



Even Warren Buffett lost his edge 20 years ago



BY ASHLEY OWEN

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The world's best investor, Warren Buffett, has suffered from the same disease that plagues every other successful fund manager in the world - fading out-performance over time. My analysis here is not covered in any of the books or articles on Buffett that I have seen.

Even Warren Buffett peaked long ago

In my last article (1), I showed how even the very small proportion of fund managers that do add value by beating their market benchmark over a decent time period, that their out-performance always fades over time.

After studying hundreds of funds, my conclusion was:

“All active fund managers peak early in their careers (in terms of beating their market index anyway) and then it is all downhill from there. Even for the best in the world.”

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BEFORE YOU GET STARTED

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This includes the greats like Warren Buffett, Peter Lynch, George Soros, John Templeton, and local ‘stars’ like Kerr Neilson, Hamish Douglass, and everybody else. The reasons are different in each case.

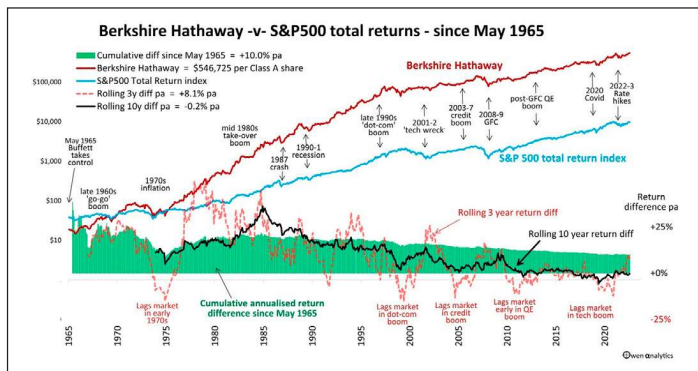
Yes, the pattern is the same for Warren Buffett.

I am a long-term shareholder in Berkshire Hathaway, so I have a vested interest in measuring its performance. It has beaten the S&P500 total return index by an astounding 10% pa since May 1965 when Buffett took over, but most of that out-performance was in the early decades.

Berkshire Hathaway has not added any value against the S&P500 index since 2002. Its out-performance fade curve is the same as other value-adding share funds in Australia and other markets.

Tracking performance decay over time

Here is my chart for Berkshire Hathaway since May 1965 when Buffett took control.



The red line is the Berkshire’s share price. Since 1965, the company has paid no dividends and has reinvested all earnings, so the share price is essentially the ‘Total Return’ series. The shares have not split over the period and the price of BRK Class A shares has grown from \$12.37 to \$546,725 per share at the end of August 2023.

The blue line is the S&P500 total return index. This is the most appropriate benchmark because Berkshire’s investments have always been US companies (listed and unlisted), with few exceptions (notably Chinese car maker BYD).

The black line shows annualised rolling 10-year excess returns above the benchmark. This is our main historical measure for long-term investors.

The orange dotted line is the annualised rolling 3-year excess returns above the benchmark. This is a good way to see performance through different cycles and market conditions.

Beat the market by 10% pa since inception

The green bars in the lower section of the chart show the annualised cumulative excess returns over the benchmark since May 1965. This is the annualised ‘since inception’

out-performance over time. It has beaten the S&P500 total return index by 10% pa compound over 58 years! No other fund manager in history has ever come close to this over such a long period.

Warren Buffett, along with his side-kick Charlie Munger, is without doubt the greatest portfolio share investor in history. I use the term ‘portfolio investor’ to differentiate him from founder/owners like Rockefeller, Carnegie, Musk, Bezos, Gates, etc. They built their own companies, but Buffett invested in other peoples’ companies, which is a different skill.

Buffett put just \$100 of his own money into his first fund in 1956. He earned the rest of his stake by taking his out-performance fees in units in his fund, rather than cash, and then rolled it into Berkshire Hathaway in 1965. So, he turned his original \$100 in 1956 into \$120 billion today.

Peaked in 1965 (year one) then downhill

Like all active fund managers, Buffett peaked early. In fact, he peaked in the very first year in Berkshire. He beat the S&P by a whopping +37% in 1965, and that was the peak of the annualised cumulative value add (green bars).

1965 was actually not his best individual year. He had several better years - and they were all early on. He beat the market by +105% in 1976, +84% in 1979, +67% in 1968, +66% in 1971, +54% in 1977, +53% in 1989. These were partially offset by some poor years in between, so the cumulative ‘since inception’ peak was in 1965.

It was all downhill from the early peak, albeit still generating higher returns than anyone else in history.

By the end of the 1960s, the annualised cumulative value add was +27% pa.

- By the end of the 1970s it was +19.7% pa.
- By the end of the 1980s it was +20.4% pa.
- By the end of the 1990s it was +15.1% pa.
- By the end of the 2000s it was +13.1% pa.
- By the end of the 2010s it was +10.5% pa.

Today, the annualised cumulative value add is down to ‘just’ 10% pa. What’s not to like? As a prospective investor you might say: *“Wow the since inception return is still 10% pa over 58 years. It should still be a great investment!”*

That’s why fund managers and their sales reps love talking about ‘since inception’ returns. But they are meaningless.

The problem with ‘since inception’ numbers

This highlights the big problem with ‘since inception’ numbers. The great-looking ‘since inception’ return of 10% pa masks the fact that most of that out-performance was generated in the early years, half a century ago.

We see a clearer picture of performance by looking at returns per decade:

Buffett's pattern has been very consistent over seven decades. His 'value investing' strategy lagged the overall market in booms (by avoiding fads/bubble stocks) but then added value in the busts when the fads/bubble stocks collapsed. The only exception was poor returns in the 1973-4 crash, but that was recovered big time in the late 1970s and 1980s. ”

Berkshire Hathaway since May 1965

	BRK-A	S&P500 TR	Excess return pa (arith)
1960s	31.2%	4.2%	+27.0%
1970s	22.2%	5.9%	+16.4%
1980s	39.1%	17.6%	+21.5%
1990s	20.5%	18.2%	+2.3%
2000s	5.9%	-0.9%	+6.8%
2010s	13.1%	13.6%	-0.5%
2020s	13.9%	11.3%	+2.6%

(to end Aug 2023)

© Owen analytics

In the 1990s, it added almost no value as Buffett lagged the market by deliberately avoiding the crazy 'dot-com' boom. This earned him a lot of derision at the time but he was vindicated when he added value in the 2000s by avoiding the 'tech wreck'. However, virtually no value was added in the 2010s and 2020s.

Rolling 10-year value-add

The black line (rolling 10-year value added pa) is the key. It shows rolling 10 year annualised value add is currently zero. In fact, the black rolling 10-year value add line has been running at around zero for the past 10 years since 2012, because it has added no value at all since 2002.

That's a long time going nowhere. It didn't actually go nowhere of course. It has gained 650% since 2002, but so has the passive S&P500 total return index. That's better than the 490% return from the Australian market over the same period.

Rolling 3-year value-add

The orange dashes (rolling 3-year value added pa) is a good way of showing where the value is added or detracted through market cycles.

Buffett's pattern has been very consistent over seven decades. His 'value investing' strategy lagged the overall market in booms (by avoiding fads/bubble stocks) but then added value in the busts when the fads/bubble stocks collapsed. The only exception was poor returns in the 1973-4 crash, but that was recovered big time in the late 1970s and 1980s.

True to form, Buffett was also vocal in avoiding the most recent 2020-21 Covid stimulus tech bubble, and the share price lagged the market (orange dash line below zero) as expected. There were also some poor deals in the recent cycle - notably Kraft-Heinz, and the disastrous Airline bets in 2020.

In the rebound over the past year, performance has improved, thanks to huge bets on Apple and oil/gas.

Reasons for performance fade

Buffett and Munger certainly have not succumbed to the problems that afflict many older fund managers, such as selling out, no longer lean and hungry, family problems or diversions, buying football teams, hubris, ego, etc, etc.

In their case, there are probably two reasons:

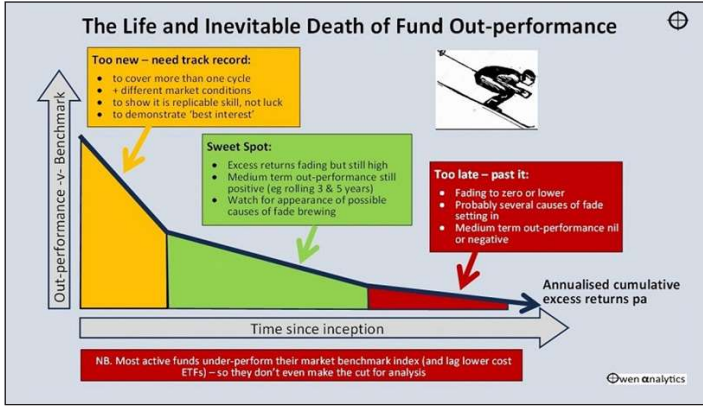
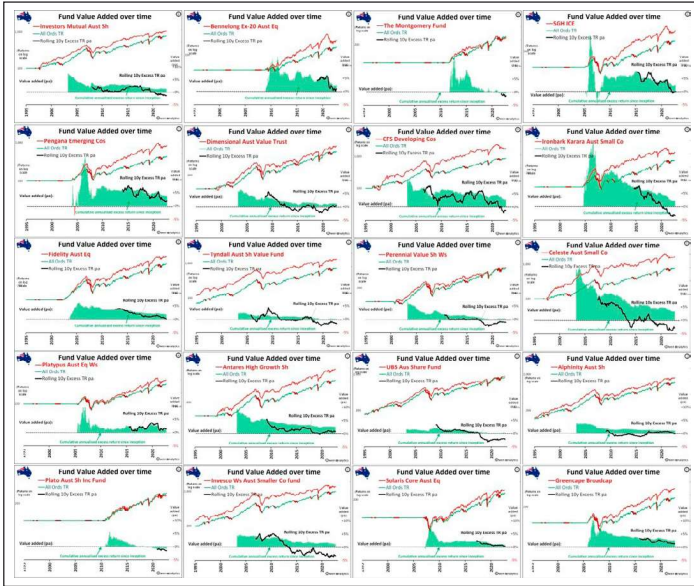
1. Berkshire has become too large and they cannot deploy the huge sums effectively without moving markets.
2. It has too much cash, which is largely the result of the first problem.

Am I a seller? Probably not until my SMSF is in tax-free pension mode, so I avoid CGT on sale!

Same pattern of fading out-performance

For reference, here is a copy of the charts on 20 'value-adding' Australian share funds. Just as with Berkshire Hathaway, the general pattern is the same. Excess returns (green bars) start out with a bang early in the fund's life, but then fade over time in every case.

The difference is of course that Buffett and Munger added a lot more value for a lot longer than anyone else.



Three stages of out-performing fund managers

Here is the chart from my last article, outlining the three stages in the life of an out-performing fund:

Berkshire Hathaway was in the Sweet Spot for decades but has probably been in Stage 3 since the early 1990s. The orange 3-year value-add line on the main chart shows there are certainly some short-term opportunities through the cycles, but as a long-term investor, the black 10-year value-add line has flat-lined.

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EXECUTIVE SUMMARY

- The key drivers of expensive housing in Australia have been low interest rates and a chronic housing supply shortfall.
- Thankfully Australian governments are now focussing on boosting supply, but this will face various constraints and more effort needs to be put into decentralisation.
- The role of high immigration levels (now about 500,000 per annum) can't be ignored. On our estimates it needs to be cut back to nearer 200,000 people a year to line up with building industry capacity & to reduce the supply shortfall.

BY DR SHANE OLIVER

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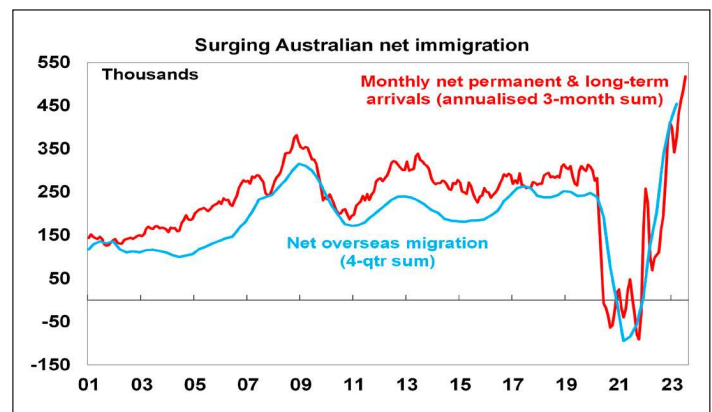
Introduction

For years now there has been much discussion about poor housing affordability in Australia but debate about how immigration contributes to this issue is often lacking. For a country with abundant land, it's ironic that housing affordability is so poor. Much of the focus has been on grants and other means to make it easier for first time buyers to get a loan or on rent subsidies. But of course, this just boosts demand making affordability worse. In recent times, there seems to be more recognition of constraints on the supply side. But surging immigration levels could easily overwhelm these efforts and lead to an even worse situation.

Australia's surging population

March quarter data showed that Australia's population rose by 563,000 or 2.2% over 12 months, with 454,000 of that coming from immigration. Permanent and long-term arrival data up to July suggest that the surge in immigration

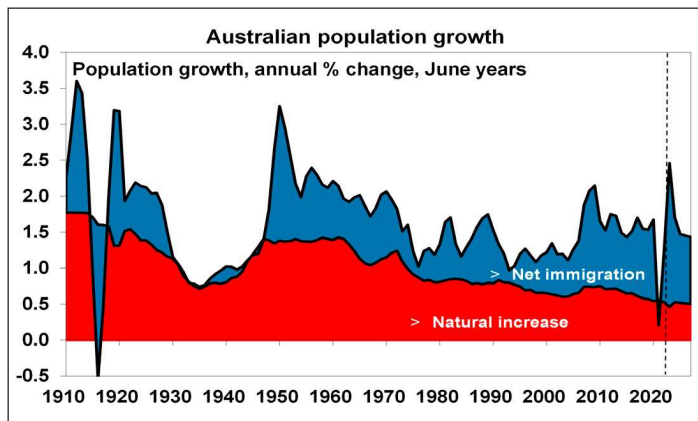
is continuing and we are on track for net immigration of 500,000 or more in the last financial year.



Source: ABS, AMP

This would take population growth to 2.5% in 2022-23, its fastest since the 1950s. Note the next chart assumes net immigration falls to 315,000 this financial year and 260,000 thereafter as consistent with the May Budget projections,

but budget immigration projections have been very unreliable. For example, net immigration for 2022-23 was projected to be 180,000 in the March 2022 Budget, 235,000 in the October 2022 Budget and 400,000 in the May Budget but now looks like 500,000 or more.

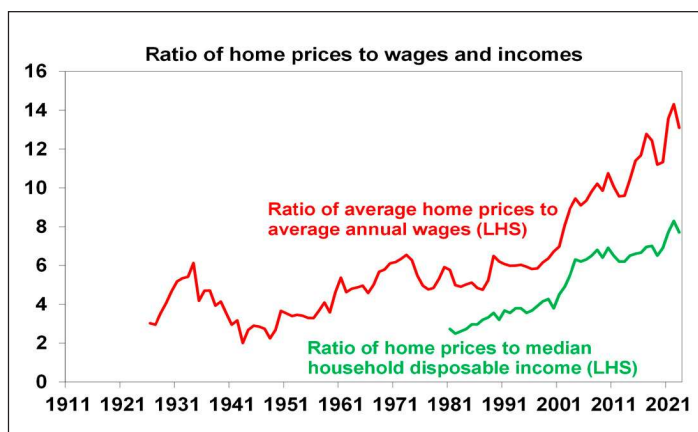


Source: RBA, ABS, AMP

Some of the surge is catch up after the pandemic slump. It will help boost GDP growth and immigration makes for a more dynamic economy. But what really counts for living standards is per capita GDP (and it's going backwards) & surging immigration is making the housing shortage worse.

Poor housing affordability

At its core, housing affordability is determined by home prices, income levels, and interest rates. Whichever way you cut it housing affordability has deteriorated massively in recent decades.



Source: ABS, CoreLogic, AMP

- The ratio of home prices to wages and household income (which allows for the rise of two income families) has surged since the 1980s.
- According to the 2023 Dermographia Affordability Survey, the median multiple of house prices to income

for major cities is 8.2 times in Australia versus around 5 times in the UK & US. In Sydney, it's 13.3x!

- The share of mortgage interest as a share of household income is set to rise to record levels once current interest rates fully flow through.
- Since the mid-1990s, the time taken for someone on average full-time earnings to save a 20% deposit has doubled from about 5 years to 10.

Deteriorating housing affordability is something to be concerned about as it is driving increasing inequality and could threaten social cohesion.

Key drivers of poor housing affordability

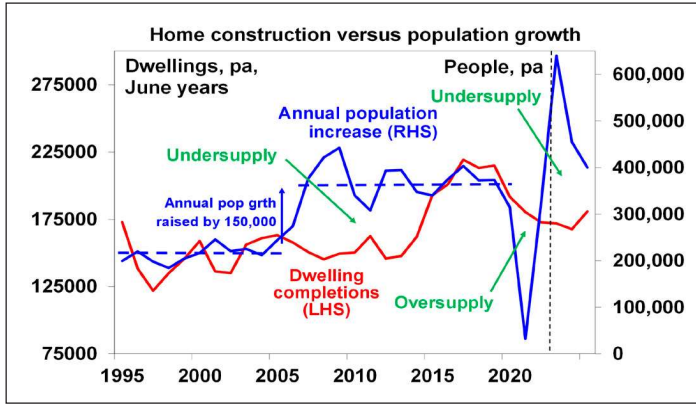
The drivers of poor housing affordability have been subject to much debate. At times many zoom in on things like tax concessions for investors, SMSF buying and foreign demand. But investor and foreign demand were not big drivers of the surge in prices going into early 2022. Rather the fundamental drivers have been a combination of three things:

- The shift from high interest rates at the start of the 1990s to low interest rates along with the increased availability of debt has boosted borrowing ability and hence buyers' capacity to pay for homes. But this can't be the full story because lots of countries have had low interest rates without such expensive housing relative to incomes.
- Looking a bit deeper, there has been a fundamental failure of housing supply (for lots of reasons ranging from development controls to capacity constraints) to keep up with a surge in demand for housing that started in the mid-2000s with rapid population growth.
- The concentration of people in just a few coastal cities hasn't helped.

The role of immigration in the demand/supply mismatch is critical.

Population growth and Australia's housing shortfall

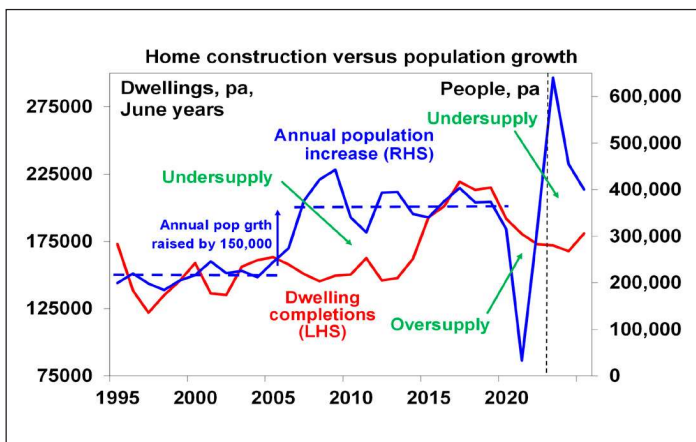
Starting in the mid-2000s annual population growth jumped by around 150,000 people on the back of a surge in net immigration levels - see the blue line in the next chart. This should have been matched by an increase in dwelling completions of around 60,000 per annum but there was no such rise in completions until after 2015 leading to a chronic undersupply of homes - see the red line. The unit building boom of the second half of last decade and the slump in population growth through the pandemic helped relieve the imbalance but the unit building boom was brief and a decline in household size from 2021 resulted in demand for an extra 120,000 dwellings on the RBA's estimates. The rebound in population growth has taken the property market back into undersupply again.



Source; ABS, AMP

The next chart looks at this in terms of underlying demand (blue line) and supply (red line) for homes and the cumulative undersupply gap between them (green line). Up until 2005 the housing market was in rough balance. It then went into a massive shortfall of about 250,000 dwellings by 2014 as underlying demand surged with booming immigration. This short fall was then cut into by the unit building boom and we nearly got back to balance in the pandemic. A rebound in underlying demand on the back of this year’s immigration surge and weak completions has now pushed the shortfall back up to 120,000 and by mid next year it will be around 165,000. This makes no allowance for the pandemic induced fall in household size which could take the shortfall up to around 285,000.

Meanwhile the surge in immigration has pushed underlying demand for homes to an average 220,000 dwellings over the three years to 2025. But thanks to rate hikes and capacity constraints dwelling completions look like averaging around 175,000 which means a new shortfall each year of about 45,000 dwellings adding to the already existing shortfall.



Source; ABS, AMP

The housing shortfall is confirmed by record low rental vacancy rates.

Housing supply

The good news is that Australian governments appear at last to be serious about focussing on supply as a key to improving housing affordability. The target to build 1.2 million new homes over five years from July 2024 (or 240,000 pa) - supported by 50,000 social and affordable homes over five years from the Housing Australia Future Fund and the National Housing Accord along with various programs to incentivise states to build more homes - are to be welcomed. Over the five years to 2022 Australia built nearly one million new homes (or 200,000 pa) mostly in the private sector but we need a stretch target to solve the housing affordability issue given a shortfall of 165,000 to 285,000 dwellings by mid next year. However, this is not going to be easy. First, despite a backlog of approvals yet to be completed we are struggling to complete 180,000 dwellings pa with labour and material shortages and regular failures amongst home-builders. We may be able to get this back up to 200,000 pa with more units/lower cost housing in the mix (like late last decade) but it’s hard to see where the capacity is going to come from to get to 240,000 dwellings a year.

Secondly, similarly albeit less ambitious supply side commitments in the past have failed. And finally, as noted, the surge in immigration is adding to the already large supply shortfall and threatening to swamp the extra supply commitments governments are making.

Immigration levels need to be lower

There are a lot of things that need to be done to improve housing affordability: making it easier to build more homes but in a way that does not lead to ever worsening urban congestion and compromise the very things that make Australia great (yes like many Australians I admit to being a NIMBY); encouraging greater decentralisation to regional Australia to take pressure off cities; and tax reform in terms of replacing stamp duty with land tax and reducing the capital gains tax discount. But it’s impossible to escape the conclusion that immigration levels need to be calibrated to the ability of the home building industry to supply housing. This is critical. Current immigration levels are running well in excess of the ability of the housing industry to supply enough homes exacerbating an acute housing shortage and poor housing affordability.

Our rough estimate is that if home building supply capacity is 200,000 dwellings a year (as we managed in the five years to 2022) then immigration levels need to be cut back to 260,000 from around 500,000 now. But if capacity is just 180,000 dwellings pa or we want to reduce the accumulated supply shortfall by say 20,000 dwellings a year then immigration should be cut back to near 200,000 people a year.

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Not all ETFs are created equal

BY TOM WICKENDEN

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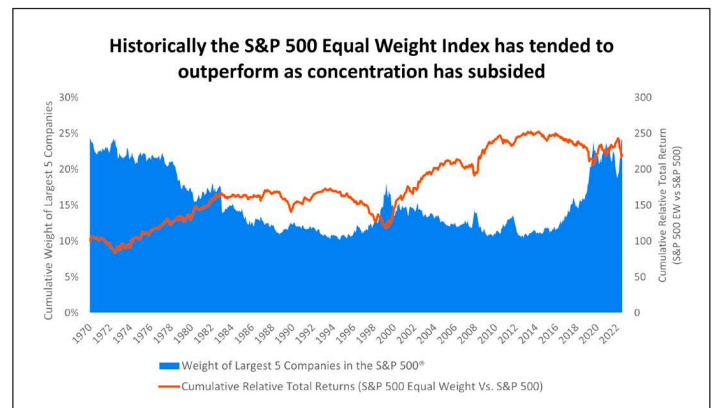
Passive broad market ETFs offer investors a wealth of benefits and are often used as ‘set-and-forget’ core exposures. Despite this, investors still have an onus to monitor their investments to manage portfolios from a risk perspective. For example, the diversification benefits of broad market indices are well-known, as they generally invest in a large universe of stocks rather than a selected few. However, market cap weighting does not necessarily optimise diversification or minimise stock-specific risk.

Currently, the US market, as measured by the weight of the top 5 companies in the S&P 500 Index, is experiencing its highest levels of concentration in over 50 years. For investors with exposure to the market capitalisation-weighted S&P 500, this poses a threat to portfolio diversification, particularly since these top 5 names - Apple, Microsoft, Amazon, Nvidia and Google, belong to related sectors. However, it may also present an opportunity.

The S&P 500 Equal Weight Index is the equal-weight version of the widely used S&P 500. The index includes the same constituents as the market capitalisation-weighted S&P 500, but each company in the S&P 500 Equal Weight Index is allocated a fixed weight at each quarterly rebalance - being 0.2% of the index total - helping to ensure greater diversification across the top 500 US companies.

Historically, concentration in the US market has been mean-reverting, and when concentration has been high and subsiding the S&P 500 Equal Weight Index has tended to experience its greatest outperformance compared to its market

capitalisation-weighted counterpart. For example, between August 2020 and December 2022, the S&P 500 Equal Weight Index outperformed the market capitalisation-weighted S&P 500 Index by 16% as top 5 concentration fell from 24% to 19%.



Source: S&P Dow Jones Indices LLC. Chart shows cumulative relative returns for the S&P 500 Equal Weight Index versus the S&P 500, based on monthly total returns between December 1970 and June 2023. Cumulative weight of largest five S&P 500 companies based on month-end constituents. Past performance is no guarantee of future results.

Equal weight - much more than a short-term solution

However, the S&P 500 Equal Weight Index should not be considered a tactical trading idea, but a potential long term US equity core allocation. Since the index’s inception in December 2002, the S&P 500 Equal Weight Index has outperformed the S&P 500 Index by 1.1% p.a. That said, over the shorter run, the equal-weighted index has gone through periods of underperformance, when larger cap stocks had periods of outperformance.



Source: Bloomberg, as at 31 July 2023. Shows performance of the index that Betashares S&P 500 Equal Weight ETF (ASX: QUS) seeks to track, and not the ETF itself. Does not take into account QUS's management fee and costs (0.29% p.a.). You cannot invest directly in an index. Past performance is not indicative of future performance of any index or ETF.

Whilst not targeting any specific investment factor, the S&P 500 Equal Weight Index's longer-term outperformance can be attributed to 4 key drivers:

1. Rebalancing impact:

Each quarter, as stocks are rebalanced to 0.2%, those that have risen in value are sold and stocks that have fallen in value are bought. This systematic "buy low sell high" rebalancing strategy can add value over time.

2. Increased diversification/lower concentration.

Diversification is often said to be the only 'free lunch' in investing. This alone could make an equal weight strategy a compelling consideration as a longer-term investment approach in US equities.

3. Size impact:

The size premium refers to empirical evidence that smaller companies have on average tended to offer greater growth potential compared to larger cap stocks over the long run.

4. Stock return skew:

Historically, in equity markets, the average stock return has tended to be higher than the median stock return. Given that the average return is higher than the median return, it means that more than half the stocks deliver a return below the average. Equal weight indices typically hold a higher weight in a larger number of stocks compared to the equivalent market capitalisation index resulting in a higher probability of an overweight position in the smaller subset of stocks with outsized returns.

Perfect timing? US investors buy in as market breadth improves

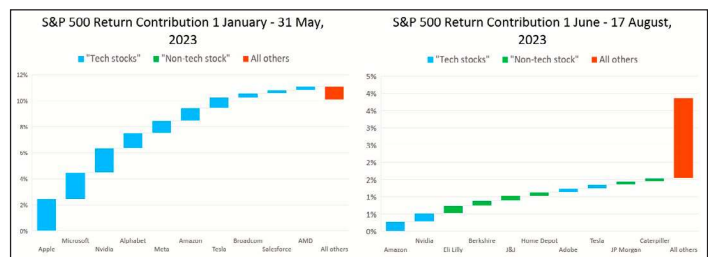
Over the past three years, as concentration has increased in the market capitalisation-weighted S&P 500, we have seen increased inflows into the largest US-based S&P 500 Equal Weight Index-tracking ETF. Investors seem to be increasingly considering the S&P 500 Equal Weight Index as a potential complement for, or alternative to, the market capitalisation-weighted S&P 500 Index.



Source: Bloomberg, as at 18 August 2023. 'Largest S&P 500 Equal Weight ETF' is the Invesco S&P 500 Equal Weight ETF (RSP).

The most recent surge in flows has come at a time when US market breadth is starting to improve. From 1 January 2023 to 31 May 2023, just 10 "tech stocks" contributed more than 100% of the S&P 500 Index's gains, with the remaining 490 companies detracting from overall performance. However, since 1 June 2023 (as of 17 August 2023), the market rally has broadened, with only four of the top 10 contributors being "tech stocks", and, more importantly, the other 490 companies contributing to over 60% of the total returns for the S&P 500 Index, as visualised below. This increased breadth could help to position an equal-weighted strategy for strong outperformance potential compared to a market cap-weighted strategy.

Investors are contemplating what lies ahead for US equities, with some predicting a market pullback led by the same mega-cap names that have driven most of this year's rally, while others are calling for market breadth to continue improving. We believe that both of these scenarios make it an appropriate time to consider the benefits of allocating to the S&P 500 Equal Weight Index from both a risk perspective and as long-term core portfolio allocation.



Source: Bloomberg. Provided for illustrative purposes only. You cannot invest directly in an index. Past performance is not indicative of future performance of any index or ETF.

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Q&A = Ask a Question

Question 1

I am planning to buy my first home in the next 5 or so years and I heard somewhere that you can save for your house more effectively through the First Home Super Saver Scheme (FHSSS). How is contributing to super for the FHSSS more effective?

FHSSS was designed by the federal government and comes with a number of unique benefits:

A key benefit is that your contributions can be claimed as a tax deduction, also known as a personal deductible contribution, to reduce your tax liability for the year you contributed it. This results in reducing your tax based on your marginal tax rate (MTR) and your contribution. However, your contribution will be taxed at 15% upon contribution. The net benefit is your MTR less 15% on the contribution.

Another key benefit of the FHSSS is in regard to the associated earnings you'll receive. The earnings are based on the shortfall interest charge (SIC) rates and as of the upcoming Oct - Dec 2023 period, the SIC rate is 7.15%, which is quite high compared to current high interest savings account or term deposits. In addition, these earnings are guaranteed regardless of market performance so there is no risk of capital loss.

It's important to understand that the FHSSS has specific rules and contribution limits, so consulting with a financial adviser is advisable to ensure compliance and to maximise your tax savings.

Question 2

I am considering owning Income Protection personally rather than through my super. What are the benefits of doing that?

One of the benefits of holding income protection insurance in your own name, is that it provides you with complete control and customisation of your policy. You can tailor your coverage, terms, and features to your specific needs without requiring the approval from your super fund trustee. This flexibility allows you to personalise your insurance to be in line with your unique lifestyle and financial situation.

Secondly, owning income protection personally may offer you a tax deduction on your premiums, depending on your occupation and circumstances. These deductions can lower your overall taxable income, which may potentially reduce your tax liability. This is a valuable tax-saving benefit that is often not available with insurance held within your super funds.

Lastly, insurance outside of super has no impact on your superannuation contributions or balance. Premiums paid from your super account can erode your retirement savings over time. By maintaining income protection insurance separately, you can safeguard your super balance and secure your retirement savings. Additionally, greater control over the claims process can ensure your needs are efficiently met during times of financial stress.

Question 3

I have recently sold my primary residence and downsized into a smaller home. People have been telling me to use the remaining proceeds to make a downsizer contribution into super. How does the downsizer contribution work?

A downsizer contribution is a non-concessional contribution meaning it is a contribution that is sourced from your after-tax funds. The downsizer contribution may be available for you if you are aged 55 or older and have recently sold your primary residence. To qualify, the property sold must have been owned for at least ten years. This contribution allows you to invest the proceeds from the sale of your primary residence into your superannuation fund, with a maximum contribution limit of \$300,000 per person.

One significant advantage of downsizer contributions is that you can contribute it regardless of your current super balance and it can be made in conjunction with other non-concessional contributions without affecting those contribution caps. As the downsizer contribution is a non-concessional contribution, your contribution will not be taxed upon entering the fund.

There is no maximum age limit for making downsizer contributions, making it available to older individuals. You must adhere to a 90-day window for making the contribution, starting from the settlement date of the property sale. Please see your financial adviser to make informed decisions regarding this strategy.

If you have a question that you would like to see answered in **Wealth Adviser**, please send it through to centraladvice@wtfglimited.com.

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