ADVISOR PERSPECTIVES

GMO: Two Questions We Can't Answer

By Robert Huebscher
March 27, 2012

Its reputation was built on stellar returns achieved with long-term bets on undervalued asset classes. Current market conditions, however, pose two unanswerable questions for Grantham, Mayo, van Otterloo (GMO) – leaving the firm with an uncertain strategy for its equities and fixed-income allocations.

Those questions have arisen because GMO foresees unattractive performance from both stocks and bonds in the next seven years, the time horizon over which the firm has traditionally forecast asset class performance. Ben Inker, the head of asset allocation at the Boston-based GMO, spoke at a Boston Security Analyst Society seminar on trends in asset allocation last Tuesday.

Given negative real interest rates, Inker said the first of those two questions is that it is not clear what role bonds should play in a portfolio. Second, is not clear that investors should overweight stocks, just because bonds are unattractive.

As a result, he said, GMO has upped its allocation to cash.

Let's look at GMO's outlook for bonds and stocks and at the reasons Inker cited for increasing its cash position. I'll also review why there is only one commodity resource in which GMO is willing to invest.

GMO's capital market outlook

GMO employs a straightforward methodology to project asset class performance, which I've described previously. Its forecasts are based on certain key metrics – P/E ratio, profit margin, sales growth and dividend yield – that GMO believes will revert to their mean over a seven-year time horizon.   Given that those variables are known today, anticipating future returns is a simple matter of assuming that these measures will revert to their historical means and calculating the implications.

GMO's forecasts have been remarkably accurate. Inker said that, over the last 10 years, it had ranked asset classes correctly by their relative performance with 94.5% accuracy. "The stuff that was cheap proceeded to do well," he said, "and the stuff that was expensive proceeded to do badly."

Moreover, correlations between asset classes proved largely irrelevant, he said. Over long periods of time, the performance of asset classes can diverge widely, even in the face of high correlations.

Inker said he is confident that GMO's methodology will continue to work, because "it is what capitalism is supposed to do." Capital should flow into markets where the return on cash is high and the cost of capital is low; conversely, there will be few investments when the return on cash is low and the cost of capital is high.

"Things revert," he said, "and if you bet on them reverting you will be able to make some money."

Moreover, he presented data showing that the most undervalued asset classes not only achieve the best returns, but do so with less risk than one would normally expect.

Inker reviewed the firm's most recent forecast, as of February 29:

Forecast annual real (after-inflation) returns for a seven-year horizon

Equities		**Fixed-income**	
US large cap	0.4%	US bonds	-1.1%
US small cap	-1.8	International bonds	-2.5
US high-quality	4.4	Emerging debt	0.8
International large cap	4.0	Index-linked bonds	-1.8
International small cap	3.3	Cash	0.6
Emerging	5.0	Timber	6.5

According to Inker, the historical real return for US equities has been 6.5% over the last 100 years, and "there is nothing we think that is priced to do better than that."

Inker said that US high-quality stocks are "worth owning" at their present valuations, but "there is nothing that is a screaming 'buy' within equities."

High profit margins are the biggest impediment to returns in the equity markets. "The big issue is profits are at an all-time high relative to GDP," Inker said. "We don't think that is sustainable. We think it's going to come down."

The question is, why has that occurred amid a relatively weak global economy? And what could cause it to change?

Inker believes the reversal of government budget deficits will kill margins. Profits have risen as corporations have successfully cut labor costs, but that was a short-term gain, Inker said. Normally, wage reductions and workforce cutbacks leave less money for consumers to spend across the whole economy. That didn't happen over the last several years because the government stepped in with offsetting stimulus measures, allowing disposable income to remain high despite the fact that labor income has been shrinking.

Hence current profits cannot last for long. Even though he expects modest growth in the global economy, lower unemployment and higher capacity utilization, Inker said that “as a necessary condition of decent growth, we need to see profit margins come down.”

On the fixed-income side, he said, “it is really hard to like much of anything.” Unless inflation is “incredibly low” over the next seven years, or unless real yields remain negative, “it is hard to see how you can possibly get much of a real return out of bonds,” he said.

With central banks more or less guaranteeing to keep real cash yields negative for the foreseeable future, “you’re not going to get anything out of cash either,” he said.

Questions about bonds and stocks

Given this outlook, investors’ first question should be what to do about bonds.

Bonds play two roles in a portfolio, Inker said. Because they are less risky than equities, than can reduce the overall risk of a portfolio. But Inker said that investors are overestimating the value of bonds’ risk reduction. In the past several years, he said, the correlation between stocks and bonds has been starkly negative.

GMO thinks that extreme lack of correlation is unlikely to persist, Inker said. Over longer time periods, the stock-bond correlation has been zero or, at times, highly positive. Looking only to the recent past, in other words, leads investors to assume bonds offer more diversification than they really do.

Bonds’ other role is as a hedge against deflation. The problem, Inker said, is that yields these days are too low. The potential return from, for example, a 10-year bond going from 2% to 1% is not offset by the risk of loss of capital if yields increase from 2% to 3%.

Moreover, Inker said, investors should consider the possibility that governments might not be able to service debt if there is prolonged deflation. Under that scenario, a government’s debt-to-GDP ratio would rise, eventually threatening its ability to service debt payments.

“Even sovereign bonds are not necessarily a perfect hedge against deflation if the debt load is high,” he said. “Right now, even if you assume they are very good insurance against deflation, that insurance has a pretty high premium, because if you don't get the deflation, you are not going to get much of anything out of them.”

Given that bonds are unlikely to be as attractive an element of one’s portfolio today as they have been, on average, over the last 40 years, Inker said the next question investors should consider is whether to overweight stocks, given the “lousy” alternatives.

The danger, Inker said, is that stocks might quickly go from modestly overvalued to fair value, in which case investors would suffer a permanent impairment of capital. “That scares us,” he said – unlike the situation in the winter of 2009, when bonds were priced similarly to how they are today, but stocks were clearly undervalued.

Inker said his discomfort lies with the notion that investors should increase their overall portfolio risk simply because they are being offered a bad opportunity set. If the return potential from both stocks and bonds is low, Inker said, why is that cause to increase overall risk?

Why we own cash

“I don't really know what to do about this,” Inker said. “We own more cash today because we can't stomach holding bonds.”

Inker said his equity allocations are “kind of normal,” and his increased cash allocations are the result of decreasing his fixed-income exposure.

“It is hard to want to be underweight stocks when they are the best thing available,” he said. “But it is hard to want to be taking high absolute risk in an environment where there are no cheap assets.”

A key reason Inker likes cash now is because of its “option value” – money remains available until other assets become cheaper. This opportunity value may trump the near-zero yields cash offers now.

Of course, there is an opportunity cost to cash as well, Inker said. If no cheap asset classes emerge, then investors will endure negative real yields in cash. Indeed, if asset classes are at fair value, the option value of cash is worthless.

Inker said he holds about 20% in cash in GMO’s balanced portfolio and about 25% in his absolute return portfolio. But he will be tempted to increase cash allocations to 40% or more, he said, if the equity markets continue to rise.

What about commodities?

GMO’s chairman, Jeremy Grantham, has written extensively about his concern that our natural resources may be rapidly depleting. That outlook, however, does not suggest any compelling investment opportunities, according to Inker.

For a long time, GMO has advocated timber as an asset class. As Inker explained, it’s easy to forecast timber’s returns. Investors purchase a forest at a fixed price, they know how fast trees grow, and they can assume a fixed real price for timber. From those inputs, one can easily determine an expected return. GMO holds significant timber assets.

But for other commodity futures, Inker said the picture is more complex.

The problem, he said, is that it is hard to see why investors should expect a systematic long-term return – despite the fact that there has been one historically. For there to be long-term returns, Inker said, it is essential to know why the investor on the other side of the trade should be prepared to lose money to you.

In the case of equities, the other side of the trade is the issuing company. For them, equity is the safest form of capital they can issue, since there is no principal to be repaid and no contractual obligations, such as interest payments on bonds.

“If you are going to make risky long-term investment decisions, you want equity,” he said, “and you should be willing to pay for it.”

But with commodity futures, if you are long, somebody else is short, and there is no reason to expect that those short investors to be dupes who are willing to cede a long-term return to you in perpetuity.

Some hedgers might be willing, Inker said, but there aren’t enough of them to reward the entire pool of long investors. Commodity index funds do not require a prospective positive return either, he said, because they are not paying any attention to the price of what they are buying.

The net is that commodity markets are imbalanced, according to Inker, with more investors short than long, and the systematic return usually accrues to the short side. Although there has been a long upward trend in spot prices, it was more than offset by the roll yield, which has been substantially negative, he said.

Owning commodities, in other words, is possible is you own the asset directly, as GMO does with its timber assets. But if the asset is “in the ground,” then Inker said you want to own the companies that own those assets.

But GMO has found it exceedingly difficult to forecast returns for those companies. The problem is that one must forecast the price of the resource, and the cost of extracting it. Inker said that the reason gold mining companies have not appreciated in price during the recent bull market in gold is because the cost of the energy required to mine gold has also gone up.

“The cost of production rose apparently every bit as fast as the price of what they were getting paid for their production,” Inker said. “We haven't figured out exactly what to do about that.”

It's even more complex today because China, he said, has an incredibly resource-intensive approach to growth. That will have to stop, he said, as the returns on Chinese investments diminish, and their economy will become less resource intensive.

Uncertainty about commodities mirrored Inker's larger lack of confidence about the prospects for returns in virtually all asset classes. Value-oriented asset allocators, like GMO, will need to wait to find an opportunity that presents a sufficient margin of safety.

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