

Excerpted from Warren Buffett's
Annual Report 2006
Page 21-22:

In 2006, promises and fees hit new highs.

A flood of money went from institutional investors to the 2-and-20 crowd.

For those innocent of this arrangement, let me explain: It's a lopsided system whereby 2% of your *principal* is paid each year to the manager even if he accomplishes nothing – or, for that matter, loses you a bundle – and, additionally, 20% of your profit is paid to him if he succeeds, even if his **success is due simply to a rising tide.**

For example, a manager who achieves a gross return of 10% in a year will keep 3.6 percentage points – two points off the top plus 20% of the residual 8 points – leaving only 6.4 percentage points for his investors. On a \$3 billion fund, this 6.4% net “performance” will deliver the manager a cool \$108 million.

He will receive this bonanza even though an index fund might have returned 15% to investors in the same period and charged them only a token fee.

The inexorable math of this grotesque arrangement is certain to make the Gotrocks family poorer over time than it would have been had it never heard of these “hyper-helpers.” Even so, the 2-and-20 action spreads.

Its effects bring to mind the old adage: When someone with experience proposes a deal to someone with money, too often the fellow with money ends up with the experience, and the fellow with experience ends up with the money.

* * * * *

Let me end this section by telling you about one of the good guys of Wall Street, my long-time friend Walter Schloss, who last year turned 90.

From 1956 to 2002, Walter managed a remarkably successful investment partnership, **from which he took not a dime unless his investors made money.**

Excerpted from Warren Buffett's *Annual Report 2006*

Page 21-22:

My admiration for Walter, it should be noted, is not based on hindsight. A full fifty years ago, Walter was my sole recommendation to a St. Louis family who wanted an honest and able investment manager.

Walter did not go to business school, or for that matter, college. His office contained one file cabinet in 1956; the number mushroomed to four by 2002. Walter worked without a secretary, clerk or bookkeeper, his only associate being his son, Edwin, a graduate of the North Carolina School of the Arts.

Walter and Edwin never came within a mile of inside information. Indeed, they used “outside” information only sparingly, generally selecting securities by certain simple statistical methods Walter learned while working for Ben Graham. When Walter and Edwin were asked in 1989 by *Outstanding Investors Digest*, “How would you summarize your approach?” Edwin replied, “We try to buy stocks cheap.” *So much for Modern Portfolio Theory, technical analysis, macroeconomic thoughts and complex algorithms.*

Following a strategy that involved no real risk – defined as permanent loss of capital – Walter produced results over his 47 partnership years that dramatically surpassed those of the S&P 500. It's particularly noteworthy that he built this record by investing in about 1,000 securities, mostly of a lackluster type. A few big winners did not account for his success.

It's safe to say that had millions of investment managers made trades by a) drawing stock names from a hat; b) purchasing these stocks in comparable amounts when Walter made a purchase; and then c) selling when Walter sold his pick, the *luckiest* of them would not have come close to equaling his record.

There is simply *no* possibility that what Walter achieved over 47 years was due to chance. I first publicly discussed Walter's remarkable record in 1984. At that time “efficient market theory” (EMT) was the centerpiece of investment instruction at most major business schools.

Excerpted from Warren Buffett's *Annual Report 2006*

Page 21-22:

This theory, as then most commonly taught, held that the price of any stock at any moment is not demonstrably mispriced, which means that no investor can be *expected* to overperform the stock market averages using only publicly-available information (though some will do so by luck).

When I talked about Walter 23 years ago, *his record forcefully contradicted this dogma.* And what did members of the academic community do when they were exposed to this new and important evidence?

***Unfortunately, they reacted in all-too-human fashion
Rather than opening their minds, they closed their eyes.***

To my knowledge *no* business school teaching EMT made any attempt to study Walter's performance and what it meant for the school's cherished theory. Instead, the faculties of the schools went merrily on their way presenting EMT as having the certainty of scripture.

Typically, a finance instructor who had the nerve to question EMT had about as much chance of major promotion as Galileo had of being named Pope. Tens of thousands of students were therefore sent out into life believing that on every day the price of every stock was "right" (or, more accurately, not demonstrably wrong) and that attempts to evaluate businesses – that is, stocks – were useless.

Walter meanwhile went on overperforming, his job made easier by *the misguided instructions that had been given to those young minds.* After all, if you are in the shipping business, it's helpful to have all of your potential competitors be taught that the earth is flat.

Maybe it was a good thing for his investors that Walter didn't go to college.