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Hadas: Enough with the cult of Warren Buffett

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LONDON (Reuters Breakingviews) - Warren Buffett has become a cult object. The 86-year-old chairman of Berkshire Hathaway is venerated for his tremendous investment returns, as well as his folk wisdom and cheerleading for America. But the sage of Omaha deserves as much criticism as adulation.

Warren Buffett, chairman and CEO of Berkshire Hathaway, speaks at the Fortune's Most Powerful Women's Summit in Washington October 13, 2015. REUTERS/Kevin Lamarque

Over the years, Buffett's stellar reputation has slipped a bit. That's fair on two counts. First, no amount of good-humoured self-deprecation can hide the inability to keep investment returns at the same impressive level at Berkshire Hathaway's ballooned market value of \$420 billion. Buffett and his small team may still be good, but their wonder-working days are over.

Back in 2002, the annual total return on Berkshire Hathaway common stock for the previous decade was 20 percent, an astounding 10.6 percentage points higher than the S&P 500 Index. By 2016, the annual gap had shrunk to 1.3 percentage points. That's far better than most active fund managers, but not enough to qualify for oracle status.

Second, while his returns are falling, Buffett's hypocrisy is rising. He keeps playing in the derivatives market, despite calling such instruments "financial weapons of mass destruction". More seriously, his backing for the slash-and-burn style of the Brazilians behind Kraft Heinz – Berkshire owns 27 percent of the company – belies his longstanding reputation as a friend of careful bosses who invest for the long term.

The biggest problem with the cult of Buffett, however, is not at all new. From the beginning, his single-minded interest in beating the market has added little to the economy. It is a poor model for financial capitalism.

When economists try to explain why finance helps the economy, they emphasise the importance of new capital. Companies can use money lent by banks or invested by shareholders to develop new products, build new factories or deliver new services. The financial system is supposed to be a valuable supplement to the main source of funding for investments, the retained profit of existing businesses.

In these explanations, the pro-finance economists have to deal with the awkward fact that most of the activity in both public and private financial markets has little to do with raising new productive capital. In particular, trading in shares of established companies cannot create anything new or valuable for the whole economy.

This activity does offer liquidity to investors, and the ability to sell easily might conceivably encourage investors to provide more capital. Or there may be some value in having outside investors who put pressure on managers. But those are pretty flimsy reasons to laud a zero-sum game. For every percentage point of one investor's outperformance, there has to be a percentage point of underperformance by some other investors. It is a wash for the economy.

That is exactly the game the Buffett has been so good at. Though in his most recent letter to shareholders, he tries to dispel what he considers to be a misapprehension that Berkshire Hathaway ever intends to keep stocks forever, his trick has been to buy low and mostly hold on. He was and probably still is good at finding opportunities, but Buffett's relative gains were inevitably the relative losses of others.

To his credit, Buffett has not squeezed the companies Berkshire Hathaway owns and backs to spew out the maximum cash possible. His hands-off style may even have allowed some of them to invest a higher portion of their profit than, say, some private-equity firms would have countenanced. He boasts in the missive sent on Saturday that Berkshire "ranked first among American businesses in the dollar volume of earnings retained". And although his conglomerate plowed some \$13 billion into capital expenditures for operating businesses last year, it was nearly a fifth less than in 2015.

Still, Buffett's favourite type of company is as likely to harm as to help the social-economic fabric. He prefers enterprises with pricing power or friendly regulators, but which do not have to take big risks with rapidly changing technology or fickle tastes. In other words, he likes efficient companies which operate in inefficient markets.

The aborted Kraft Heinz bid for Unilever, warmly backed by Berkshire Hathaway, is typical. The would-be acquirers planned to slash costs far more than prices. Even if they wanted to maintain the Anglo-Dutch target's carefully cultivated image as a friend to developing

economies and a supporter of healthy living, the largest portion of any gains would have accrued to investors. Customers would be toward the bottom of the priority list.

Berkshire Hathaway has provided new capital on occasion, most notably during the financial crisis. It extracted excellent, not to say extortionate, terms from Goldman Sachs, General Electric and Bank of America. But the large subsequent gains largely came because the Federal Reserve and U.S. taxpayers stumped up to save the financial system from self-destruction. Buffett, who describes America's "economic dynamism" as "miraculous", looked more like a profiteer than a hero.

The Buffett-worship among investors is based on beating the market, not helping the economy. The enthusiasm would be harmless if investing had no more social importance than, say, football. There is, however, currently a populist fury against a system that does less to promote growth than to augment the wealth of insiders. This is no time for playing games.

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