James Grant: A Positive Lesson from the Great Depression

By Susan B. Weiner, CFA
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Great price tags on a number of investments are the silver lining of the current recession, according to James Grant, founder of *Grant's Interest Rate Observer.*

Grant shared his "Thoughts on the Financial Markets and the Current State of the Economy" with the Boston Security Analysts Society on February 11. He spoke at length about the virtues of value investing, as exemplified by the Depression-era strategies of Floyd Odlum of Atlas Corporation.

Today's investors can learn from Odlum's strategy of underpaying for assets, Grant said.

Odlum and Atlas Corp.: Bad economic times offer opportunities

Odlum, Grant explained, was a master of finding opportunities. "We can have no finer role model," Grant said. "First and foremost, he was a value investor — a member of that eccentric tribe that believes it's better to underpay than to overpay."

Odlum made a fortune during the Great Depression by buying publicly traded shares of investment trusts (predecessors of today's closed-end mutual funds) at a steep discount. It's a strategy that Grant called "buying dollar bills at 50 cents." Odlum would buy an entire investment trust, liquidate its assets at a profit, then repeat the process with more trusts. He did this 22 times from 1930 to 1933, doubling his investment from roughly $50 million to $100 million.

Grant doesn't recommend that investors follow Odlum's strategy exactly. For one thing, the values of closed-end funds haven't fallen as much as they did during the Great Depression. Odlum bought investment trusts at discounts to net asset value of more than 40%. By contrast, closed-end funds sold at a discount of only 6.1% at the end of January, down from a recent peak of 26% on October 10.

Odlum's tactics would also be illegal today, because he secretly bought out fund directors at a premium to enlist their help in getting minority shareholders to sell.

But Odlum would still find opportunities in today's environment, said Grant, because "great investors adapt to the times," and the core tenets of Odlum's investment philosophy still apply today.

"Odlum was bullish on America, as many of us are — and ought to be," Grant said. "But he put money on it only when he was sure of the odds." That meant paying a price low enough to create a margin of safety.

"That was the silver lining of the Great Depression — plenty of great price tags," Grant said. He sees opportunities today as well, though fewer than in the 1930s.

Applying Odlum's lessons today

"Odlumites … are looking under every available rock for opportunity," Grant said. Like Odlum, he's seeking opportunity with a margin of safety at a good price. That translates into buying "low-priced options on … certain events of unlikely timing." Low prices limit investors' downside risk.

One certainty is inflation — Grant doesn't have much faith in central bankers. "We expect that neither the Fed nor the Reserve Bank of Zimbabwe nor the Swiss National Bank will shut down the printing presses in a timely fashion to skirt major new inflation," he said.

Grant sees opportunities in several places, including gold, fixed income, and stocks. "Gold isn't merely a refuge against inflation. It's principally a refuge against monetary disorder," Grant said.

About 18% of his business balance sheet is in gold, he said. He believes there will be a flight from paper money because it will be debased by central bankers increasing the money supply. "I feel sure the dollar will go through the wringer," he said.

Fixed income is currently priced for bad events that aren't likely to happen, Grant said. Grant likes value-priced residential mortgage-backed securities (RMBS), convertible bonds, and leveraged loans. For example, three years ago RMBS were priced as if no homeowner would ever default, Grant said. Now they've gone to the opposite extreme, with some tranches priced to break even if losses rise to the 60% range.

Yields are attractive, Grant said, because "through brute regulatory force and the power of the printing press, we expect credit will skirt the abyss." He believes in the traders' axiom that "there are no bad bonds, only bad prices." In other words, just about any bond is attractive at the right price.

Grant likes the underpriced common stock of companies that will eventually benefit from developments under way. For example, energy prices will rise again due to inflation, he said, and raw materials producers are curtailing their investments. Grant said Natco Group (NTG), a producer of oil wellhead process equipment and related services, is a potential beneficiary. In his Jan. 23 newsletter he quotes *Grant's* analyst Dan Gertner saying, "In 2007, Natco was priced for a never-ending bull market in crude oil; today, it is priced for a large portion of society living in peat-heated caves."

"There are increasingly compelling bargains in securities markets," Grant said. But there are also some overpriced investments. He expressed concern that investors are pursuing the wrong opportunities. "*The Wall Street Journal* can't stop talking about toxic mortgages and super-safe Treasuries," he said, "but could it be the reverse?"

Grant is puzzled by human nature. "We humans seek … bargains at the mall, but shun them on Wall Street." It's too bad more investors won't learn the lesson taught by Floyd Odlum.

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