Buffett's Explicit Instructions to His Wife: Index!

It's interesting that Warren Buffett, the fourth wealthiest person in the world (according to Forbes) and one of our most successful investors, offers some sage investment advice to his adoring public that is largely ignored. His simple message to investors is to avoid trying to beat the market. His suggestion to implement a portfolio of well-diversified, low-cost mutual funds and think long-term is not well-followed by the masses.

His recent letter to Berkshire Hathaway shareholders reveals that he, upon his passing, has directed the trustee for his wife's benefit to "put 10% of the cash in short-term government bonds and 90% in a very low-cost S&P 500 index fund." Mr. Buffett goes on to say, "I believe the trust's long-term results from this policy will be superior to those attained by most investors — whether pension funds, institutions or individuals — who employ high-fee managers."[1] Buffett clearly understands the many flaws associated with active management including high costs, tax inefficiency and the inability for active managers to consistently beat the market. We applaud Mr. Buffett for his overarching message. We would sheepishly chastise Mr. Buffett for his lack of diversification amongst certain stock asset classes such as international stocks, emerging markets, small cap stocks, value stocks, etc., but again we applaud his overall theme.

Critics of indexing often cite Buffett's admirable performance versus the benchmark as a reason to be an active manager. Buffett's long-term performance is certainly impressive, but most experts consider Buffett's results an anomaly. We're guessing that Mr. Buffett thinks he himself is an anomaly based on his recommendation to index. A commonly heard rebuttal to Buffett's outstanding active performance is, "Until you wake up in the morning and see Warren Buffett in the mirror you should continue to index." We would agree! On a side note, the Oracle of Omaha's performance the last several years has been a bit ordinary. He's trailed the S&P 500 four of the last five years.

Consider this if you're still in doubt: Morningstar's most recent data shows that at the end of 2013 the average US equity mutual fund had a 10-year average return of 8.18%. Meanwhile, the average investor only earned 6.52% during that same stretch. Why the 1.66% return difference? Investors held their equity positions on average for only six months, missing out on the "ups" more than they avoided the "downs," all the while creating higher costs for themselves.

The majority of active investors, and their advisors, govern their portfolios with emotion and under the premise that they're somehow privy to information known only to them. Consequently, they trade on this perceived proprietary information. The notion that what you read in the paper or hear on a financial news network is somehow "new" information that can be leveraged to improve your portfolio returns is fundamentally flawed. By the time you hear it or read it, the information is already old and market prices have already adjusted to reflect this information in the stock price before you have the opportunity to "take advantage."

In the words of one of Buffett's more famous quotes: "Benign neglect, bordering on sloth, remains that hallmark of our investment process."

[1] 2013 Berkshire Letter to Shareholders. http://www.berkshirehathaway.com/letters/letters.html