BY WARREN E. BUFFETT

EARLY FEARS ABOUT INDEX FUTURES

One of America's best investors warned in 1982 that stock index futures were bad news for the markets.

■ *Buffett wrote the following letter to John Dingell, chairman of the House subcommittee on oversight and investigations, in March 1982 when Congress was considering whether to allow the Chicago Mercantile Exchange to trade futures contracts tied to the level of stock indexes such as Standard & Poor's 500. Some critics argue that futures trading helped feed the October 19 stock market crash. Buffett stands by the views he expressed five years ago.*

This letter is to comment upon the likely sources for trading activity that will develop in any futures market involving stock indexes. My background for this commentary is some 30 years of practice in various aspects of the investment business, including several years as a securities salesman. The last 25 years have been spent as a financial analyst, and I currently have the sole responsibility for an equity portfolio that totals over $600 million.*

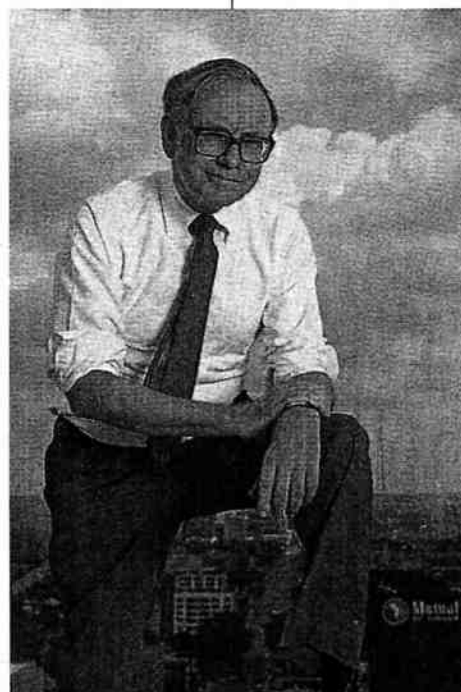
It is impossible to predict precisely what will develop in investment or speculative markets, and you should be wary of any who claim precision. I think the following represents a reasonable expectancy:

(1) A role can be performed by the stock index future contract in aiding the risk-reducing efforts of the true investor. An investor may quite logically conclude that he can identify undervalued securities, but also conclude that he has no ability whatsoever to predict the short-term movements of the stock market. This is the view I maintain in my own efforts in investment management. Such an investor may wish to "zero out" market fluctuations, and the continual shorting of a representative index offers him the chance to do just that. Presumably, an investor with $10 million of undervalued equities and a constant short position of $10 million in the index will achieve the net rewards or penalties attributable solely to his skill in selection of specific securities, and have no worries that these results will be swamped—or even influenced—by the fluctuations of the general market. Because there are costs involved—and because most investors believe that, over the long term, stock prices in general will advance—I think there are relatively few investment professionals who will operate in such a constantly hedged manner. But I also believe that it is a rational way to behave and that a few professionals, who wish always to be "market neutral" in their attitude and behavior, will do so.

(2) As previously stated, I see a logical risk-reducing strategy that involves shorting the futures contract. I see no corresponding investment or hedging strategy whatsoever on the long side. By definition, therefore, a very maximum of 50% of the futures transactions can be entered into with the expectancy of risk reduction, and not less than 50% (the long side) must act in a risk-accentuating or gambling manner.

(3) The actual balance would be enormously different from this maximum fifty-fifty division between risk reducers and risk accentuators. The propensity to gamble is always increased by a large prize vs. a small entry fee, no matter how poor the true odds may be. That's why Las Vegas casinos advertise big jackpots and why state lotteries headline big prizes. In securities, the unintelligent are seduced by the same approach in various ways, including: (a) "penny stocks," which are "manufactured" by promoters precisely because they snare the gullible—creating dreams of enormous payoffs but with an actual group result of disaster, and (b) low margin requirements through which financial experience attributable to a large investment is achieved by committing a relatively small stake.

(4) We have had many earlier experiences in our history in which the high total commitment/low down payment phenomenon has



BONNIE SCHIFFMAN—ONYX

WARREN E. BUFFETT, *one of the most successful investors ever, is chairman of Berkshire Hathaway, an Omaha company with large holdings in Capital Cities/ABC, Geico, Washington Post, and others.*

*It is now worth more than $2.5 billion.

can happen to a broker in terms of his immediate income. A great deal of money will be left behind by these 95% as the casino takes its bite from each transaction.

(7) In the long run, gambling-dominated activities that are identified with traditional capital markets, and that leave a very high percentage of those exposed to the activity burned, are not going to be good for capital markets. Even though people participating in such gambling activity are not investors and what they are buying really are not stocks, they still will feel that they have had a bad experience with the stock market. And after having been exposed to the worst face of capital markets, they understandably may, in the future, take a dim view of capital markets generally. Certainly that has been the experience after previous waves of speculation. You might ask if the brokerage industry is not wise enough to look after its own long-term interests. History shows brokers to be myopic (witness the late Sixties); they often have been happiest when behavior was at its silliest. And many brokers are far more concerned with how much they gross this month than whether their clients—or, for that matter, the securities industry—prosper in the long run.

WE DO NOT NEED more people gambling in nonessential instruments identified with the stock market in this country, nor brokers who encourage them to do so. What we need are investors and advisers who look at the long-term prospects for an enterprise and invest accordingly. We need the intelligent commitment of investment capital, not leveraged market wagers. The propensity to operate in the intelligent, prosocial sector of capital markets is deterred, not enhanced, by an active and exciting casino operating in somewhat the same arena, utilizing somewhat similar language and serviced by the same work force.

In addition, low-margined activity in stock equivalents is inconsistent with expressed public policy as embodied in margin requirements. Although index futures have slight benefits to the investment professional wishing to "hedge out" the market, the net effect of high-volume futures markets in stock indexes is likely to be overwhemingly detrimental to the security-buying public and, therefore, in the long run to capital markets generally. ■