Case 1

1. Describe GMO's background and business.

   GMO was a Boston-based asset management firm with $97 billion of total assets under management and over 500 employees. And it was famous for well forecasting the market over the past 35 years.

2. Describe GMO's Asset Allocation business/process.

   1)GMO's original approach had been to invest in "value" stocks that were currently out of favor among investors.

   2)Then, GMO had compiled an impressive track record of spotting both overvalued and undervalued asset classes.

   3)Most of his customers are large institutional investors.

3. Describe the ERP - why it exists, how GMO estimates it, how they try to profit from it.

   ERP stands for equity risk premium which is the return that investors required on stocks over riskless bonds over the long run. And the investors demanded such a risk premium because stocks tended to lose money at "bad times." GMO thought that market prices could significantly deviate from fundamental value, it also believed that the expected return on stocks over the intermediate term could differ from investors' long-run required return. ERP can be estimated by subtracting the risk-free return from the expected asset return. And for the expected return, GMO built its forecast using the fact that the return on stocks was equal to the dividend yield, plus the percentage change in the price-earnings multiple, plus the percentage change in profit margins, plus the percentage changes in sales per share. Over the very long run, GMO's approach to forecasting expected returns was consistent with the Gordon growth formula in which required returns were equal to the sum of the dividend yield and dividend growth. GMO expected equities to earn their required return only "when the pricing of the stock market gives enough cash flow to shareholders to fund that return," or when the current market price was equal to GMO's assessment of fair value.

4. Why do GMO believe they can outperform other managers?

   Because of career risk in asset allocation. Due to career risks, even when other managers were confident that prices had deviated far from fundamentals, they were reluctant to act on this belief. However, Of the $97 billions of total assets under management, roughly $37 billion was in accounts where GMO had meaningful discretion to alter the mix between stocks, bonds, cash, and other assets in accordance with the firm's evolving views about expected returns.

5. How has GMO's performance been in the past?

   GMO had compiled an impressive track record of spotting both overvalued and undervalued asset classes and its forecast had proven to be almost entirely true. On average, the GMWAX fund (GMO Global Asset Allocation Fund) had earned almost twice the return on its benchmark with only 70% of its benchmark's volatility. Thus, the Sharpe ratio of GMWAX was more than 2.5 times of its benchmark.

6. What is their view of the future?

   GMO thinks that it would be a bear market in intermediate-term U.S stock market.