Deconstructing Warren

By Kerry Pechter *Thu, Dec 12, 2013*

In new research, three quants from AQR Capital Management have tried to explain exactly why Warren Buffett has been so successful. They neglect to mention that he made the mother of all market-timing moves in October 1974.

Warren Buffett has moved into my neighborhood. To be more precise, Berkshire Hathaway HomeServices' For Sale signs have sprouted on lawns in my neighborhood, supplanting signs once posted by Prudential Fox & Roach, the curiously named regional real estate brokerage that Buffett's flagship firm recently acquired.

For me, as for many investors, the Oracle of Omaha is an object of speculation—not in the investing sense but in the sense of wondering how and why he's been able to master the markets for so long. Even when the market eluded him, as it did in the late 1990s, it soon came running back to him with its tail-risk between its legs. It, not he, had failed.

Many have tried to explain Buffett's record of outperformance. Roger Lowenstein, the longtime *Wall Street Journal* columnist, wrote a superb biography of Buffett nearly two decades ago. Last month, three quants from AQR Capital Management in Greenwich, Conn., published a research paper in which they claim to have deconstructed Warren's wizardry.

"Buffett's returns appear to be neither luck nor magic, but rather reward for the use of leverage combined with a focus on cheap, safe, quality stocks," write Andrea Frazzini, David Kabiller, and Lasse H. Pedersen in "Buffett's Alpha" (NBER Working Paper 19681).

These authors take stock of Buffett's technique and track record, as an owner of a publicly traded company, Berkshire Hathaway, and as an investor in public and private companies. The record speaks for itself: a dollar invested in Berkshire Hathaway in November 1976 would have been worth more than $1,500 at the end of 2011. That entails an average annual return 19% over the riskless T-bill rate, compared to 6.1% for the general stock market.

"Buffett's Alpha" is a technical paper, but the takeaways are fairly straightforward. The authors attribute the success of the folksy Nebraskan—an apparently uncomplicated man of occasionally liberal views who enjoys Coca-Cola and cheeseburgers—to a combination of three factors:

- Selection of safe, high-quality, cheap stocks. Buffett uses the principles of fundamental analysis that he learned at Columbia University directly from the source, Ben Graham. Berkshire Hathaway's portfolio companies and stock holdings includes household names like GEICO, Benjamin Moore, Dairy Queen, Fruit of the Loom, Wrigley, Heinz, Dow Chemical and so on.
- The use of leverage in the purchase of stocks. The authors estimate Buffett's average leverage at 1.6%, which by itself would magnify the market's historic return to about 10%. More important, he has had a "unique access to stable and cheap financing." His leverage has been financed by premia from his insurance and reinsurance companies at an average annual cost of only 2.2%.

- Buffett's deep pockets and captive financing have allowed him to weather market storms without resorting to asset fire sales. Though Berkshire Hathaway lost 44% of its value during a 20-month stretch at the end of the 20th century (while the overall stock market was gaining 32%), his "impeccable reputation and unique structure as a corporation allowed him to stay the course and rebound as the Internet bubble broke," the authors write.

One measure of the success of this strategy, the authors point out, is that Berkshire Hathaway stock has a higher Sharpe ratio (a measure of risk-adjusted performance; it is calculated by subtracting the risk-free rate from a portfolio's rate of return and dividing the result by the standard deviation of that return) of any U.S. stock or mutual fund continuously traded for at least 30 years since 1926.

Speaking of Buffett's insurance and reinsurance holdings: According to Berkshire Hathaway's 2013 third-quarter report,

> "In 2013, life and annuity premiums earned in the third quarter and first nine months of 2013 increased $340 million (46%) and $663 million (33%), respectively over premiums earned in the comparable 2012 periods. Premiums earned in the third quarter of 2013 included $470 million from one annuity reinsurance contract, which was partially offset by a decrease in life reinsurance premiums earned. In the first quarter of 2013, premiums of $1.7 billion were earned in connection with a new reinsurance contract under which BHRG (Berkshire Hathaway Reinsurance Group assumed certain guaranteed minimum death benefit coverages on a portfolio of variable annuity reinsurance contracts that have been in run-off for a number of years."

With all due respect to the authors of this academic paper, who themselves are the creators of investment models like Betting-Against-Beta and Quality-Minus-Junk, they failed to mention two Buffett advantages that Lowenstein related in *Buffett: The Making of An American Capitalist* (Random House, 1995).

First, Buffett was fortunate enough to have a father who was a successful stockbroker and a U.S. Congressman; he arguably stood on taller shoulders than most of us groundlings ever will. Second, almost 40 years ago, the champion of buy-and-hold finessed the mother of all market-timing moves.

After doing very well in the go-go 60s Buffett liquidated his portfolio in 1969. He sat on his mountain of cash until October 1974 when, with the Dow Jones Industrial Average at 580, he decided to start buying blue chips. How do you feel? a *Forbes* reporter asked him at the time. "Like an oversexed guy at a whorehouse," Buffett replied. "This is the time to start investing."

The rest, as they say, is history.