Buffett's Bracket Billion
Jim Whiddon

March has truly gone mad as the inimitable Warren Buffett has teamed up with Quicken Loans to produce perhaps one of the most brilliant marketing boondoggles and at the same time one of the most bogus prize offers ever devised. And it will almost certainly work beautifully with no one to claim the reward.

The NCAA basketball tournament — otherwise known as "March Madness" — is one of the most popular and lucrative sporting events of the year. Warren Buffett is offering a billion-dollar prize for anyone who can correctly choose the winner of every basketball game in the men's tournament bracket of 68 teams.

So what is the chance of claiming this jackpot?

According to a March 6 article in USA Today, there is a one in 9.2 quintillion chance of picking a perfect bracket randomly. But not all of the game outcomes will be equally likely because in the early rounds the strongest and weakest teams are paired against each other. So even though there will be some upsets in Round 1, even someone who knows something about college hoops has only about a one in 128 billion chance of winning the billion dollars. (For the record, the ESPN online bracket contest over the past 16 years, with more than 30 million entries, has had no perfect bracket ever. I admit I play every year. I am a junky.)

The odds of picking winners in the investment world via the mutual fund "tournament" are not much better than winning Buffett's contest — practically speaking. Standard & Poor's Indices Versus Active (SPIVA) Funds Scorecard sheds some light on how difficult it is for an active manager to outperform the benchmark. We'll take a look at four asset classes to see how many funds outperformed their benchmark index over the previous year. (Investors should actually use somewhere between six and 12 asset classes in a properly diversified portfolio, including bonds. However, for our discussion, four easily makes the point).

Here are the numbers from the SPIVA study:

Percentage of Funds that Outperformed Their Benchmark	
Asset Class	**1 Year (%)**
US Large Cap	40
US Large Cap Value	28
US Small Cap Value	29
International	46

As you can see from the chart, a mere 40 percent of the active large U.S. blend company managers beat their benchmark the previous year. The other three asset classes achieved percentages of 28 percent, 29 percent and 46 percent, respectively. So what were the chances that an investor could have picked active managers who beat their benchmark indices in each of the four asset class categories for the one-year period? The calculation is as follows (assuming the percentages from the June 30 SPIVA are proxies for future probabilities and that the fund selection in each asset class is independent from one another):

.40 x .28 x .29 x .46 = 1.49%

or 1:67

Investors had less than a 2 percent chance of finding money managers that could beat the market in each of the four asset classes. Keep in mind we are not supposing we have found the best fund — just one that has beaten its benchmark index for one year.

Now since one year does not an investment horizon make, what if we wanted to pick four funds that could beat the index five years in a row? Here it is (assuming the percentages from the June 30 SPIVA are proxies for future probabilities, the fund selection in each asset class is independent from one another and that the selection in one year is independent of the selection or results in a previous year):

Five Years: 0.010 x 0.002 x 0.002 x 0.021 = 0.000000745% or 1 in 1.3 billion

So would Buffett offer the same prize money for anyone who could beat these odds? Probably not. But just like basketball fans who will dive headlong into the futile March Madness contest, many investors believe they can "beat the market" by simply choosing the winners.

As a practical matter, it is unlikely that such speculative habits would mesh with the buy-and-hold posture that is needed to patiently wait out a fund manager's poor years for even a five-year timeframe. Most investors would jump ship after one or two "bad" years thus annulling their "winning teams." This all speaks once again to the time-honored investing wisdom of using passive, evidence-based strategies to provide the best opportunity of "winning" in the long run.

So have a little fun with the NCAA bracket this month. It won't cost you anything. But when you take the same speculative chances like this with real money, the price you pay for losing can be the difference in a retirement where you watch the big game from your padded courtside chairs - or you squint through the rafters from the cheap seats.

P.S. Buffett brackets are due March 19.

About Jim Whiddon, Wealth Advisor and national thought leader for the BAM ALLIANCE

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