



## Just Deserts and Markets Being Silly Again

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### Just Deserts

I can't tell you how surprised, even embarrassed I was to get the Nobel Prize in chemistry. Yes, I had passed the dreaded chemistry A-level for 18-year-olds back in England in 1958. But did they realize it was my third attempt? And, yes, I will take this honor as encouragement to do some serious thinking on the topic. I will also invest the award to help save the planet. Perhaps that was really the Nobel Committee's sneaky motive, since there are regrettably no green awards yet. Still, all in all, it didn't seem deserved. And then it occurred to me. Isn't that the point these days: that rewards do not at all reflect our just deserts? Let's review some of the more obvious examples.

#### 1. For Missing the Unmissable

Bernanke, the most passionate cheerleader of Greenspan's follies, is picked as his replacement, partly, it seems, for his belief that U.S. house prices would never decline and that at their peak in late 2005 they largely just reflected the unusual strength of the U.S. economy. As well as missing on his very own this 3-sigma (100-year) event in housing, he was completely clueless as to the potential disastrous interactions among lower house prices, new opaque financial instruments, heroically increased mortgages, lower lending standards, and internationally networked distribution. For these accumulated benefits to society, he was reappointed! So, yes, after the fashion of his mentor, he was lavish with help as the bubble burst. And how can we so quickly forget the very painful consequences of the previous lavishing after the 2000 bubble? Rewarding Bernanke is like reappointing the *Titanic's* captain for facilitating an orderly disembarkation of the sinking ship (let's pretend that happened) while ignoring the fact that he had charged recklessly through dark and dangerous waters.

#### 2. The Other Teflon Men

Larry Summers, with a *Financial Times* bully pulpit, had done little bullying and blown no warning whistles of impending doom back in 2006 and 2007. And, famously, in earlier years as Treasury Secretary he had encouraged (I hope inadvertently) wild and reckless financial behavior by helping to beat back attempts to regulate some of the new and most dangerous instruments. Timothy Geithner, in turn, sat in the very engine room of the *USS Disaster* and helped steer her onto the rocks. And there are several others (discussed in the 4Q 2008 Letter). You know who you are. All promoted!

#### 3. Misguided, Sometimes Idiotic Mortgage Borrowers

The more misguided or reckless the borrowers, the more determined the efforts to help them out, it appears, although it must be admitted these efforts had limited effect. In comparison, those who showed restraint and either underhoused themselves or rented received not even a hint of help. Quite the reverse: the money the more prudent potential buyers held back from housing received an artificially low rate. In effect, the prudent are subsidizing the very same banks that insisted on dancing off the cliff into Uncle Sam's arms or, rather, the arms of the taxpayers – many of whom rent.

#### 4. Reckless Homebuilders

Having magnificently overbuilt for several years by any normal relationship to the population, we have decided to encourage even more homebuilding by giving new house buyers \$8,000 each. This cash comes partly from the pockets of prudent renters once again. This gift is soon, perhaps, to be extended beyond first-time buyers (for whom everyone with a heart has a slight sympathy) to any buyers, which

would be blatant vote-buying by Congress. So what else is new?

#### 5. Over-spenders and Under-savers

To celebrate the overwhelming consensus among economists that U.S. individuals have been dangerously overconsuming for the last 15 years, we have decided to encourage consumption and penalize savers by maintaining the aforementioned artificially low rates, which beg everyone and sundry to borrow even more. The total debt to GDP ratio, which under our heroes Greenspan and Bernanke rose from 1.25x GDP to 3.25x (without even counting our Social Security and Medicare commitments), has continued to climb as growing government debt more than offsets falling consumer debt. Where, one wonders, does this end, and with how much grief?

#### 6. Banks Too Big to Fail

Here we have adopted a particularly simple and comprehensible policy: make them bigger! Indeed, force them to be bigger. And whatever you do, don't have any serious Congressional conversation about breaking them up. (Leave that to a few journalists and commentators. Only pinkos read pink newspapers anyway!) This is not the first time that a cliché has triumphed. This one is: "You can't roll back the clock." (See this quarter's Special Topic: Lesson Not Learned: On Redesigning Our Current Financial System.)

#### 7. Over-bonused Financial Types

Just look at Goldman's recent huge "profits," two-thirds of which went for bonuses. It is now estimated that this year's bonus pool will be plus or minus \$23 billion, the largest ever. Less than a year ago, these same guys were on the edge of a run on the bank. They were saved only by "government" – the taxpayers' supposed agents – who decided to interfere with the formerly infallible workings of capitalism. Just as remarkably, it is now reported that remuneration for the entire banking industry may be approaching a new peak. "Well, we got rid of some of those pesky competitors, so now we can really make hay," you can almost hear Goldman and the others say. And as for the industry's concern about the widespread public dismay, even disgust, about excessive remuneration (and, I would add, plundering of the shareholders' rightful profits)? Fuhgeddaboutit! In the thin book of "lessons learned," this one, like most of our other examples, will not appear.

#### 8. Overpaid Large Company CEOs

Even outside the financial system, there are many painfully obvious unjust deserts in the form of top management rewards. And most of the excessive rewards come out of the pockets of our clients and other stockholders, which is particularly galling. When I arrived in the States in 1964, the ratio of CEO pay to the average worker was variously reported to be between 20/1 and 40/1. This seemed perfectly respectable and had held for the previous 30 years. By 2006, this ratio had exploded to between 400/1 and 600/1, which can only be described as obscene. The results certainly don't suggest such high rewards: a) 10-year stock market returns are close to zero in real terms; and b) U.S. GDP growth has finally slipped below its 100-year trend of 3.5%. After deducting the effect of the rampant increase in the financial system, the growth in GDP ex-finance has fallen to 3.1% since 1982 and well below 3% since 2000, all measured to the end of 2007 to avoid the recent crisis. The corporate system, to be frank, seemed to run faster and more efficiently back in the 1960s before CEOs and financial types began to gobble up other people's lunches. I suppose I have done my share of gobbling. But, it still ain't right!

#### 9. Holders of the Stocks of Ridiculously Overleveraged and Wounded Corporations

Yes, I admit this is part envy and part hindsight investment regret. But, really, our financial leaders so overstimulated the risk-taking environment that junky, weak, marginal companies and zombie banks produced a record outperformance (the best since 1933) of junk over the great blue chips. (Ouch!) In a world with less moral hazard, which would be a world of just, although painful deserts, scores of these should-be-dead companies would be. As it is, they live to compete against the companies that actually deserve to be survivors. Excessive bailouts are just not healthy for the long-term well-being of the economy.

#### 10. The Well-managed U.S. Auto Industry

While firms in other industries fail and their workers look for new jobs, the auto industry is rewarded by direct subsidized loans, governmental arm-twisting of creditors forced to settle far below their legal rights, and direct subsidies for their products. All of this for

their well-deserved ranking as the most short-sighted industry of the last 20 (40?) years, and one of the worst managed.

#### 11. The World's Most Over-vehicled Country

We chew up a dangerously large amount of Middle Eastern oil (and oil desperately squeezed from Canadian tar sands), which is ruinous for our global-political well-being (and ability to avoid war) and also not so good for an overheating world. So the answer must be to subsidize more car purchases, and when the subsidies run out, you can have all the fun again. Good long-term thinking!

#### 12. Stock Options

This, of course, is the *crème de la crème* of unjust deserts. Recent practices have basically been a legalized way to abscond with the stockholders' equity. So if the stock price crashes, perhaps with considerable help from management, that's all right – just rewrite the options at the new low prices. There has been no serious attempt to match stock option rewards (or total financial rewards for that matter) to the building of long-term franchise value. Instead, the motto is: grab it now and run! You can fill in your own favorite anecdotes here – there are so many of them!

#### 13. Finally, Just in Case You've Forgotten, We Have My Old Nemesis, Greenspan

Alan Greenspan receives the title of Maestro in the U.S. and is knighted by the Queen for thoroughly demolishing the integrity of the U.S. financial system. He overtly ignored the great threat of bubbles in asset classes and, in fact, encouraged them. He Ayn Rand-ishly facilitated the progressive dismantling of governmental restrictions on financial behavior, he deliberately kept real interest rates at zero for years, etc., etc., etc. You have heard it before. Now, remarkably, in his very old age he has become imbued with the spirit of Hyman Minsky: "Unless somebody can find a way to change human nature, we will have more crises." Now he finally gets it. Too late! In his merely old age, he ignored or abhorred Minsky, and consistently behaved as though markets were efficient and the players were honest and sensible at all times. But for all of the egg on his face, the Maestro continues to consult with the rich and famous, considerably to his financial advantage. In the good old days, he would have been set in the village stocks, and not the

kind you buy and sell. And I would have been right there, Alan, with very ripe tomatoes.

#### **The Last Hurrah and Markets Being Silly Again**

The idea behind my forecast six months ago was that regardless of the fundamentals, there would be a sharp rally.<sup>1</sup> After a very large decline and a period of somewhat blind panic, it is simply the nature of the beast. Exhibit 1 shows my favorite example of a last hurrah after the first leg of the 1929 crash.

After the sharp decline in the fall of 1929, the S&P 500 rallied 46% from its low in November to the rally high of April 12, 1930. It then, of course, fell by over 80%. But on April 12 it was once again overpriced; it was down only 18% from its peak and was back to the level of June 1929. But what a difference there was in the outlook between June 1929 and April 1930! In June, the economic outlook was a candidate for the brightest in history with effectively no unemployment, 5% productivity, and over 16% year-over-year gain in industrial output. By April 1930, unemployment had doubled and industrial production had dropped from +16% to -9% in 5 months, which may be the world record in economic deterioration. Worse, in 1930 there was no extra liquidity flowing around and absolutely no moral hazard. "Liquidate the labor, liquidate the stocks, liquidate the farmers"<sup>2</sup> was their version. Yet the market rose 46%.

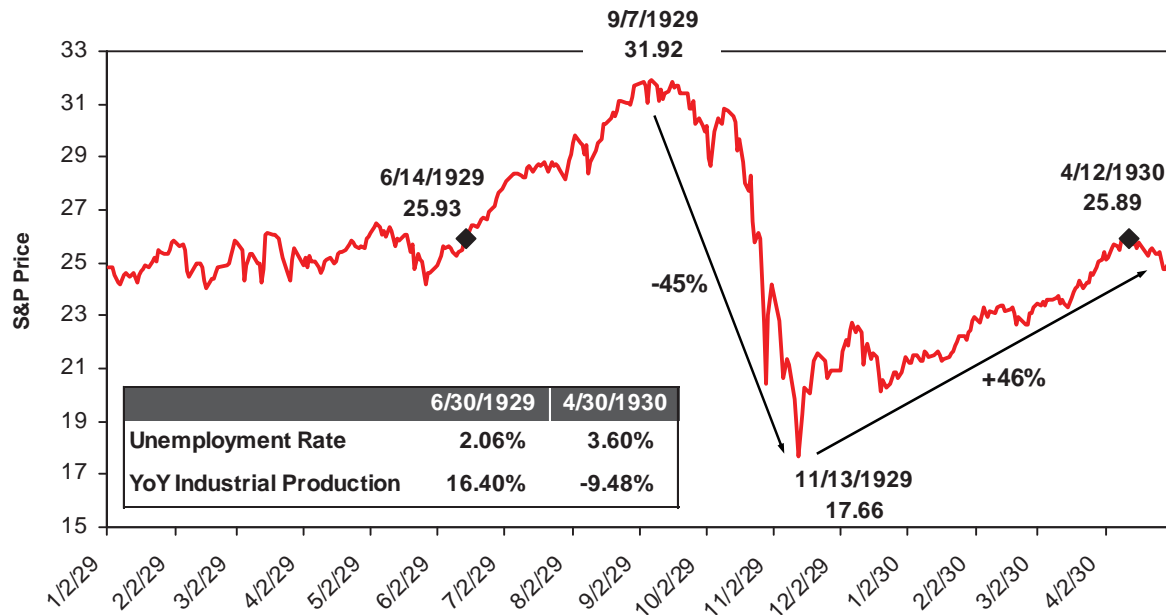
How could it do this in the face of a world going to hell? My theory is that the market always displayed a belief in a type of primitive market efficiency decades before the academics took it up. It is a belief that if the market once sold much higher, it must mean something. And in the case of 1930, hadn't Irving Fisher, arguably the greatest American economist of the century, said that the 1929 highs were completely justified and that it was the decline that was hysterical pessimism? Hadn't E.L. Smith also explained in his *Common Stocks as Long Term Investments* (1924) – a startling precursor to Jeremy Siegel's dangerous book *Stocks for the Long Run* (1994) – that stocks would always beat bonds by divine right? And there is always someone of the "Dow 36,000" persuasion

<sup>1</sup> Erratum: Last quarter I cast mild aspersions on *Finanz und Wirtschaft* by suggesting that I had not precisely said that the S&P would scoot rapidly up to 1100; I remembered it more as between 1000 to 1100. Never mess with a Swiss journalist: this one duly pointed out that his tape of April 1 confirmed his accuracy. Either way, here we are, more or less (at 1098 on October 19).

<sup>2</sup> Andrew Mellon, Secretary of the Treasury, 1931.

## Exhibit 1

### The Last Hurrah: 1929-1930



Source: Global Financial Data

to reinforce our need to believe that as markets decline, higher prices in previous peaks must surely have meant something, and not merely have been unjustified bubbly bursts of enthusiasm and momentum.

Today there has been so much more varied encouragement for a rally than existed in 1930. The higher prices preceding this crash (that were far above both trend and fair value) had lasted for many years; from 1996 through 2001 and from 2003 through mid-2008. This time, we also saw history's greatest stimulus program, desperate bailouts, and clear promises of years of low rates. As mentioned six months ago, in the third year of the Presidential Cycle, a tiny fraction of the current level of moral hazard and easy money has done its typically great job of driving equity markets and speculation higher. In total, therefore, it should be no surprise to historians that this rally has handsomely beaten 46%, and would probably have done so whether the actual economic recovery was deemed a pleasant surprise or not. Looking at previous "last hurrahs," it should also have been expected that any rally this time would be tilted toward risk-taking and, the more stimulus and moral hazard, the bigger the tilt. I must say, though, that I never expected such an extreme tilt to risk-taking: it's practically a cliff! Never mess with the Fed, I guess. Although, looking at the record, these dramatic short-term resuscitations do seem to breed severe problems down the road. So, probably, we will

continue to live in exciting times, which is not all bad in our business.

#### Economic and Financial Fundamentals and the Stock Market Outlook

The good news is that we have not fallen off into another Great Depression. With the degree of stimulus there seemed little chance of that, and we have consistently expected a global economic recovery by late this year or early next year. The operating ratio for industrial production reached its lowest level in decades. It should bounce back and, if it moves up from 68 to 80 over three to five years, will provide a good kicker to that part of the economy. Inventories, I believe, will also recover. In short, the normal tendency of an economy to recover is nearly irresistible and needs coordinated incompetence to offset it – like the 1930 Smoot-Hawley Tariff Act, which helped to precipitate a global trade war. But this does not mean that everything is fine longer term. It still seems a safe bet that seven lean years await us.

Corporate ex-financials profit margins remain above average and, if I am right about the coming seven lean years, we will soon enough look back nostalgically at such high profits. Price/earnings ratios, adjusted for even normal margins, are also significantly above fair value after the rally. Fair value on the S&P is now about 860 (fair value has declined steadily as the accounting smoke



clears from the wreckage and there are still, perhaps, some smoldering embers). This places today's market (October 19) at almost 25% overpriced, and on a seven-year horizon would move our normal forecast of 5.7% real down by more than 3% a year. Doesn't it seem odd that we would be measurably overpriced once again, given that we face a seven-year future that almost everyone agrees will be tougher than normal? Major imbalances are unlikely to be quick or easy to work through. For example, we must eventually consume less, pay down debt, and realign our lives to being less capital-rich. Global trade imbalances must also readjust. To repeat my earlier forecast, I expect developed markets to grow moderately less fast – about 2.25% – for the next chunk of time, and to look pretty anemic compared to emerging countries growing at twice that rate. We are nervous about the possibility of a major shock to Chinese growth. (My personal view of a major China stumble in the next three years or so is that it is maybe only a one in three chance, but is still the most likely important unpleasant surprise of the fundamental economic variety.) Notwithstanding this concern, I believe we are well on the way to my “emerging emerging bubble” described 18 months ago (1Q 2008 Quarterly Letter). I would recommend to institutional investors, including my colleagues, to give emerging equities the benefit of value doubts when you can. For once in my miserable life, I would like to participate in a bubble if only for a little piece of it instead of getting out two years too soon. Riding a bubble up is a guilty pleasure totally denied to value managers who typically pay a high price to the God of Investment Discipline (Thor?) for being so painfully early. I think the first 15 percentage points over fair value would satisfy me. If I'm right, the first 15% will be a small fraction of the eventual bubble premium. So in a sense, we would be early once again.

We believed from the start that this market rally and any outperformance of risk would have very little to do with any dividend discount model concept of value, so it is pointless to “ooh and ah” too much at how far and how fast it has traveled. The lessons, if any, are that low rates and generous liquidity are, if anything, a little more powerful than we thought, which is a high hurdle because we have respected their power for years. And what we thought were powerful and painful investment lessons on the dangers of taking risk too casually turned out to be less memorable than we expected. Risk-taking has come roaring back. Value, it must be admitted, is seldom a powerful force in the short term. The Fed's weapons

of low rates, plenty of money, and the promise of future help if necessary seem stronger than value over a few quarters. And the forces of herding and momentum are also helping to push prices up, with the market apparently quite unrepentant of recent crimes and willing to be silly once again. We said in July that we would sit and wait for the market to be silly again. This has been a very quick response although, as real silliness goes, I suppose it is not really trying yet. In soccer terminology, for the last six months it is Voting Machine 10, Weighing Machine nil!

Price, however, does matter eventually, and what will stop this market (my blind guess is in the first few months of next year) is a combination of two factors. First, the disappointing economic and financial data that will begin to show the intractably long-term nature of some of our problems, particularly pressure on profit margins as the quick fix of short-term labor cuts fades away. Second, the slow gravitational pull of value as U.S. stocks reach +30-35% overpricing in the face of an extended difficult environment.

On a longer horizon of 2 to 10 years, I believe that resource limitations will also have a negative effect (see 2Q 2009 Quarterly Letter). I argued that increasingly scarce resources will give us tougher times but that we are collectively in denial. The response to this startling revelation, for the first time since I started writing, was nil. It disappeared into an absolutely black hole. No one even bothered to say it was idiotic, which they quite often do. Given my thesis of a world in denial, though, I must say it's a delicious irony.

So, back to timing. It is hard for me to see what will stop the charge to risk-taking this year. With the near universality of the feeling of being left behind in reinvesting, it is nerve-wracking for us prudent investors to contemplate the odds of the market rushing past my earlier prediction of 1100. It can certainly happen.

Conversely, I have some modest hopes for a collective sensible resistance to the current Fed plot to have us all borrow and speculate again. I would still guess (a well-informed guess, I hope) that before next year is out, the market will drop painfully from current levels. “Painfully” is arbitrarily deemed by me to start at -15%. My guess, though, is that the U.S. market will drop below fair value, which is a 22% decline (from the S&P 500 level of 1098 on October 19).

Unlike the really tough bears, though, I see no need for a new low. I think the history books will be happy enough with the 666 of last February. Of course, they would probably be slightly happier with, say, 550. The point is that this is not a situation like 2005, 2006, and 2007 when for the first time a great bubble – 2000 – had not yet broken back through its trend. I described that reversal as a near certainty. I love historical consistency, and with 32 bubbles completely broken, the single one outstanding – the S&P 500 – was a source of nagging pain. But that was all comfortably resolved by a substantial new low for the S&P 500 last year. This cycle, in contrast, has already established a perfectly respectable S&P low at 666, well below trend, and can officially please itself from here. A new low (or not) will look compatible with history, which makes the prediction business less easy.

### Forecast Summary

Bonds, except emerging, have very low seven-year return forecasts: on our numbers, they are below 1.25% real. The forecast for the S&P 500 is well below 3%, but the high-quality subset is still handsome. We score international developed stocks as close to fair value, and emerging equities as expensive, although just within range of normal if I am allowed to give them a seven-year bonus of 2% a year (15% in total).

### Portfolio Recommendations

Having reinvested back in March to be almost neutral in equities, we have recently taken just a few chips off the table and recommend that anyone who was neutral weighted in equities or even overweighted (lucky you!) do the same. For us, the neutral 65% equity position that we reached has been slightly pulled back to 62%, leaving plenty of room to pull back further if the market runs above 1100, say, to 1200 later this year. This reduction is slight for two other reasons. First, we can find a sufficient group of equities at or very close to fair value. U.S. high quality, foreign developed (EAFE), and some emerging (with the benefit of the doubt) are collectively a reasonable buy. [Let me take a moment to make it clear that this is my personal view on emerging, since my suitably stern colleagues don't believe in giving the benefit of the doubt, and feel that the overpricing of emerging should determine everything. This is a pretty mild disagreement, and I recognize that I may be getting carried away by my confidence in an emerging bubble.] The second reason for the smallness of our pullback is that typically

we do not micromanage the portfolio dispositions, but try to allow for extremes to occur and then make a very significant move. Although the U.S. market is still in a routine overpricing range, we are making an exception this time since we had a strong prior assumption in April that a healthy last hurrah would overrun and eventually slam into the longer-term disappointments of the seven lean years variety. And it still seems likely to work out that way. So we are breaking our rules and teasing out a few percentage points more of safety margin as the market runs. The 1Q 2009 Quarterly Letter, by the way, said "in a rally to 1000 or so, the normal commercial bullish bias of the market will of course reassert itself, and everyone and his dog will be claiming it as the next major multi-year bull market." Well, now it's happened precisely that way, and you should not believe them! As we have demonstrated to our clients in earlier cycles, earnings estimates in particular merely follow the market up (not the other way around, as one would hope). So it is a law of nature that strong estimates will abound after a major market rally. The earnings and economic growth estimates in such cases are usually throwaways. But the economic data next year will indeed look strong. The irony may well be that just as nine months of weak economic data this year has been accompanied by a very strong market, so the strong economic data next year is likely to be accompanied by a weak stock market.

### Yet Another Plug for U.S. Quality Stocks

Our main argument is quantitative. Quality stocks (high, stable return and low debt) simply look cheap and have gotten painfully cheaper as the Fed beats investors into buying junk and other risky assets, a hair-of-the-dog strategy if ever there was one. In our seven-year forecast the quality segment has a full seven-percentage-point lead per year over the whole S&P 500, or 9% over the balance ex-quality. This is now at genuine outlier levels.

In addition, there are qualitative arguments. We like owning high-quality blue chips if we are indeed going into a more difficult seven years than any we have faced since the 1970s. The problems of reducing debt and the potential share dilution that can go with it as it did in Japan for a decade, particularly play to the strength of the largely debt-free high-quality companies. And for nervous investors there is yet another reason for favoring quality stocks: their more than 50% foreign earnings component, which is higher than the balance of the S&P

500 with its heavy financial component. In the long run, quality stocks have proven to be the one free lunch: you simply have not had to pay for the privilege of owning the great safe companies, as plain logic and established theory would both suggest. Exhibit 2 shows that quality stocks have slightly outperformed the market for the last 40 years. Not bad.

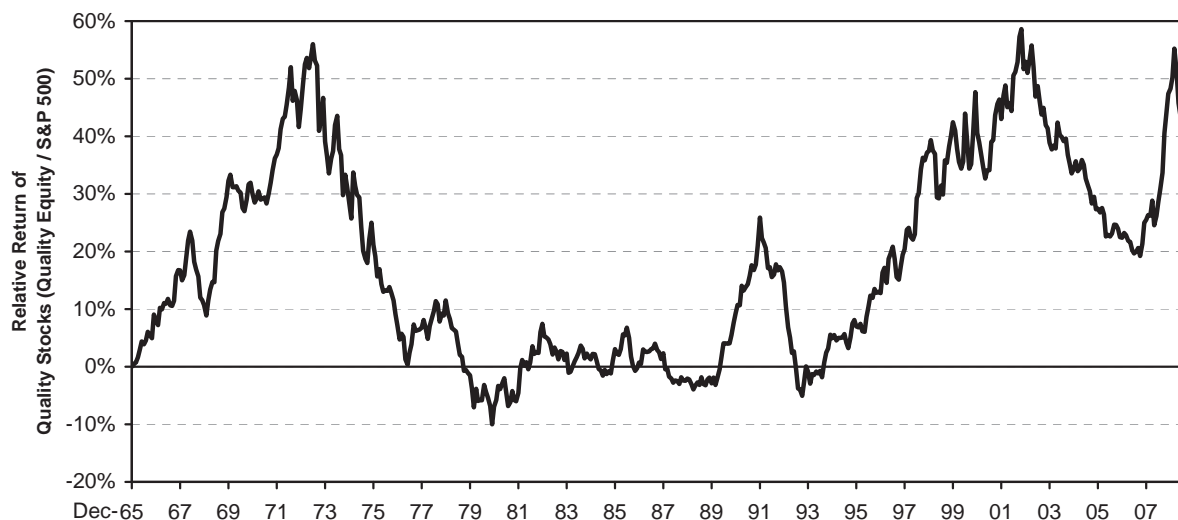
### A Footnote: Endowment Troubles, or, The Budgeting Blues

Suddenly we are reading of serious college cutbacks and janitors being laid off. What has precipitated this crisis is a decline in a broad range of assets to ... fair price! Global equities were underpriced for a few months, and by the end of the scholastic fiscal year on June 30, market prices were approximately on their long-term trend. In fact, they were about as close as they ever get, with foreign stocks slightly cheap and U.S. stocks almost spot-on fair value. So why would a drop to fair value induce so broad a crisis? Clearly, this was a budgeting problem rather than an investment performance problem. Because asset prices had been above normal prices for most of the last 20 years (defined, as usual, by normal profit margins times normal price/earnings ratios), the budgeting departments, sometimes perhaps advised by investment committees, had built abnormally high prices into normal income assumptions. The percentage of the budget coming from the endowments had been allowed to increase with

the rise of valuations. The truth is that colleges spent these last 20 years half believing, at least, in the efficient market. Even now, after the shocking revelations of the NASDAQ-Growth bubble of 2000 and the Housing-Asset bubble of 2008, they still seem to half believe it. Keynes said, "Practical men who believe themselves to be quite exempt from any intelligent influence are usually the slaves of some defunct economists." Well, our independent committee members in this case are the unwitting (or witting) slaves of the theories of French, Fama, Malkiel, Lucas, et al. And one could not find a more defunct collection of theories than these! Rational expectations and the efficient market hypothesis are as dead as dodos, yet their baleful and painful influence lives on in two ways.

First, committee members by and large buy into the idea that portfolio composition should not change and should be fixed as closely as possible to the policy benchmark, which certainly would make sense in that parallel universe where markets really are efficiently priced. This means that you cheerfully own just as much equity in 2000 at 35 times earnings as you did in 1982 at 6 times. This is not a good idea unless you derive enormous personal utility from a display of discipline, perhaps better viewed as inflexibility in this case. Assets in our very inefficient world should surely be moved slowly toward the best mix of risk and return.

### Exhibit 2 The One Free Lunch



Source: GMO As of 9/30/09

Second, and the point of this argument, is that budgeting should be based on asset values at fair price. Withdrawals should be a fixed percentage of fair price or should lean heavily in that direction. The more common practice is to take out more when assets are overpriced, particularly when the overpricing lasts for years as it did for the 1993-2007 period and so is incorporated into smoothing equations. And yes, it is satisfying to take out more, which means to sell more when prices are high, but this approach of having your funding boat rise with the temporary tides can get you hooked on unsustainably high withdrawals. Such a situation is bound to end badly. All overpriced markets will eventually mean revert and when they do they will leave most institutions with, shall we say, withdrawal symptoms. In contrast, a policy that recognizes fair value will effectively build up a safety margin in overpriced times that can be drawn down in underpriced times.

And while I'm defending endowment managers, I might as well add that complaining about an 8%+ underperformance by the traditionally elite managers for the single year just ended, after they have beaten the average endowments by at least 5% per year for the previous 10 years using the very same approach, is pure short-term silliness. It gives the alumni, the local papers, and the college VIPs who are not on the investment committee a long-delayed and satisfying opportunity to complain. (Yes, I know you don't need defending!)

### **Recent Shortcomings**

Where we got most things right last year, ex-fixed income, we have tended to mess up this year, again ex-fixed income, which has now climbed a remarkable three quarters of the way out of the deepest hole I ever remember seeing. Our biggest mistakes this year clearly involved a dose of the "terminal paralysis" that is so hard to overcome on those rare occasions when the world really is trying to fall to pieces and actually might pull it off unless the authorities get lucky or clever. We were simply too slow to get the message that the combined stimulus package was so heavily weighted toward stimulating risk-taking and paper transactions and relatively less toward stimulating the real economy. It was, as they say, "an available insight!" The data was there for intelligent analysis. We showed less flexibility than is desirable, and stayed precisely with our seven-year forecasts in asset allocation, where we could have substantially tilted more to risk and generally raised our beta. In equity accounts we stuck with a massive overweight in quality even though quality

had contributed a huge win last year. You could call this the winner's curse or winner's inertia. Regardless, it has always been a big thing in investing and one that's hard to resist. Greater flexibility might well have suggested that emerging equity and small cap international were close enough to U.S. quality stocks in expected return to justify some greater risk diversification. We regret these missed opportunities and will very seriously consider being more flexible next time.

Today, at these very different prices, there are two important mitigating arguments. First, even if we had reduced a big chunk of our quality bet in the spring, with today's extreme spread we would now be moving most, and maybe all, of the money back into quality. Second, there is the classic GMO argument. Even back in March we believed it was a winning bet against the market over our seven-year horizon, and by enough to cover most of our typical measurement errors. Quality was also the cheapest subset of global equities. Over the years, we have had some very tough times waiting out losses in the early days of some of our forecasts, only to have the forecasts eventually prove correct. Too, the S&P 500 could have gone much lower – 500 or so would have been quite normal. Had this happened, quality stocks combined with our cash reserves would have given us relative performance from heaven. We have all been learning to live with regrets these last 18 months!

To rub in the previous point that our forecasts are useful, we are reproducing the seven-year forecast from seven years ago in June (Exhibit 3). This is a particularly interesting point in time because markets were close to fair value in June. At fair value our estimates, in theory, should turn out to be pretty close. As can be seen, it worked out well. As my 2Q 2009 Quarterly Letter said, it was "Boring Fair Price." Because our methodology assumes a move back to normal pricing every time the market hits fair value, about every six or seven years, for a few minutes, our forecasts almost by definition look nearly perfect at those rare fair value moments. (By the end of September, in contrast, with most markets overpriced, the average return for all 13 asset classes taken together was over 2.5% a year above our forecast of seven years ago, although the rank order was still better than chance at a 1 in 30,000 level.) We now have over 70 estimates since 1994, admittedly with overlapping time periods, and every single one of them was better than random, and the best – 10 years ending October 2008 – had a 1 in 100,000



chance of being just lucky. Still, it would be very nice indeed to twist and turn a little more along the seven-year path in order to make more money and avoid losses. After all, we've done it once – I'm afraid that's all there is so

far – by underweighting emerging equity last summer just in time to avoid its two-month freefall of 40%. So maybe there's hope for a second time.

### Exhibit 3

#### The 7-Year Forecast from June 2002 to June 2009: 'Boring Fair Value'

Forecasts from June 30, 2002 vs. actual as of June 30, 2009

Asset Class	Estimated Rank	GMO 7-Yr Forecast June-02 (% Real Return/Yr)	Actual 7-Yr Return*	Actual Rank
Emerging Market Equities	1	10.0	14.3	1
International Small Cap	2	8.9	7.7	3
U.S. REITs	3	8.1	1.5	10
Emerging Country Debt	4	6.9	9.2	2
EAFE	5	6.5	4.0	7
Foreign Bonds	6	4.6	6.8	4
U.S. TIPS	7	3.1	5.3	5
U.S. Small	8	2.8	3.0	8
Lehman Aggregate	8	2.8	4.4	6
U.S. T-Bills	10	2.1	2.1	9
U.S. Large Value	11	1.1	0.9	12
S&P 500	12	0.5	0.8	13
U.S. Large Growth	13	-0.2	1.2	11

**Correlation of rank order: 78.7%**  
**Probability of picking same or better rank order randomly: 1 in 900**

\* Actual compound annual real returns are for the period 6/30/02 to 6/30/09.

The accuracy of these forecasts does not guarantee that current or future predictions will be accurate either with respect to the ranking of those asset classes over a 7-year period, the absolute levels of real return, or results over shorter periods. The accuracy of forecasted rankings and absolute returns in the asset class forecasts generally varies from period to period.

Source: GMO

P.S.: We plan to post the entire set of forecasts to our website along with some preliminary analysis of the results. We will keep you informed as to when these will be available.

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(Written in early July and held back from last quarter's letter for health reasons: attacked by a small tick bearing a large grudge.)

## Lesson Not Learned: On Redesigning Our Current Financial System

Jeremy Grantham

I can imagine the company representatives on the *Titanic II* design committee repeatedly pointing out that the *Titanic I* tragedy was a black swan event: utterly unpredictable and completely, emphatically, not caused by any failures of the ship's construction, of the company's policy, or of the captain's competence. "No one could have seen this coming," would have been their constant refrain. Their response would have been to spend their time pushing for more and improved lifeboats. In itself this is a good idea, and that is the trap: by working to mitigate the pain of the next catastrophe, we allow ourselves to downplay the real causes of the disaster and thereby invite another one. And so it is today with our efforts to redesign the financial system in order to reduce the number and severity of future crises.

After a crisis, if you don't want to waste time on palliatives, you must begin with an open and frank admission of failure. The *Titanic*, for example, was just too big and therefore too complicated for the affordable technology of its day. Given White Star Line's unwillingness to spend, she was under-designed. The ship also suffered from agency problems: the passengers bore the risk of unnecessary speed and overconfidence in "too big to sink!" while the captain stood to be rewarded for breaking the speed record. No captain is ever rewarded for merely delivering his passengers alive. Greenspan, nearly 100 years later in his short-lived "irrational exuberance" phase, did not enjoy being metaphysically slapped by the Senate Subcommittee for threatening the then speedy progress of the economy. What is needed in this typical type of agency problem is for the agent on those rare occasions when it really matters, whether a ship's captain or a Fed boss, to stop boot licking and say, "No, this is wrong. It is just too risky. I won't go along."

We have a once-in-a-lifetime opportunity to effect genuine change given that the general public is disgusted with the financial system and none too pleased with Congress. I have no idea why the current administration, which came in on a promise of change, for heaven's sake, is so determined to protect the status quo of the financial system at the expense of already weary taxpayers who are promised only somewhat better lifeboats.

It is obvious to most that there was a more or less complete failure of our private financial system and its public overseers. The regulatory leaders in particular were all far too captured and cozy in their dealings with reckless and greedy financial enterprises. Congress also failed in its role. For example, it did not rise to the occasion to limit the recklessness of Fannie and Freddie. Nor did it encourage the regulation of new financial instruments. Quite the reverse, as exemplified by the sorry tale of CFTC Chairman Brooksley Born's fight to regulate credit default swaps.

But, at least now, Congress seems to realize the problem: the current financial system is too large and complicated for the ordinary people attempting to control it. Even Barney Frank, were he on his death bed, might admit this; and most members of Congress know that they hardly understand the financial system at all. Many of the banks individually are both too big and so complicated that none of their own bosses clearly understand their own complexity and risk taking. The recent boom and the ensuing crisis are a wonderfully scientific experiment with definitive results that we are all trying to ignore. And, except for bankers, who have Congress in an iron grip, we all want and need a profound change. We all want smaller, simpler banks that are not too big to fail. And we can and should arrange it!

Step 1 should be to ban or spin off that part of the trading of the bank's own money that has become an aggressive hedge fund. Proprietary trading by banks has become by degrees over recent years an egregious conflict of interest with their clients. Most if not all banks that prop trade now gather information from their institutional clients and exploit it. In complete contrast, 30 years ago, Goldman Sachs, for example, would never, ever have traded against its clients. How quaint that scrupulousness now seems. Indeed, from, say, 1935 to 1980, any banker who suggested such behavior would have been fired as both unprincipled and a threat to the partners' money. I, for one, saw Goldman in my early days as a surprisingly ethical firm, at worst "long-term greedy." (This steady loss of the old partnership ethic is typically underplayed in descriptions of Goldman.) Today, Goldman represents a potential hedge fund trade as being attractive precisely because they themselves have already chosen to do it. These days, all – or almost all – large banks do proprietary trading that is pure hedge fund in nature. Indeed the largest bank, Citi (owned by us taxpayers), is gearing up to substantially increase its aggressive prop trading as I write. ("No, no, we're not!")

Some insiders have argued that we should not worry about prop trading because they claim it did not play an important part in the recent crisis. I think this is completely wrong for it misses the very big picture. Prop trading can easily introduce an aggressive hedge-fund type mentality into the very hearts of what ideally should be conservative, prudent – even boring – banks. This hedge-fund mentality became a dominant organizing principle, particularly with respect to compensation practices. It encouraged personal aspirations over corporate goals and invited bonus-directed behavior at the clients' expense and ultimately, as we have seen, at the taxpayers' expense to rid itself of this problem. All Congress has to overcome is the lobbying power and campaign contributions of the finance industry itself, which I admit is no small feat. In a bank with a hedge fund heart, you can't reasonably expect ethical or non-greedy behavior, and you haven't seen it.

Of course, commercial and investment banks need to invest their own capital. They probably should have the right to do genuine hedging against investments that flow naturally from their banking business. As for the rest, they could easily be required either to limit the leverage used on prop desk trading or to be restricted to investing in government paper and, at the very least, play by the same rules as other hedge funds. What they certainly should

not be is advantaged at the cost of taxpayer back-up or insurance, as is now the case.

In the early 1930s, following the famous Pecora hearings, the conflict of interest between the management of other people's money as fiduciary and the business of dealing and underwriting in securities was considered so inimical to the public interest that Congress almost compelled separation of proprietary trading and client trading. Close, but no cigar. Instead, Glass-Steagall made the probably less useful step of separating commercial and investment banking. Unfortunately, they left intact the obvious conflict between the banks' managing their own money and simultaneously that of their clients. We now have a unique opportunity to revisit this matter.

(As we ponder the problem of prop trading, let us consider Goldman's stunning \$3 billion second quarter profit. It appeared to be almost all hedge fund trading. Be aware also that this \$3 billion is net of about \$6 billion reserved for future bonuses. Goldman's CEO had, in fact, the interesting job of deciding how much of this \$9 billion profit would be arbitrarily awarded to shareholders. [In this case, one-third. Could be worse!] This means that they extracted every penny of \$9 billion from a fragile financial system. "Good for them," you may say, and they indeed are very smart. But surely they should not have been insured against failure by us taxpayers! Remember, they are now also a commercial bank yet very, very little of their \$9 billion came from making loans. Three months later their bonus pool for the year is estimated to be a new record at \$29 billion. And the whole banking industry is back to a new record for remuneration. How resilient! How remarkable! How basically undesirable for our economy!)

In Step 2, the Justice Department, together with Congressional and other advisors, should be invited to develop a special set of rules for the banking industry that recognizes the moral hazard of "too big to fail." If really too big to fail, banks should be divided by Justice into manageable, smaller pieces that can indeed be allowed to fail. With these two steps and possibly with an intelligent son of Glass-Steagall, the deed would be done! Regulators would have a fighting chance of being able to regulate, unlike their recent woeful past. If an angel appeared, waved his wings and, lo, it was so, almost every single Congressman would sigh with relief.

The separation of commercial banking from investment banking is not as vital as the removal of prop desk

conflicts, but it would certainly make large and ineffably complicated enterprises both smaller and simpler, which characteristics I for one believe are probably essential if we are to avoid further disasters. So what is the problem? The argument against all major changes, without at least some of which we will soon surely be back in another crisis, is always the same. “Oh, you can’t roll back the clock.” But, even repeated twice before every breakfast, it is not persuasive. Why exactly can’t you roll back the clock? We did it once before and, although it was very imperfect and probably missed the central point of conflict of interest, it still produced an improved system that was successful enough for 50 years. In general, countries with simpler and less aggressive banks have had much less pain in the recent crisis while we were pawing the Crown Jewels – sorry, the Federal Jewels – to bail out aggressive bankers who were out of their depth in the new complexities.

Step by step, even as the complexity grew, our regulatory leaders enabled systemic risk to grow. They continued to push the boundaries for banks by allowing more leverage, new instruments, and less control. The details are familiar. All this was done in the name of untrammelled, unfettered capitalism, and almost all of it was a bad idea.

“Oh!” say the bankers, “If we become smaller and simpler and more regulated, the world will end and all serious banking will go to London, Switzerland, Bali Hai, or wherever.” Well, good for those other places. If that means they will have knee-buckling, economy-cracking, taxpayer-impoverishing meltdowns every 15 years and we will be left looking like a boring back water, that sounds fine to me. Remember, just like our investment management branch of the financial system, banking creates nothing of itself. It merely facilitates the functioning of the real world.

Yes, of course every country needs a basic financial system to function effectively with letters of credit, deposits, and check writing facilities, etc. But as you move beyond that it is worth remembering that every valued job created by financial complexity is paid for by the rest of the real economy, and talent is displaced from real production, as symbolized by all of the nuclear physicists on prop trading desks. Viewed from the perspective of the long-term well-being of the whole economy, the drastic expansion of the U.S. financial system as a percentage of total GDP in the last 20 years has been a drain on the health and cost structure of the balance of the real economy. To illustrate

this point, in 1965 the financial sector of the economy took up 3% of the GDP pie. The 1960s were probably the high water mark (or one of them) of America’s capitalism. They clearly had adequate financial tools. Innovation could obviously have occurred continuously in all aspects of finance, without necessarily moving its share of the economy materially over 3%. Yet by 2007 the share had risen to 7.5% of GDP!

The financial world was reaching into the GDP pie and taking an unnecessary extra 4%. Every year! This extra rent is enough to lower the savings and investment potential of the rest of the economy. And it shows. As mentioned earlier, the growth rate of the GDP had been 3.5% a year for a hundred years. It had proven to be remarkably robust. Even the Great Depression bounced off it, and soon GDP growth was back on the original trend as if the Depression had never occurred. But after 1965, the growth of the non-financial slice, formerly 3.4%, slowed to 3.2%. After 1982 it dropped to 3.1% and after 2000 fell to well under 3%, all measured to the end of 2007, before the recent troubles. These are big declines. It is as if a runner has a growing and already heavy blood sucker on him that is, not surprisingly, slowing him down. In the short term, I realize that job creation in the financial industry looked like a growth driver, as did the surge in financial profits (which we now realize were ludicrously overstated). But in the long term, like a sugar high, this stimulus was temporary and unhealthy.

The financial system was growing because it could. The more complex and confusing new financial instruments became the more “help” ordinary citizens needed from the experts. The agents’ interests were totally unaligned with the principle/clients’ interests. This makes a mockery of “rational expectations” and the Efficient Market Hypothesis, which assumes (totally unproven, as usual) equivalent and perfect knowledge on both sides of all transactions. At the extreme, this great advantage in knowledge and information held by the financial agents has the agents receiving all the rewards, according to the recent work<sup>1</sup> by my former partner, Paul Woolley, and his colleagues at the Woolley Centre for the Study of Capital Market Dysfunctionalities. (With a great name like that

<sup>1</sup> Biais, Bruno; Rochet, Jean-Charles; and Woolley, Paul. *Rents, Learning and Risk in the Financial Sector and other Innovative Industries*. September, 2009. Working Paper Series 2009, The Paul Woolley Centre for the Study of Capital Market Dysfunctionalities, London School of Economics & Political Science.

<http://www.lse.ac.uk/collections/paulWoolleyCentre/news/RentsLearningAndRisk.htm>



their job is half done before they start.)

The second problem, right on the heels of the too-big-and-complicated issue, is that of inadequate public oversight. Even with existing institutions, we would have avoided most of the recent pain, borne by taxpayers, if we had had better public leadership. Yes, the public bodies had flaws, but the individuals running the shop had far bigger flaws. Greenspan, with arguably the most important job in the world, simply did not believe in interfering with capitalism at all. His regulatory colleagues such as Bernanke and Geithner fell into line without any challenges. And Congress, strongly influenced by the financial industry, or merely misguided, or often both, facilitated the approach that capitalism in general and banking in particular would do just fine if left entirely alone. It was a very expensive error. Does anyone think we would have run off the cliff with even one change – Volcker at the Fed? I, for one, am confident that we would have done far less badly.

Behind this weakness in the recent cast of characters is a systemic (suddenly the trendiest word in the English language) weakness in our method of job selection. How can Greenspan, with his long-established record of failure as a professional economist, have resurfaced as the Fed boss? With no record of success in any important job, he gets one of the world's two most important jobs! Now we have to decide how much more decision-making power to give to the Fed – an institution with a 25-year proven record of failure. How can we separate the logical neatness of institutional design from our recent proven inability to pick effective, principled leaders with strong backbones?

It is a conundrum: too many regulatory agencies and you have too many opportunities for financial interests to shop around for regulatory bargains and to find and exploit the ambiguous seams between them. Too few agencies and we run the risk of my worst nightmare: waking up and finding Alan Greenspan with twice the authority!

At the least we must recognize the improbability of acquiring great leaders and that our financial system must be simple and robust enough to withstand the worst efforts from time to time of poor or even bad leadership. A simpler, more manageable financial system is much more than a luxury. Without it we shall surely fail again. And it looks as if we are bound and determined to bend once again to the will (and the money) of the financial lobby, which is encouraged by the unexpected conservatism of the current administration's "Teflon" men. They seem

terrified to make any substantial changes. And the one person with the character to make tough changes – Paul Volcker – is window dressing, exactly as I suggested in January. A sad, wasted opportunity!

### Summary

- Yes, this was a profound failure of our financial system.
- The public leadership was inadequate, especially in dealing with unexpected events that often, like the housing bubble breaking, should have been expected.
- Of course, we should make a more determined effort to do a more effective job of leadership selection. But excellence in leadership will often be elusive.
- Equally obvious, we could make a hundred improvements to the lifeboats. Most would be modest beneficial improvements, but in the long run they would be almost completely irrelevant and, worse, they might kid us into thinking we were doing something useful!
- But all of the above points fail to recognize the main problem: the system has become too big and complicated for even much-improved leaders to handle. Why should we be confident that we will find such improved leaders? For, even in an administration directed to "change," Obama and his advisors fell back on the same cast of characters who allowed, even facilitated, the development of the current crisis. Reappointing Bernanke! What a wasted opportunity to get a "son of Volcker" type. (Or should that be "grandson of Volcker?")
- The size of the financial system continues to grow and shows every sign of being out of control. As it grows, it becomes a bigger drain on the rest of the economy and slows it down.
- The only long-term hope of avoiding major recurrent crises is to make our financial system simpler, the units small enough that they can be allowed to fail, and, above all, to remove the intrinsically conflicted and dangerously risk-seeking hedge fund heart from the banking system. The rest is window dressing and wishful thinking.
- The concept of rational expectations – the belief in the natural efficiency of capitalism – is wrong, and is the root cause of our problems. Hyman Minsky, on

the other hand, was right; he argued that the natural outcome of ordinary people interacting is to make occasional financial crises “well nigh inevitable.” Crises are desperately hard to avoid. We must give ourselves a chance by making the job of dealing with them much, much easier.

- All in all we are likely to have learned little, or rather to act, through lack of character, as if we have learned nothing. In doing so we are probably condemning ourselves to another serious financial crisis in the not-too-distant future.

PS: As quite often happens, since I write painfully slowly (even without extra tick-borne delays), a professional slipped in with a great column that gets to the heart of this matter. Please read John Kay in the *Financial Times* of July 9. It is short and persuasive. “Our banks are beyond the control of mere mortals” – now, that’s what I call a title!

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