet at **fortune.com/Buffett.**

Protégé had a great 2007, thanks to its **bearish views on subprime** *mortgage securities.*

tions and wealthy individuals—who put their money in such funds. Very aware that the Securities and Exchange Commission prohibits broad-scale marketing by hedge funds and funds of funds, neither Seides nor Tarrant will disclose the precise names of the funds they now run, much less their performance records. But a London publication, *InvestHedge,* whose parent runs a hedge fund database, provided *Fortune* with several years of returns for the firm's flagship U.S. fund, Protégé Partners LP. From its inception in July 2002 through the end of 2007, the Protégé fund gained 95% (after all fees), soundly beating the Vanguard S&P 500 index fund's 64%. Protégé's performance was hugely helped by the fact that by mid-2006 the firm was extremely bearish on subprime mortgage securities, including CDOs, and had dispersed its investments in hedge funds to capitalize on that opinion. Most significant, it made an investment in Paulson & Co.'s hedge funds, which under John Paulson made a highly publicized killing in 2007 by short-selling securities linked to subprimes.

ALL THAT'S HISTORY, OF COURSE, so let's get back to the bet: Buffett and Seides agreed that they'd periodically disclose where the wager stood. Seides wanted this disclosure to take place whenever the market fell by 10%, because he believes that one of the virtues of hedge funds is their ability to weather tough times. Indeed, in the first quarter of this year, during a down market, Protégé Partners LP fell by only 1.9%, while the Vanguard fund dropped 9.5%. Buffett insisted, though, that the logical time for disclosure was at Berkshire's annual meeting every spring—and that was the final agreement.

Just how much Buffett will have to say about the bet every year may be limited by one fact: The names of the five funds of funds that Protégé has selected are to be kept confidential. Of course, Buffett knows what the names are, because Protégé must supply him with the audited results of these funds every year. But other than that, the designated funds of funds saw no advantage (at least for now) to declaring their participation in the bet and agreed to go along only if confidentiality was promised. The first fund that Protégé tried to recruit, in fact, wouldn't sign up even then.

Seides and Tarrant do have a few general things

to say about the five funds picked. They are equity-oriented (favoring stocks over bonds), tend to invest in hedge funds that avoid in-and-out trading, and are run mostly run by seasoned investment folk rather than tenderfoots. And we can probably assume that Protégé Partners LP is one of the five, if only because its exclusion would leave the firm with the difficult job of explaining to its investors why the firm didn't care to bet on the success of its own hedge fund choices.

AS FOR THE FEES THAT investors pay in the hedge fund world—and that, of course, is the crux of Buffett's argument—they are both complicated and costly. A fund of funds normally charges a 1% annual management fee. The hedge funds it puts that money into charge an annual management fee of their own, which for funds of funds is typically 1.5%. (The fees are paid quarterly by an investor and are figured on the value of his account at the time.) So that's 2.5% of an investor's capital that continually goes for these fees, regardless of the returns earned during a year. In contrast, Vanguard's S&P 500 index fund had an expense ratio last year of 15 basis points (0.15%) for ordinary shares and only seven basis points for Admiral shares, which are available to large investors. Admiral shares are the ones "bought" by Buffett in the bet.

On top of the management fee, the hedge funds typically collect 20% of any gains they make. That leaves 80% for the investors. The fund of funds takes 5% (or more) of that 80% as its share of the gains. The upshot is that only 76% (at most) of the annual return made on an investor's money accrues to him, with the rest going to the "helpers" that Buffett has written about. Meanwhile, the investor is paying his inexorable management fee of 2.5% on capital. The summation is pretty obvious. For Protégé to win this bet, the five funds of funds it has picked must do much, much better than the S&P.

And maybe they will. Buffett himself assesses his chances of winning at only 60%, which he grants is less of an edge than he usually likes to have. Protégé figures its own probabilities of winning at a heady 85%. Some people will say, of course, that just by making this bet, Protégé has acquired some priceless publicity. But then, Protégé clearly wants to win, and it's up against a man who hasn't made a lot of losing bets in his life. Seides himself sees one strong ray of light: "Fortunately for us, we're betting against the S&P's performance, not Buffett's." F

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