Investing in funds

Why Warren Buffett is right, but so wrong

Daniel Godfrey analyses the veteran investor's advice about investing in index funds

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Warren Buffett: 'If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes' © Bloomberg

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Warren Buffett's lexicon is like the Bible: full of wisdom, but also capable of proving almost any point. On either side.

But one oft-misquoted view of the Sage that needs to be challenged is that everyone should buy index funds. Mr Buffett, in fact, is very specific in saying this applies to the S&P 500 and not to other regional or industry-specific funds. In his view, the higher costs of fancy asset allocation will be outweighed by the long-term potential for the US economy to create wealth.

If the question is, "How do you optimise the likelihood of achieving close to the index return?", the right answer will always be, "Buy an index fund".

Unfortunately, the current business model of the active fund industry also makes this the right answer to the question, "How do you optimise your likely long-term return?"

This is because the lion's share of active funds are trying to beat an index. The problem here is that it has created a perverse business model that is not only handing victory to index funds, but, more importantly, it is a significant cause of a lack of long-term wealth creation and productivity growth in the economy, and poorer returns for investors.

Setting indices as benchmarks for active funds has led to hugely negative consequences because it has corrupted the purpose of investment.

The purpose of investment could be defined as sustainable wealth creation. Success delivers long-term absolute returns to investors. But it also drives investment in human capital, leading to better jobs, supply chains, innovation, research and development, and new products. It promotes care for local communities and the environment. It will ensure focus on corporate reputation in areas such as pay inequality, tax and lobbying.

For the economy and society, the outcome is greater productivity growth, which leads to growth in the gross domestic product and the tax revenues that underpin education, infrastructure and the welfare state.

In short, what's not to love about investment? Without long-term investment and hard work, we can forget about building a society that works for the many, not just the few — an objective that is espoused by all political parties.

And yet, the business model of the investment chain that we have is focused not on sustainable wealth creation but on short-term relative return. Competition in the industry is focused on the wrong thing.

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This is what happens when your objective is to beat an index benchmark. The question shifts from "How much sustainable wealth did you create?" to "Did you beat the index?"

In this universe, the main risk for practitioners is underperforming the index by too much.

While it is impossible to beat the index every year, it is very easy to ensure you don't underperform it by very much. All you have to do is to create a portfolio of stocks in overweight and underweight quantities relative to the index and you can control tracking error very nicely.

When a manager is underweight, it means they own less than a company's weighting in the relevant index. The main reason for doing this is because they believe that this company is going to do worse than the index. It's nuts, because what they have just done is use your money to buy shares in a company that they think is going to do badly. Why? To limit their risk of underperforming the index if that company actually ends up surprising them. So it is not about your returns, it is about commercial risk.

But perhaps even worse, they have created a conflict of interest. As the beneficial owner of the shares, you don't care if you are underweight or overweight in a company. You just want its value to go up. But the manager with an underweight position actually benefits from the shares they have bought for you doing badly, because it makes their performance better — relative to the index. As that is how they are judged, that is what they do. Totally nuts!

The real disaster here is that stewardship is the one way managers can truly add value over the long term. Investment managers should be supporting, encouraging, exhorting and, if necessary, requiring the companies in which they invest to create wealth sustainably over the long term.

But, for all the focus there has been on stewardship in recent years, if active investment managers live or die by short-term relative returns, their focus will be elsewhere. The impact is profound. Research by McKinsey, the consultancy, in February this year conclusively showed that short-termism is increasing and the costs to GDP are significant.

We have a business model that is more or less entirely dysfunctional relative to purpose.

Society needs the current chain of investment to be broken and replaced by a chain that can preserve the integrity of the purpose of sustainable wealth creation.

And it starts with us. We, as consumers, need to change our behaviour so that it aligns with our interests. This means that we need to be willing to measure our investment agents on long-term absolute returns, not short-term relative performance.

Mr Buffett is wrong for the very reason he is right. Index-benchmarked, tracking-error controlled investment management, which accounts for tens of trillions of dollars globally, needs to be replaced by patient, long-term, high-conviction, high stewardship investment.

Index funds are a correct answer to the investment industry we have. But it is wrong to suggest that they are the best answer to investors' needs to optimise cumulative total return over decades.

As the Sage himself says: "If you aren't willing to own a stock for 10 years, don't even think about owning it for 10 minutes."

You ain't going to get that from an index fund.

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