Title:
Buffett's Big Bet

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Summary:
Over the past few days, there have been several stories written about Warren Buffett’s $14 billion bet on global stock markets. I believe these stories are all in reference to this excerpt form Berkshire Hathaway’s annual report:

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Keywords:
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Article Body:
Over the past few days, there have been several stories written about Warren Buffett’s $14 billion bet on global stock markets. I believe these stories are all in reference to this excerpt form Berkshire Hathaway’s annual report:

“Berkshire is also subject to equity price risk with respect to certain long duration equity index put contracts. Berkshire’s maximum exposure with respect to such contracts is approximately $14 billion at December 31, 2005. These contracts generally expire 15 to 20 years from inception. Outstanding contracts at December 31, 2005, have been written on four major equity indexes including three foreign. Berkshire’s potential exposure with respect to these contracts is directly correlated to the movement of the underlying stock index between contract inception date and expiration. Thus, if the overall value at December 31, 2005 of the underlying indices decline 30%, Berkshire would incur a pre-tax loss of approximately $900 million.”

It’s impossible to evaluate what exactly this means for Berkshire or what it tells us about Buffett’s thinking without knowing more details. But, there are a few things I’d suggest you consider when reading the news reports.

First, the $14 billion headline number makes this bet look larger than it really is. According to the above disclosure, a 30% decline in the underlying indices would only create a $900 million pre-tax loss. One article stated that a decline in the indexes to zero was highly unlikely given historical trends. It’s a lot more than highly unlikely. But, since we don’t know the details of Berkshire’s exposure, we can’t evaluate the real risk of a very large loss.

A lot of these news stories have called Berkshire’s “long duration equity index put contracts” a bet on global stock markets. A few individuals have been quoted as saying Buffett has become bullish long-term. Buffett’s always been optimistic about the very long-term insofar as he recognizes how better things are today than they have been at any other time in history, and how that is likely to remain true for some time. Despite Buffett’s concerns about nuclear war, he doesn’t see a return to the Dark Ages and those kinds of anemic returns on capital.

That’s important to keep in mind, because I’m not sure this bet is much more than that. If you assume returns on equity will be similar to those achieved in the years since industrialization began, and you assume central governments will continue to cause inflation, a long duration equity index put contract isn’t much of a stretch.

Equity will earn returns, much of those returns will be retained by the businesses, and inflation will increase (nominal) stock prices regardless of whether the underlying businesses’ assets are increasing or remaining stable.

So, I’m not sure this is a bullish sign. In fact, it may be a bearish sign, because it suggests Buffett can’t find individual equities to buy, three of the four indexes are foreign, and someone wants to be protected against very large losses in a diversified group of holdings.

Remember, someone is paying for this protection. In my opinion, it’s not the kind of protection investors need. It’s long-term protection on an index. I suppose I can see why a pension fund might want this (to increase exposure to equities), but it seems like exactly the sort of thing an insurance company can make money selling. There’s fear of a very large loss, and a lot of factors that are hard to see that will tend to make that loss pretty unlikely.

We don’t know what premiums Berkshire is receiving, so we really can’t evaluate these contracts. If someone writes hurricane insurance it doesn’t mean they think hurricanes are unlikely, it just means they think someone is dumb enough to pay more than the protection is worth. Knowing the odds of a decline in global stock markets isn’t enough to evaluate Berkshire’s contracts, because we don’t know the price.

I’m not enamored with current valuations in the U.S., but looking out a couple decades it’s not all doom and gloom. Markets tend to overshoot in both directions, but there’s usually someone sane enough to buy when stocks get cheap enough.

What’s remarkable about the way investors move stock prices isn’t the magnitude of the truly major moves (up or down); it’s the frequency of meaningful moves when there’s no meaningful changes in underlying values. Think about the price range of an average stock in an average year – that’s the really irrational part of investor behavior. I wouldn’t want to have anything to do with a one-year contract on a single stock. That’s a very different situation.