

Jeremy Grantham's Warnings to Investors

By Robert Huebscher

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Of the thousands of investment letters penned in the industry, only one draws as much readership as Warren Buffet's annual letter to his shareholders: The quarterly commentary written by Jeremy Grantham.

Grantham, the Chairman of the Boston-based investment firm Grantham Mayo Van Otterloo, was a featured speaker at Morningstar's Investor Conference last week, and he spoke at two breakout sessions. Those who, like me, attended both were richly rewarded, as he gave two distinctly different talks, addressing many subjects not covered in his commentaries.

Grantham's March quarterly commentary was titled "Reinvesting When Terrified," which he says he wrote for himself – not for anyone else. Beginning in February, he sensed a déjà vu of 1974, when he felt he had lost the power to make changes. That bear market, like the most recent one, "hugely reinforced" the resolve of those who held cash as the market when down, and left those fully invested praying for a miracle.

He concluded there was only one answer: follow a simple battle plan ("plans that are too fancy mess you up") where the key decision was how cheap the market would have to get for investors to "throw in all they have." Otherwise, he said, if market opportunities evaporate, so does enthusiasm.

Grantham's 2009 battle plan

But Grantham did not advocate "throwing in" everything at once, instead recommending a three-step plan, gradually increasing equity allocations to their normal levels as the market neared its target valuation.

In his standard asset allocation accounts, for 19 of the last 20 years he maintained a 50% allocation in global equity, to facilitate the marketing of his funds. By October of 2008, the market had declined to his first trip point, and he increased equity allocations by 7.5%. Later that year, when the S&P hit 740, it reached his second trip point, and Grantham increased equities by another 7.5%. The final move occurred very close to the market bottom, when the S&P reached 666.

Grantham almost over-weighted US and global equities, which he said were overpriced for most of last 20 years, and were close to becoming undervalued.



Grantham called this discipline “Plan A,” which he said was absolutely critical. “Most of us fail and are left behind. That’s what I was writing about – when you are left behind it causes panic.”

Those who fail at Plan A must follow Plan B: “You take a deep breath, recognize you lost round one, and plan to take a year to 15 months and average into the market,” he said. “Give the market plenty of time to have second thoughts. You may win a few months and lose a few months.”

Locking yourself in – staying in cash – and praying for a major setback is a mistake which Grantham called “regret minimizing.” On the other hand, if you barrel in, you are exposed to the market overcorrecting. “Either way you are screwed,” he said. “You have to balance those regrets. That is the real world.”

Investing based on bubbles

Grantham’s plans for timing his equity exposure belie his true investing style. “Normally,” he said, “we do nothing.” He waits for extreme outliers and then “whacks them.” He will patiently “sit around” and wait for outliers and “silly things.” “I have been blessed by many incomprehensible things. In time they will be less ridiculous and eventually will be normal,” he said.

Outliers are identifiable only in the context of fair value, a core principle of Grantham’s investment philosophy. “Fair value is like gravitation pull; it is not very powerful but is absolutely unrelenting. Everything catches up and eventually reaches fair value.”

“It’s incredibly easy to see the outliers,” he said “but we don’t do much when they are only 10 or 20 percent away from fair value.” He might underweight an asset a little bit, but will hold back his “fire power” until the divergence increases.

For a long time, Grantham was puzzled by an apparent paradox. He acknowledged that the movement to fair value is unreliable over periods as short as one year. So, how can this movement be reliable over many years, which are nothing more than the sum of one year periods?

A powerful analogy resolved the paradox, and showed Grantham how something can be certain in the long run but dangerous in the short run. If you go to Florida in a hurricane and stand on top of a building with a bag of feathers and throw them in the air, some will hit the ground two or three blocks away. But some will go all the way to Maine in eight or nine days.

“Amongst that swirling uncertainty, every feather will hit the ground,” he said. “We are in the feather predicting business. Every bubble will hit the ground and, unlike that analogy, some will bury themselves deep in the ground.”



Grantham said high-quality growth stocks are the only mispriced asset class today. These companies are debt-free, as opposed to companies at the bottom which are burdened with massive debts.

“The only things that matters in life are the bubbles. The rest of the time just show up for work,” he said.

Career risk and the business of investing

During the height of the Tech Bubble, when the market P/E was 31, Grantham asked 1,200 equity professionals: if P/E ratios go back within 10 years to below 17.5, will it guarantee a major bear market? They responded unanimously “Yes.” He then asked how many think such a move will occur. Only seven of those professionals believed it would *not* come back down. A staggering 99% believed in data guaranteeing a major bear market, but were apparently unwilling to communicate this to their clients.

“Those running the engine rooms knew this, but not their clients. This was a betrayal of trust,” Grantham said. “If those in the engine room squeaked publicly that there was going to be a major bear market, they were through.” He noted that Goldman Sachs’ Abby Cohen was the icon of that group, but she was not alone. The spokespeople of major investment firms were bullish, with almost no exceptions.

“It is not good for business to be bearish. In general, our industry was not bearish, because it understands how to make money,” Grantham said. He called the rationalizing of 35-times earnings “simply splendid.” “You can’t deliver the hard truth and prosper,” he said. Paraphrasing Keynes, Grantham said “if you’re right on your own it’s a bit dangerous, when you are wrong on your own will not receive much mercy.”

His advice, which underlies his investment philosophy, is to look and see what everyone else (brokers, institutions, mutual funds) is doing and do the same, but be quicker and slicker on the draw. “We are not picking winners in beauty contest; we are picking what others will pick.”

Markets move in herds, and Grantham said every single asset class is driven by momentum. “In the long run the economic fundamentals do matter, but the problem for the long-term fundamentalist is that the feathers fall at different rates. The force that drives this, though, is overwhelming and gravitational.”

Sometimes the movement to fair value takes longer than the institutional client’s “3.0 years of patience. That career risk makes that game so difficult to play.”

“There is a lot of career risk in moving assets.” Grantham said endowments, foundations, and pension funds knew market was overpriced and dangerous prior to



2008 and have paid a huge price. “Jeremy Siegel is never right [about stocks for the long run], despite what people hope.” Siegel’s mistake is not recognizing that valuations drive returns. He said “stocks for the long run” was a “very dangerous contribution.”

Markets have a pyramid-like structure. At the bottom are “little stocks” which carry very little career risk. “It is not easy to lose your job picking insurance company stocks,” Grantham said. But once you start betting on oil stocks against insurance stocks your head is on the block. The risks go up as the decisions go to the asset sub-class and asset class levels. “The killer is at the top, when you must decide between equities and cash,” he said. “Then, life expectancy drops quickly.”

Grantham reduced investing to a “battle between career risk and avoiding herding.”

P/E ratios and presidential election cycles

Understanding herding is central to forecasting price movements, but it is not the only cause of mispriced markets. Grantham closely monitors P/E ratios and profit margins which, in a rational world, would be inversely related – when margins are high, P/E ratios should be low, and vice versa. That has not been the case, as the two variables have a positive correlation of .32. “The market can’t even get the sign right,” Grantham said.

During the five years ending 2007, GDP grew at a faster rate than at almost any time previously, mostly driven by the BRIC economies. But P/E ratios remained elevated. Conversely, in 1982 profit margins were at their nadir, but so were P/E ratios.

Presidential election cycles strongly influence markets. Grantham showed that US markets have registered inflation-adjusted total performance of -3.4%, -10.1%, 15.3% and -0.3% in years one, two, three and four of presidential terms since 1932. His explanation is that by the third year in office, US presidents have figured out what is important and actually get it done. In tandem, the “completely independent” Fed makes money freer and rates lower, but this alone does not drive the 25 percent difference between years two and three. In addition, investors benefit from moral hazard; if they speculate in years one and two, they lose. But by year three, presidents will bail them out, even if inadvertently so.

Overall, Grantham respects the power of the Fed, which he said “rules the way everywhere and is the dominant force in the world.”

Seven lean years and the risks ahead

Where are we today? “Global equities are within noise levels of normal,” Grantham said, which is the case only about 20% of the time. But he is not willing to commit to



normal equities allocations, because of a series of fears which he collectively labeled the “seven lean years” – “a series of long, slow burning negatives.”

Grantham’s concerns begin with the big imbalance between over-consuming countries, such as the U.S. and the U.K., and over-saving countries – Japan, China, and Germany. As a result, the great deficit created by the U.S. has flooded the market with dollars that have been monetized, creating deficits elsewhere around the world.

Grantham lamented that consumers are not as rich as they thought they were, as a result of the residential housing and stock market collapses, which he fears will be followed by a collapse in the commercial real estate market over the next six months. “We missed a decade of savings,” he said, which will not be recovered. “We just have to work longer and learn to have a more frugal retirement.” Frugality will be an important theme for investors, as he believes vendors like Wal-Mart are far better positioned than luxury providers like Maseratti.

Our political and financial institutions have done a “disastrous” job of managing the crisis, and the loss of confidence in these institutions will erode growth. Grantham called out the Fed, Treasury and SEC for encouraging crime, such as when they beat back attempts by the Chicago Board of Trade to control subprime lending.

Grantham cited the adage that capitalism works best when there is a policeman on the corner, but the policeman was taken away when the Glass-Steagall Act was repealed in 1999. He faulted former Fed Chairman Alan Greenspan for encouraging this repeal, which Greenspan said would increase the safety of the financial system.

For Grantham, no failure was as great as that of political leadership during the peak of the housing bubble. “The housing market had been a flat plain that rose to a Himalayan peak,” Grantham said. While he and others warned of a bubble, Bernanke said that the U.S. housing market merely reflects strong demand. “I have no idea what he was thinking, other than the possibility that he believes so much in market efficiency that bubbles are impossible,” Grantham said.

As for former Treasury Secretary Henry Paulson, Grantham said he – more than anyone – understood the inferior quality of the securitized debt instruments. Paulson should have “done some arm-twisting” early on, before AIG ran into trouble, and forced institutions to raise capital. Paulson should have delivered an ultimatum: raise capital and be the government’s friend or else institutions would be on their own.

In April of 2007, when Paulson said “the subprime problem seems to be contained,” Grantham wrote in his quarterly commentary at the time that the container is likely to be Pandora’s.



“Our institutions have been incredibly badly led and it should make us nervous about the future,” he said.

Next on Grantham’s list of worries is a scarcity of resources, which include demographic shifts which are shrinking our workforce to the depletion of raw materials, all of which will squeeze profits.

“China and India together have caused us to enter a new era,” he said. Real prices of commodities are rising, following decades of decline. “We are running out of everything.” He believes there will be plenty of cheap energy, since higher prices spur the development of new sources. But supplies of every mineral, oil, coal and arable land will run out, after which “we will be on our own using our brains.”

The market outlook

Grantham compared the current market to the 1970s when he made a lot of money, but warned that investors must recognize we are in a range-bound market.

His team does a forecast every month, and project returns by asset class over a seven-year period. Just over 10 years ago, in September of 1998, they forecast real returns of -1.1% for the S&P 500 and 10.9% for the emerging markets. This 12-point gap translated to a 310-to-1 performance advantage by picking the right asset class.

Grantham faulted institutions that spend time chasing alpha through mutual fund or security selection, questioning how many correct choices they must make to improve performance. “Big asset classes drive success and are very inefficiently priced – amazingly inefficiently priced,” he said.

Current bearish sentiment is fueled by analysis which projects S&P valuations based on comparisons to historical markets. If the market follows the path of the Great Depression, the S&P will bottom at 300. The equivalent for the 1974 bear market is 450, and the 1982 market’s equivalent is 400.

“You can see why there are bears,” Grantham said, but added he has “parted with the bears.” He has more confidence in the resilience of economies than they do, based on the experiences of Germany and Japan after World War II. “We are not the delicate flower that the bankers tell us we are. We can handle a couple of Lehman-like bankruptcies,” he said.

“What separates me from the bulls are the seven lean years,” Grantham said, noting that his sentiment lies between the bulls and the bears.

He is markedly optimistic about the long-term prospects for the US economy. “Debt doesn’t matter – it’s just an accounting entry and not real life,” he said. “Unless you



blow up factories, the economy will come roaring back.” He expects the developed economies to grow at 2.4%, but emerging markets to grow at 4%.

He warned of an emerging emerging market bubble, and cautioned investors that there is no connection between making money and top-line GDP growth. Leaders in those markets have objectives, such as protecting jobs, which may conflict with maximizing shareholder return. “You make money in companies through the filter of return on equity,” Grantham said, and not by betting on high growth economies.

“China will achieve monster GDP growth, but there is no guarantee at all that it has anything to do with the returns you will make on Chinese stocks,” he said. The only correlation to high returns is investing at a low starting value.

Grantham hates gold as an asset class, and never invested in it until last fall, when he broke his vows and bought some because he thought a state of panic was about to unfold. “I was perfectly right, but I still lost money,” he admitted.

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