Equities

Buffett's Alpha

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While much has been said and written about Warren Buffett and his investment style, there has been little rigorous empirical analysis that explains his performance. Every investor has a view on how Buffett has done it, but we seek the answer via a thorough empirical analysis in light of some the latest research on the drivers of returns.

We rigorously study Buffett's record, comparing it to the long-term performance of other stocks and mutual funds, and decomposing Buffett's performance into its components due to leverage, shares in publicly traded equity, and wholly owned companies.

We document how Buffett's outstanding performance is the best among all stocks and mutual funds that have existed for at least 30 years. Nevertheless, his Sharpe ratio of 0.76 might be lower than many investors imagine. While optimistic asset managers often claim to be able to achieve Sharpe ratios above 1 or 2, long-term investors might do well by setting a realistic performance goal and bracing themselves for the tough periods that even Buffett has experienced.

In essence, we find that the secret to Buffett's success is his preference for cheap, safe, high-quality stocks combined with his consistent use of leverage to magnify returns while surviving the inevitable large absolute and relative drawdowns this entails. Indeed, we find that stocks with the characteristics favored by Buffett have done well in general, that Buffett applies about 1.6-to-1 leverage financed partly using insurance float with a low financing rate, and that leveraging safe stocks can largely explain Buffett's performance.

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