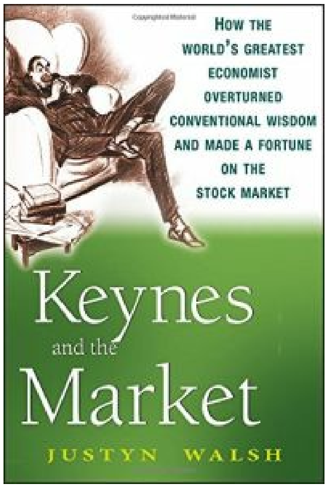

Book Keynes and the Market

How the World's Greatest Economist Overturned Conventional Wisdom and Made a Fortune on the Stock Market

Justyn Walsh
Wiley, 2008

Recommendation

Now that everybody seems to be a Keynesian again, the perfect time may have arrived to revisit Keynes' oft-overlooked – and wildly successful – strategies for succeeding in the stock market. This lively look at Keynes' evolution as an investor is sure to convince readers that value investing is a wise approach. With pithy language and an engaging style, investment banker and financial reporter Justyn Walsh points out that Warren Buffett isn't the only value investor worth emulating. Investors familiar with Buffett's mantras will find little new advice here, but Walsh does an admirable job of casting Keynes' life in a new light. He also concisely sums up Keynes' economic theory. *BooksInShort* recommends this book to investors looking for insight from one of capitalism's great minds.

Take-Aways

- John Maynard Keynes was a revolutionary economist and a wildly successful investor.
- He became rich by pioneering value investing.
- Warren Buffett is value investing's most famous contemporary advocate.
- Keynes, who once disdained material aspirations, became an avid speculator in 1919, when he began trading currencies.
- In the 1920s, Keynes was a momentum investor who paid little attention to underlying fundamentals. By 1930, his portfolio fell to £8,000, an 80% plunge in two years.
- The market collapse of the late 1920s didn't just change Keynes' economic thinking – it also provoked an about-face in his investment strategy.
- Keynes knew that stock prices sometimes diverged from the true value of the underlying stock. He viewed these mismatches as an opportunity.
- Keynes scoffed at conventional wisdom, a stance he called "leaning into the wind."
- He advised buying stock in out-of-favor companies with sustainable earnings.
- Keynes believed that too much diversification doesn't remove risk but intensifies it.

Summary

A Man of Many Talents

The world knows John Maynard Keynes as the influential economist whose then-radical theories rescued the world from the Great Depression. However, his investing success is less well known. When he died in 1946, Keynes was worth £480,000, the equivalent of about $30 million now. He was well paid for some of his best-selling books, but he earned little from his work as an economist. Instead, he amassed his fortune largely by investing. He pioneered a brand of common sense trading, or value investing, used more recently by Warren Buffett. Keynes was the most unusual of dismal scientists: a brash economic theoretician who put his knowledge to practical use.

> "Keynes was a paradoxical figure – a Bohemian eventually embraced by the establishment, an aesthete who prospered in the world of Mammon, the savior of capitalism with scant regard for the free enterprise system."

Keynes was born in 1883 in Cambridge, England, where he later studied mathematics and classics at Cambridge University. As a young man, he had little interest in money. He embarked on a career as a civil servant but soon became bored and returned to academia. At Cambridge, he led the Bloomsbury crowd of aesthetes and Bohemians. Called the "Bloomsberries," this group was renowned for its complicated love triangles and disdain for convention. During this time, Keynes cultivated the innate contrarian streak that later made him a groundbreaking investor and economist. Without any formal qualifications, he began teaching economics and finance at King's College in 1909. In 1911 he became editor of the prominent *Economic Journal*. World War I deeply affected Keynes, who lost many close friends in the conflict.

> "Keynes would utilize the insights gained from his roller-coaster ride on the financial markets to develop a revolutionary theory that accounted for the booms and busts of modern economies."

Even as he aged, Keynes could be, as an ambassador said in 1917, "too offensive for words." His reputation for harsh language continued during negotiations for the post-war Treaty of Versailles. As economic adviser to the British delegation, he strongly warned that imposing punitive sanctions on Germany would destabilize Europe. In 1919, as treaty talks neared completion, Keynes quit in protest. His well-received book, *The Economic Consequences of the Peace*, came out in December 1919. In it, he criticized the onerous agreement and pilloried Georges Clemenceau, Woodrow Wilson (a "blind and deaf Don Quixote") and fellow Briton, David Lloyd George. Keynes' willingness to spear all comers with his poison pen made him unpopular with his victims. Yet, his contrarian nature served him well as an economist, where willingness to defy the establishment led him to create the dominant economic theory of the coming decades; and as an investor, where going against the grain made him wealthy.

> "In the time of its greatest crisis, capitalism simply did not have the luxury of waiting for the economy to heal itself."

Keynes became an avid speculator in 1919. He traded currencies, which fluctuated violently in the absence of a gold standard. He cashed in profits of £6,000 (around $375,000 today) in five months. Emboldened, he raised £30,000 and launched a trading business in early 1920. After brief success, he lost big in May 1920, but he rebuilt his stake to £21,000 (the equivalent of $1.5 million today) by the end of 1922. In 1925, Winston Churchill reinstituted the gold standard, ending lucrative currency fluctuations. Keynes decried the shift to a strong currency as bad for Britain because exports would become very expensive. With currencies no longer offering attractive investing opportunities, Keynes became a stock trader. He extolled the "dizzy virtues of compound interest" and became a cheerleader for the growing interest in common stocks.

Going Broke as a Momentum Trader

Keynes' strategy, then called "credit cycle investing," is now called "momentum investing." Its 1920s practitioners sought to buy stocks low and sell them high without studying the underlying virtues and faults of the companies. Always imbued with vast self-regard, Keynes convinced himself that he had the savvy to time the market. But in the late '20s, his portfolio began to plummet. A foray into commodity trading soured as his positions in rubber, corn, cotton and tin lost value. His stock in Austin Motor Company also collapsed. By 1930, his portfolio fell to £8,000, about an 80% plunge from £44,000 two years earlier. Keynes' self-confidence and misguided faith in his stock-picking abilities left him nearly broke.

> "The man who confirmed the primacy of money in economic theory thought very little of it in practice."

Keynes' financial misadventures informed the development of his revolutionary economic philosophy. Classical economics said markets were efficient, prices were rational, and labor and natural resources inevitably sought a healthy equilibrium. But having suffered two major drops in his investments, Keynes learned the hard way that classical economics couldn't explain everything. The misery around him underscored this dawning idea. The world had entered the Great Depression, complete with skyrocketing unemployment and plunging consumption. Classical economists essentially blamed workers for their joblessness and argued that these problems would solve themselves in the long run. That offended Keynes' sensibilities, prompting his famous quip that "in the long run we are all dead."

> "The investor staking a large proportion of his or her total funds on only one security is more likely to rigorously scrutinize this potential investment."

In formulating his breakthrough economic theory, Keynes worried that inaction would give momentum to the growing communist and fascist movements, which he saw as flawed alternatives to capitalism. He also disdained the laissez-faire approach of free-market economists. He believed capitalism driven only by naked self-interest glorified unsavory traits like "avarice and usury and precaution." Waiting for the invisible hand to heal capitalism was too dangerous, Keynes argued. He called for heavy government spending to push capitalist economies out of the doldrums. The late 1920s collapse didn't just change Keynes' economic thinking, it reversed his investment strategy. No longer a market timer, he morphed into a value investor, embracing fundamental analysis and a buy-and-hold strategy. He succeeded by adhering to six rules:

Rule One: "Focus on the Estimated Intrinsic Value of a Stock"

After his ill-fated foray into momentum investing, Keynes became a dedicated value investor and bargain hunter. Because markets are inherently irrational, the best strategy, he believed, was finding stocks the market has underpriced. Keynes looked for stocks with intrinsic value greater than the value assigned by the market. Efficient market theory holds that stock prices reflect all information at all times. Keynes knew that stock prices sometimes diverged from the true value of the underlying stock, mismatches that he viewed as opportunities. He applied his bargain-hunting ethos to other aspects of his life. A known cheapskate, he once scored a Cezanne painting at auction for the microscopic price of £327.

Rule Two: "Ensure...a Sufficiently Large Margin of Safety"

Keynes dismissed the possibility of accurately pegging the value of a stock to a specific number. He felt people should protect their capital and said that precise stock valuations, backed by spreadsheets and graphs, only distract investors from a stock's underlying risk. Such valuations were fine for bonds, but unreliable in the unpredictable world of stocks. Instead, Keynes maintained that experts could glean a reliable measure of a stock's worth by analyzing the value of the company's underlying assets. That was simpler in Keynes' day, when physical assets dominated balance sheets. Now, intangibles, like brand equity, patents and human capital, make up much of a firm's net worth. Calculating underlying value can reassure stock investors who want to integrate a sufficiently wide margin of error into their stock valuations.

"Fear of loss can concentrate the mind wonderfully."

In addition to calculating the value of underlying assets, value investors also heed worst-case scenarios. They analyze downside risk to make certain that a move in the wrong direction won't wipe out their capital. In the 1930s, Keynes touted public utilities as investments with limited downside risk. He wrote that "monopoly privileges" essentially assured their yield and that regulations promised bulletproof profits. This 1933 bet helped Keynes triple his net worth in a year. Buffett similarly found a winner in the *Washington Post*'s near monopoly position in the U.S. capital. In 1974, the company was valued at $80 million, yet the worth of its newspapers, TV stations, land and other holdings reached into hundreds of millions of dollars. Buffett protected his capital by sitting out the Internet bacchanal of the late 1990s and focusing on old-economy firms like Coca-Cola. Value investors seek opportunities based on measures like low "price-to-earnings" and "price-to-book" ratios, as well as some competitive advantage that gives a company a market stranglehold or pricing power over its rivals.

Rule Three: "Apply Independent Judgment in Valuing Stocks"

Keynes famously believed in being a contrarian and "leaning into the wind," scoffing at conventional wisdom and ignoring investment fashion. The value investor's mantra is to "be greedy when others are fearful, and fearful when others are greedy." If efficient market theory worked, neither Keynes nor Buffett would have made big money in the market. But stock values sometimes become divorced from reality. Buffett learned this during the Internet bubble, when the price of his Berkshire Hathaway holding company hit bottom just as the tech-heavy Nasdaq peaked. Keynes' contrarian bets didn't always work. In July 1914, as the market panicked over the possibility of war, Keynes loaded up on mining and transportation stocks. He bet that Europe would avoid war and he was wrong, proving that sometimes the market is right. Buffett, too, swung and missed when he bought Berkshire Hathaway – then a maker of men's suit linings. Its price-to-earnings and price-to-book ratios looked suitably low, but Buffett didn't recognize that it lacked the pricing power of a commodity business. As these examples show, contrarian plays can fail, but in the long run, value stocks routinely outperform growth stocks. The value investor must identify out-of-favor companies that offer a sustainable flow of earnings.

Rule Four: "Maintain a Steadfast Holding of Stocks"

Keynes feared that easy trading and the constant flow of data about stock prices would destabilize the markets and sap investors' wealth. He advised ignoring the noise and remaining calm in the face of other investors' irrationality. Not trading is often the most profitable decision. In 1938, he described his philosophy as, "a steadfast holding...through thick and thin," despite what he had said before about human mortality expiring in the long run. His principle of "being quiet amid the noise" encouraged investors to look past short-term fluctuations and focus on the long range. Keynes and Buffett both warned against investment managers who may too often encourage investors to trade just to generate more commissions. "Never ask the barber if you need a haircut," Buffett once said. Capital gains taxes pose another disincentive to active trading. Value investors advise holding stocks for a long time, exercising relentless oversight and frequently re-evaluating your holdings to verify that your original reasons for buying each stock are still applicable.

Rule Five: "Practice...Portfolio Concentration"

Diversification is the modern market mantra, but don't diversify too much since diversification – as practiced by most investors – doesn't work. Keynes believed that holding a few "ultra favorites" was better than owning a large portfolio. Buffett also argues for holding a small group of "superstars." Why own your 20th-favorite stock, Buffett wonders, instead of more of your top favorites? Keynes and Buffett see overdiversification as a tactic for novice investors who lack the expertise to analyze stocks. True, diversification limits downside risk, but it also reins in upside potential. A small portfolio of well-chosen stocks trumps a more far-reaching portfolio of weaker issues. In fact, diversification can lead to risky behavior. Just like flood insurance may encourage property owners to build too close to the water, diversification can tempt investors to speculate too aggressively. Another common misstep is to "rebalance" a portfolio that is full of winning stocks. Buffett likened this to buying an interest in the future earnings of half a dozen promising basketball players, then dumping a big star because he earned too much of the revenue stream. Value investors prefer quality to quantity. Keynes argues that a small portfolio is less risky than a larger, more diversified group of holdings. He did not disdain diversification altogether. He espoused holding "opposed risks," such as buying gold as a counterweight to stocks.

Rule Six: Balance "Equanimity and Patience with the Ability to Act Decisively"

After the 1929 stock market crash, a number of bereft investors committed suicide, including one of Keynes' friends. Keynes himself generally had a bemused, detached attitude toward money, which he considered a tool and a measuring stick but not an end in itself. Calm self-discipline was a foundation of his investment approach. He realized he could control his reactions even if he couldn't control the madness of the markets. Successful value investors need persistence and patience to stick with convictions that the market disputes and emotional detachment to realize that a winning stock doesn't make the owner any happier or better, just as a loser doesn't lessen its owner. That's not to say Keynes was an emotionless automaton who traded with robotic efficiency. He pleaded guilty to holding on to his winners for too long, a mistake attributed to his natural optimism. Warren Buffett has confessed to the same mistake.

About the Author

Justyn Walsh is a director at investment bank Renaissance Capital in London and Moscow. He previously worked as a corporate lawyer and financial journalist.