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Buffett Makes $14 Billion Bet That Global Stocks Won't Plunge

April 3 (Bloomberg) -- Warren Buffett, struggling to find acquisitions big enough to boost Berkshire Hathaway Inc.'s returns, is making a $14 billion bet on the global stock market.

Berkshire sold a form of insurance to buyers who wanted protection from a drop in ``four major equity indexes'' over the next 15 to 20 years, according to a U.S. Securities and Exchange Commission filing. Instead of buying the individual shares, Buffett is wagering the indexes, three of which are outside the U.S., won't tumble and force Omaha, Nebraska-based Berkshire to pay a claim.

The ``long-duration equity index put contracts'' are among the largest transactions Berkshire has disclosed, and they represent the kind of risk that Buffett, the company's chief executive officer, and Vice Chairman Charles Munger are turning to more often as undervalued companies get harder to find. Buffett calls such investments, including stakes in oil derivatives, silver and zero-coupon bonds, ``unconventional.''

``They figured out a very interesting strategy that basically nobody else can do because of their size and long- duration capital,'' said David Winters, who manages $400 million at Wintergreen Advisers LLC in Mountain Lakes, New Jersey, and has held Berkshire stock for his own account for more than a decade. ``Buffett and Munger have made the ultimate contrarian play here. They take a premium in today and they're willing to buy securities if markets really plunge.''

Buffett, 75, has become the world's second-richest person largely by buying stocks he considered undervalued, such as Coca- Cola Co., Gillette Co., Wells Fargo & Co. and American Express Co., and holding them for years.

`Maximum Exposure'

The stock-index contracts, derivatives that function like put options, increase Berkshire's risks from market losses. A 30 percent decline in each of the indexes last year would have led to a $900 million pretax loss for the company, according to the March 7 SEC filing. Berkshire's ``maximum exposure'' was about $14 billion at the end of last year, the filing said.

Berkshire didn't disclose which stock indexes are covered under the contracts, how they're structured, who bought them or how much Berkshire was paid. Berkshire Chief Financial Officer Marc Hamburg didn't return telephone calls seeking comment. Buffett's assistant, Debbie Bosanek, declined to comment.

For Berkshire to lose the $14 billion that the company says is at risk, all four indexes covered by the puts would have to fall to zero, according to Gary Gastineau, managing director of ETF Consultants LLC, a research firm in Summit, New Jersey. That's unlikely given historical trends.

The S&P 500, the benchmark index for U.S. stocks, has generated a positive return over any 25-year period since 1925, assuming dividends are included, according to a 2002 study by Ned Davis Research Inc. in Venice, Florida. Since the beginning of 2002, the index has generated a total return of about 22 percent.

`Mass Destruction'

``Over long periods of time, stock markets generally go up,'' said David Blitzer, chairman of S&P's index committee. ``Japan was obviously an exception if you chose the wrong 12 years.''

Japan's Nikkei 225 index dropped in eight of the 12 years from 1990 through 2001 for a total decline of 73 percent. During the 25-year period ending in 2001, the Nikkei was still up 111 percent.

Buffett has been a critic of derivatives, financial obligations whose value is tied to the price of underlying assets such as stocks, debt or oil. In 2003, he called them ``financial weapons of mass destruction'' in a letter to Berkshire shareholders, and since 2002 Berkshire has been unwinding the derivatives positions at the securities unit of its General Re Corp. subsidiary.

Credit-Default Swaps

Still, Berkshire, controlled by Buffett since 1965, continues to use derivatives to take on financial risks of its own. The March 7 filing said it had $801 million of derivative- contract assets and $5.06 billion in liabilities as of Dec. 31. That included $35 million of assets and $1.59 billion in liabilities on equity-option contracts with a notional value of about $14.5 billion.

In addition to the equity-index options, Berkshire disclosed in the filing that it sold a similar type of insurance on bonds known as credit-default swaps. In those contracts, also derivatives, Berkshire bet the bond issuers won't default.

``Berkshire utilizes derivatives in order to manage certain economic risks of its businesses as well as to assume specified amounts of market and credit risk from others,'' the company said in the filing.

By 1999, the year after Berkshire bought General Re for $17.6 billion, Buffett said his ``search for large equity investments'' was finding ``nothing on the horizon.''

Bet Against S&P

Buffett made an opposite bet on the stock market in 2002, when he bought put options on the Standard & Poor's 500, anticipating the index would fall by the time the contracts came due that June. The S&P declined, meaning Berkshire stood to collect $60 million.

The same year, Buffett and Munger, 82, started to speculate that the widening U.S. trade deficit would weaken the dollar. Berkshire has since reaped $2 billion of investment gains on as much as $21.8 billion in foreign-currency forward contracts.

Short-term equity index options are widely available, and S&P 500 contracts are the most active on the Chicago Board Options Exchange. The options sold by Berkshire, which expire in 15 to 20 years, may not be available anywhere else, said Bob Gordon, president of Twenty-First Securities Corp., a New York- based brokerage that specializes in hedging.

The longest index option traded on the CBOE is for three years, though investors can arrange for customized contracts from the exchange that extend as long as a decade. Most securities firms that write custom derivatives won't enter into contracts for more than five years, Gordon said.

Just Like Insurance

Berkshire would compensate buyers in the event the stock indexes fall below a predetermined value over the life of the contracts. In exchange, Berkshire gets a fee or premium for providing the hedge against declines.

``It's really no different than selling insurance,'' Gordon said. ``If anybody should be in the business of selling puts, it should be an insurance company.''

Berkshire subsidiaries sell reinsurance contracts to other insurers on catastrophes such as earthquakes, hurricanes and wind storms. They also specialize in coverage of one-of-a-kind risks, such as insuring Chicago's Sears Tower after the Sept. 11 attacks and underwriting the $1 billion prize in a PepsiCo Inc. promotional contest.

Berkshire's customers for the index contracts probably were pension funds or insurers that hold stocks for long periods, said Michael Morrissey, CEO of Santa Fe, New Mexico-based Firemark Advisors, which specializes in insurance stocks. Holding the puts would limit a pension fund's risk of losses in a stock-market crash, allowing it to invest more in equities, which tend to outperform bonds over time, he said.

``Some long-duration asset manager thought of Buffett's combination of deep pockets and investment creativity and thought they might be able to work something out with him,'' Morrissey said.

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