GMO
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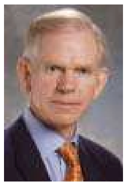


Obama and the Teflon Men, and Other Short Stories. Part 2.

Jeremy Grantham

1. The Year of the Value Trap

Since time immemorial, the most successful value investors have been the bravest. The greatest advantage of value investing has always been that when your cheap stock goes down in price, it gets even cheaper and more attractive. This is the complete opposite of momentum stocks, which lose their momentum rating as they decline and hence become unattractive. But averaging down in value stocks can take lots of nerve and considerable ability in convincing anxious clients of the soundness of the strategy. For at least 60 years, those value investors who managed these problems and bought more of the stocks that had tumbled the most emerged with both the strongest performance and the most business success. (Of course, analytical skills also help, but let's assume that these skills were distributed evenly between brave and nervous investors.) Major market declines in the past set up the best opportunities for brave value managers: the 50% declines of 1972-74 and 2000-02. Value investors in 1972 and 2000 were also able to buy value stocks at their biggest discounts to the general market at least since 1945. In addition, averaging down in those value stocks that fell the most eventually added substantially to an already strong return. Those value managers with the best analytical skills within this group became the few handfuls of super-successful investors.

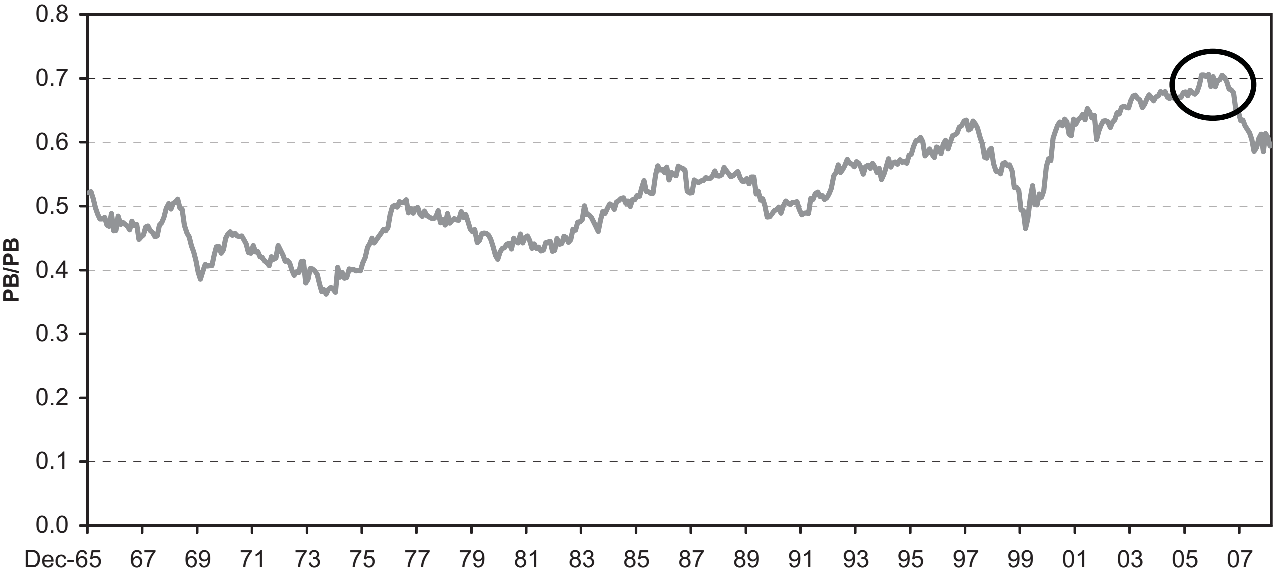
Outsiders could view this as a return to bravery, but it was also a return to risk. The cheapest price-to-book stocks are those deemed by the market to have the least desirable assets. And Mr. Market is not always a complete ass. Because these companies are so often obviously undesirable and are seen as such by clients, they represent a career or business risk to the manager who owns them. This career risk is usually reflected in an extra discount that will deliver an extra return for bearing the career risk. This "career risk" return is in addition to the discount for buying lower quality companies with more fundamental risk. Problems arise when this pattern of over-discounting and handsome recovery has taken place dependably for several cycles in a row. It begins to look like the natural, even inevitable, nature of things rather than merely the most usual outcome. The growth in the number of quantitative investors exaggerated this tendency because quants model the last 10 or 20 years (or even 40) without really requiring a full understanding of the very long-term pattern and why it behaves the way that it does. And none of us modeled data that included the last great value trap: the Great Crash of 1929.

In mild economic setbacks, even the wounded value stocks recover fully. In substantial setbacks, a very small number fail, but not nearly enough to offset the large discounts. Only in the really severe economic setbacks do enough casualties occur to bring home a truth: price-to-book (P/B) and price-to-earnings (P/E) are risk factors. Buying them and averaging down routinely has an element of picking up not nickels in front of the steamroller – that would belittle the substantial returns – but, say, $1000 bills in front of the steamroller. Because of the extra discounts for career risk in the long run (at least for those who are not dead), the strategy will probably still pay off even if the rare, severe fundamental crises are included. But investors should be aware that the fundamental part of the risk premium is justified by the pain of these outlier events and is absolutely not a free lunch.

The value problems of the last two years were particularly bad because of the outperformance that value stocks had between 2002 and 2007. They won for five years in a row, so that by mid 2007 the value/growth spread was about as unfavorable as possible for value stocks in the U.S. (see Exhibit 1). (We recognize that some value investors disagreed with this data when it was first presented. We were, and still are, puzzled by how they arrived at their more positive conclusion.)

To put a measure on how awful the value trap was during this time, please see the Fall 2007 edition of

Exhibit 1
Price to Book – Cheapest Quartile vs. Expensive Quartile



Source: GMO As of 1/31/09

the *Outstanding Investor Digest*. This publication concentrates on a dozen or so of the top value investors and is readable, interesting, and chock-full of insight. However, that particular issue is a heartbreaker as one after another of these superior investors put forward the case that – down 30% to 50% – AIG, Lehman, Wachovia, Fannie Mae, etc., were ridiculously underpriced, and represented enormous long-term franchise value that the nervous market was missing.

It has long been my view that the pricing of value stocks has a folk memory of the Great Depression when many cheap companies went bust and the expensive Coca-Colas survived the best. Remember, you cannot regress from bankruptcy. Using proprietary research data, we examined one fixed time slot: October 1929 to June 1932. With no rebalancing, the data showed a massive "value" wipeout in which high P/E stocks declined far less than low P/E stocks.

As we have pointed out before, one thing is certainly true: on fundamental measures of risk – level of profitability, volatility of profitability, and debt levels – stocks with low P/B and P/E ratios have much lower "quality" and should be expected to be hurt badly in a very serious economic setback such as the one we are now experiencing. And so it was that many of the very best investors had their very worst year in 2008, and were exceedingly happy to see the back of it. Whether 2009 will see a snapback for value is an important question, and not one that we can answer clearly. On the one hand, value stocks are now at least much cheaper on a relative basis than they were a year ago. On the other hand, they can get a lot cheaper, and they face the worst economy since 1938. I would give them at best a 50/50 bet this year. ("Thank you very much for such useful advice!")

2. GMO's Central Skill Set and Loss of Near Certainties

That last point leads neatly into one of my principal regrets: in recent years we have been spoiled by the market in that we were presented with investment opportunities that seemed to us to be near certainties, which we define as probabilities over 0.9. Our principal skill has been to study major <u>upside</u> outliers or bubbles in all financial series, trying to understand and recognize their patterns. That's it. Not a profound exercise. In fact, my hero Keynes was quite disrespectful of this exercise. You are probably familiar with his famous quote from 1923, "But this long run is a misleading guide to current affairs. In the long run we are all dead." What you may be unaware of is how it continues: "<u>Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.</u>" Presumably, he would have been equally contemptuous of the reverse: the prediction that after a long calm, you had better be prepared for another storm sooner or later. I believe it is a rare example of Keynes simply being wrong in both cases. Ironically, for someone who 13 years later wrote the Bible on career risk (Chapter 12 of his General Theory), his error in 1923 was because he underestimated the career and business pressure to keep dancing. In real life, Mr. Market usually acts as if the calm will go on forever, even though he presumably knows it cannot. It's so deliciously profitable until it isn't. And even when the music stops, you can still be considered a "prudent man" – you will have failed, with lots of company, in the traditional way. It turns out that shouting warnings about impending storms after a long calm is a very unpopular pursuit. Even being bullish when everyone else is finally bearish – i.e., predicting a calm after the storm – is not free of career risk.

Well, dear Keynes, that is what we do at GMO. We are specialists in warning of eventual storms after calms, and of calms after storms. In the last 10 years we have benefited from the opportunities offered by a world-record number of extreme storms and outliers, and in September 2007 I was able to warn of three bubbles in one sitting.[1] All of them were world records, and all were "near certainties" to break: extremely high U.S. house prices, extraordinarily high global profit margins, and the lowest risk premiums ever recorded! By then, we had already addressed the extraordinary bubble in U.K. house prices, and soon afterwards we hit the mother lode: a warning of a bubble in all asset prices everywhere. Talk about pigs in mud!

Now, regrettably in some ways, the outliers and near certainties are ending. It is still nearly certain that global profit margins will decline a lot further. But it is no longer certain that this belief is not reflected fully in stock prices. It is merely likely that it is not, and that stock prices will therefore decline to new lows. Perhaps the odds are 2 to 1, which is a very good bet, but far from the rare 9 to 1 odds of a near certainty. Similarly, U.S. house prices are very likely to decline their last 5% to trendline and, since it was an extreme bubble, to overrun by, say, another 10%. But, again, this is at best a 2 to 1 bet. Yes, a bet that U.K. house prices will continue to decline is a lay-up, but it has always been hard to play. Its main effect now will be to impose a lot more pain on a system already so weakened that it makes it very likely that more bailouts or the nationalization of U.K. financial companies will continue. Weakness in the pound was my favorite near certainty in the U.K., but that was at over $2 to the pound. It is now at under $1.50 and, like the other bets, this one has also become a low-confidence bet, although one I personally still hold half of, principally out of consideration for future housing weakness. And the same goes for the yen. It was fundamentally cheap and, as the reverse of the popular and risky carry trade, it was a simple and powerful way of playing the movement against an ultra-low risk premium. It worked better than one could have hoped. But now, after a magnificent move, it is a low-confidence bet where I timidly cling to one-quarter of my original position, since I still believe there are a few more shoes left to drop in the anti-risk move. But there may not be many more.

The bets that global economic weakness was underappreciated – especially in China and the U.K. – were also near certainties, but, here again, perceptions have changed so fast that these are ordinary, decent bets now. This goes for economic policy as well. I was completely confident that "they," our noble leaders, were completely missing the point before. Now I'm not so sure. Yes, I disapprove of the swallow-the-whistle retreads in Obama's financial lineup, but these are brilliant (or, at the very least, very bright) people who know now that things are extreme. They may rise to the occasion. Their potential ineptitude is by no means a near certainty. Thank heaven! So, all in all, the wonderful world of "near certainties" has come to an end, and a pity it is for those in the prediction business.

3. On Exiting a World of Bubbles and Entering a World of Busts

Economic wipeouts and severe market over-corrections, should they arrive, are second best for us. It is true that they are outliers, but busts are not so dependable as bubbles. In contrast to Greenspan's reluctance and vacillation in recognizing bubbles and Bernanke's dismissal of their existence, bubbles do, of course, exist. More to the point, they always, always break, and their breaking is the most dangerous situation the Fed – or the whole economy, for that matter – ever faces. Similarly, strong economies and heroic profit margins always weaken. In crunches, you must lower the odds of regression back to normal to "nearly always." On rare occasions, you can stay down for the duration. If, like Zimbabwe, you really want to take your country back to the Stone Age, you can probably do it. (Thank goodness for term limits in the U.S.) Argentina, the fourth richest country in 1945, has taken its very best shot at resisting the tendency to revert back upward to normal, and is still trying hard. If you

[1] Danger: Steep Drop Ahead, *Fortune*, September 17, 2007.

are in a bubble, then competition in one form or another is guaranteed to chip away at exceptional opportunities, or confidence will suddenly break, or both. In a crunch, in contrast, no one will reliably come to your rescue or help you recover. You're on your own, and can continue to make mistakes, which we in the U.S. may very well do this time.

We at GMO have another problem: almost all of our work has been aimed at the study of bubbles or upside outlier events. Until eight minutes ago, the study of a real bust seemed, in comparison, academic. Now, however, we have thrown ourselves into studying the reverse. This very morning – true story – I unpacked The Panic of 1819, a new book by Murray Rothbard. As I write this at our large and untidy breakfast table, I can see the recently read The Forgotten Man by Amity Shlaes. It is a book about the plight of working men and FDR's erratic experiments with stimulus programs in the Great Depression. At GMO, we are now in full-court press mode, studying the patterns of economic and market lows and looking for predictive clues (with luck, see next quarter's Letter). But this is a relatively new effort after spending 12 years studying bubbles. Ah, well. Of course, this is all written assuming that we are indeed heading to extremes of undervaluation. It could be much worse: we could get stuck in a no man's land where stocks are around fair price and all certainties disappear. Please not.

4. On Accepting Blame and Ethics in General

I think it would be cathartic if all professional investors confessed to making a few mistakes. Lord knows, it has become a lost art. By degrees over recent years, we have become a culture that apparently never makes mistakes, or certainly never admits to them. Almost none of the CEOs who brought companies to their knees – or graves – accepted blame clearly and emphatically. Honchos at Lehman and Bear Stearns were victims, it seems, rather than incompetents. Hundreds of billions of stockholders' money was obliterated without clear apologies. Government agencies that nearly ruined us all have also admitted no mistakes. Greenspan only apologized for other peoples' shortcomings – he failed to realize how bankers would be so greedy in the short term and bereft of rigor and analysis. Really! More recently it is claimed that no one – neither the Fed nor the Treasury – had the legal authority to save Lehman. But such excuses were given only after it appeared to have been a disastrous decision. The last two years were very difficult for everyone. In difficult times, people make mistakes. Why don't they say so? As a typical, if painful, example, I followed Paul Bremer (a classmate, no less!) to the podium at a pension conference. He had just returned from his catastrophic series of miscalculations in Iraq. All decisions had been the best that a difficult situation had permitted, he argued, with a tone that implied that anyone suggesting otherwise should be locked up. This was indeed the tone that characterized the whole last eight years of government. Are the Japanese the only people left with a code of honor? When you make mistakes, or even when the people you are responsible for make serious mistakes, you should surely admit it, at least once in a while. In cases of extreme error, of which we have just had an unprecedented number, someone might even offer to resign. Not a prayer. As a postscript, hot off the press (courtesy of Maureen Dowd in *The New York Times*) comes a shocking admission of guilt from former Vice President Dick Cheney on CBS Radio: "I think we made good decisions. I think we knew what we were doing." Dowd also reports that Rumsfeld said, "My conscience is clear." Surely anyone saying that doesn't have one! In terms of admitting no errors and denying all responsibilities, the Bush administration is certainly going out with a bang.

If this section is to be credible, I must do some confessing. Rats! Well here goes: I was not always effective in capturing, through implementation, the full benefits of top-down insights. The same could be said for our asset allocation group, to which I belong. With the benefit of hindsight, we as a firm took too much liquidity risk in one or two strategies, and tilted toward too much risk in others. Even those insights we got right, we could have played harder. I regret all of these shortcomings, and believe that we can do better. I and GMO promise that we will strive to be more effective help next time.

This has also been the very lowest point for ethical standards within the financial industry. Rather than go on at length, allow me to single out one issue: the fees charged by managers, including large and previously reputable European banks, who shoveled off clients' money to Bernard Madoff. Their legal documents are no doubt impeccable and make it clear they cannot be held liable for anything, including outright fraud. Of course, we must then ask what the 1.5% fee plus performance incentives were for, since they were not actually managing a dollar of the money. But that is not the point.

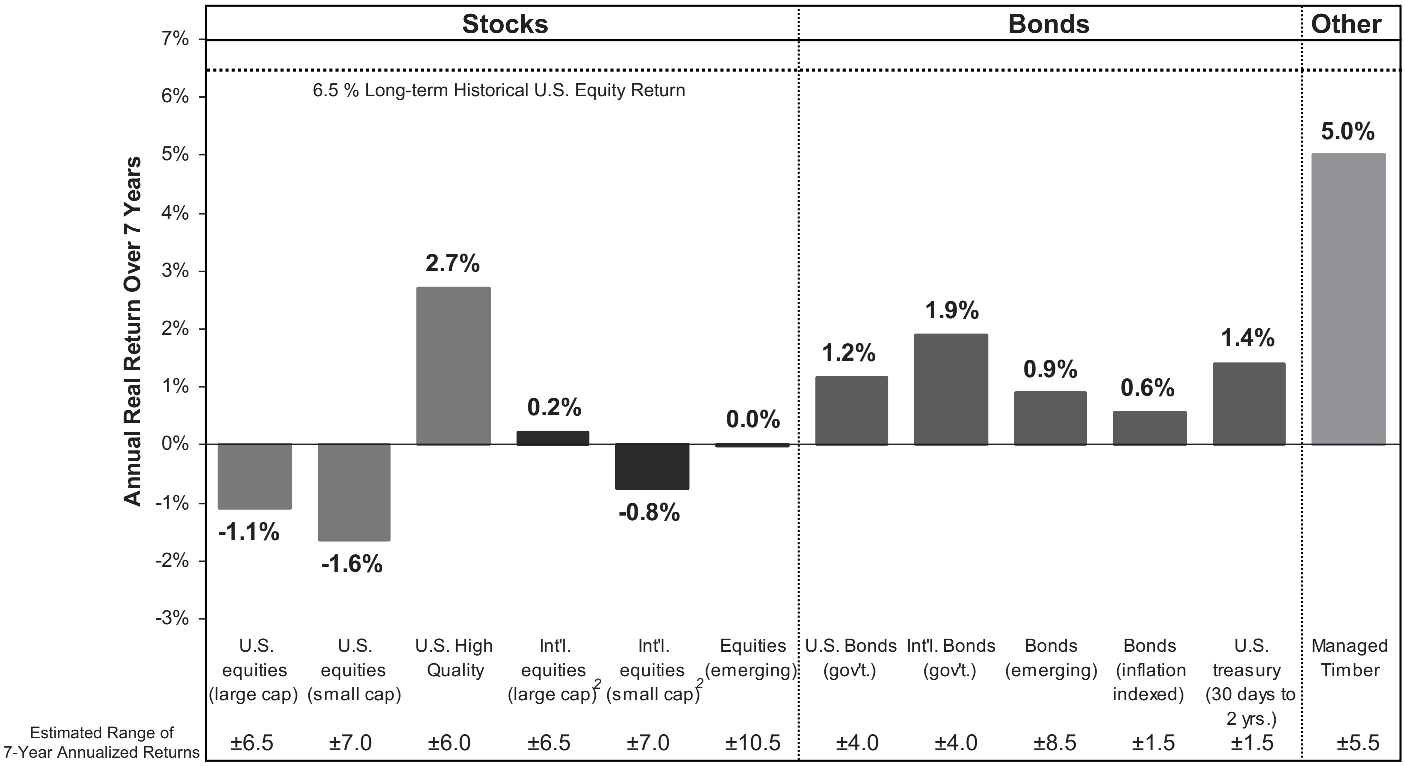
Reflecting high ethical standards, they should return all of the money for doing so shoddy a job. With even the merest hint of ethical standards, they should at least return their fees. Union Bancaire Privée, for example, charged a substantial fee for investing their clients' money with Fairfield Greenwich Group, who, in turn, charged a lot to invest with Madoff, who actually did the "work!" At least Madoff had the decency to waive his fee. Settling for the principal was enough. You could call this a fund of funds of funds of Ponzi. Even if there had been a real investment at the end of the pipeline, this would have been iniquitous.

5. 7-Year Forecast and GMO's Current Strategy

Our 7-year forecast as of December 31 is a very far cry from that of a year ago. Exhibit 2 shows what a dismal forecast we had for everything on December 31, 2007. Today all equities are moderately – one might say, boringly – cheap. The forecast for the S&P has been jumping around +6% to +7% real, with other global equities slightly higher. To put that in perspective, a 1-year forecast done on the same basis we use today that started in December 1974 would have predicted a 14% return (which, by the way, it did not deliver since the market stayed so cheap). For August 1982, the forecast would have been shockingly high – over 20% real! So do not think for a second that this is as low as markets can get. Now, I admit that Greenspan and 9/11 tax cuts caused the "greatest sucker rally in history" from 2002-07. We therefore cannot rule out another aberrant phase in which extreme stimulus causes the market to rally once again to an overpriced level for a few more years, thus postponing the opportunity to make excellent long-term investments yet again. But I think it's unlikely.

GMO has attempted to tiptoe through the land mines in asset allocation and to minimize regrets as described last quarter, caught between the potential regret of missing decent investment opportunities, and the potential regret of investing too much too soon and then watching our tactical 2 to 1 guess of a new low come true. In October, our Global Balanced Asset Allocation Strategy was at 39.8% in global equities, well below our 45% target

Exhibit 2
GMO 7-Year Asset Class Return Forecasts* as of December 31, 2007



***The chart represents real return forecasts[1] for several asset classes. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Actual results may differ materially from the forecasts above.**

[1] Long-term inflation assumption: 2.5% per year. [2] Return forecasts for international equities are ex-Japan.

Source: GMO

minimum (itself lowered from 50% in the previous year with clients' consent). We are now at 55% against a 65% norm and a 75% maximum equity position. If the market stays moderately below fair value, our current intention is to move "creeping like snail" toward a neutral 65% by late summer. If prices pull ahead of fair value, we will freeze and stay underweight. If prices plummet to new lows, we will invest more rapidly according to a prepared schedule, e.g., at 600 on the S&P, invest in another several percentage points of equities, etc. This plan minimizes our potential regrets and leaves us feeling as little discomfort as possible, given the strange world in which we now live.

6. GMO and Big Bets

Dick Mayo and I bet on small caps and hard-core value in the Nifty Fifty blue chip market of 1972. Being young and rash, and having a senior partner – Dean LeBaron – who admired flash, we put 100% of our money into small cap value before either small or value existed as sub categories. We were measured against the S&P, which made for a bumpy, but eventually very successful, ride.

We took that philosophy with us to GMO and refined it, with one refinement being to add a little more moderation, but not too much. In 1987, for example, in EAFE accounts (where we were one of the earliest players) we went to zero in Japan against a Japan weight in the EAFE benchmark that rose to 65%! More recently, for the last 10 years we had a handsome overweight in emerging equities and a minimum weight in U.S. equities, reflecting our 10-year-ago forecasts of +10.9% real for emerging and -1.1% real for the S&P. (This 12.0% difference for 10 years would have compounded so that every $1.00 in the S&P would be matched by $3.10 in emerging. This gives you some idea of the degree of aggressiveness in the forecast. And 10 years later, on October 1, 2008, there was $3.20 in emerging for every $1.00 in U.S. equities. Ta da!) But our biggest bet recently has been on quality stocks in the U.S. – a bet on the great franchise companies. Our U.S. Quality Strategy became more than 90% of our U.S. equity money in our Global Balanced Asset Allocation Strategy. And 50% of the quality stream was injected into our venerable U.S. Core Strategy. This was the first important override of our U.S. quant model in its 29-year history! We used to call the Japanese underweight a once-in-a-lifetime override. It was done – of course – three years too soon, and cost us 10% a year against a dramatically rising EAFE market. It then gained us almost 20% a year as Japan crashed. At the end, we had added over 4% a year and lowered the real absolute volatility as opposed to the benchmark volatility. Our timing of injecting quality into U.S. Core was better than the timing of the Japan bet as we won last year by 11 percentage points on a divided basis. (This is the number that determines your compound advantage: for example, a 10-point gain in a year when the market doubles is worth only 5% compounded, and a 10-point gain in a market that halves is worth 20%. I wish there were a convenient, accepted terminology for this.) The bet on quality was perhaps U.S. Core's once-in-a-lifetime override.

Perhaps the biggest and most painful bets in GMO's career, though, were against the 2000 Growth Bubble. In asset allocation, we had the allowed minimum percentage (50%) in global equities, and within that 50% minimum, we had a minimum exposure to U.S. equity. Further, within that minimum U.S. position, we had the minimum exposure to growth stocks and large caps. And, as we've been bragging recently, some of our long-term forecasts were bizarrely accurate. Yet in the short term – two-and-a-half painful years – we delivered low double-digit returns in a high double-digit world, and lost the quickest 60% of our book of asset allocation business on record!

In early 2006, I was asked at a Boston Security Analysts Society forum what the secret was to our rapid growth of assets then (*sic transit gloria*). I replied that it was the easiest question of the evening, and added, "We are simply willing to lose more business than the other guys." By this I meant that we are extremely attached to the idea that we make very big bets on those relatively rare occasions when we have very high confidence. I believe that career and business risk – the fear of losing clients – dominate our business, and it is so hard to sidestep that the big bets will always be available and will always be career threatening. And that is the turf we have staked out: make the "near certain" bets as large as we can, sweat out the timing problems, and pray for patient clients.

7. On the Joys of Buy and Hold

Jeremy Siegel and I have had several debates, and he has always been the bull. In late 1999, he was nervous about Internet stocks and a few tech stocks, but felt that the S&P would muddle through with an about-normal return. In his honor, I have always named two of our exhibits "Stocks for the very, very long-term." In the first exhibit, which we've used before, we show that buying at both the peak of 1929 and the peak of 1965 would have sentenced investors to identical 19-year periods of waiting to get their investment back in real terms, with precisely zero positive return. Two 19-year periods in only the last 80 years, in a country that was spared the worst of global misfortunes! The second exhibit shows a 26-year round trip in Japan from 1982 until today that made no gain, and a 19-year period in Japan from 1989 until today that cost the investors 78% of their money! Now patience is a virtue, but this is ridiculous! Heavy buy-and-hold equity positions are fine for long-lived computers, but for impatient humans – given as we are to waves of overconfidence and abject fear – they are simply dangerous and unsuitable.

The buying and holding of a fixed portfolio mix with annual rebalancing is okay, I suppose, for individuals who are intimidated by making changes. And even for these individuals we had better hope that they don't panic and abandon stocks completely when all risky assets fall together as they did recently. But for institutions with access to professional advice and with long investment horizons, surely a fixed mix is aiming too low. If the last 15 years has taught us anything, hasn't it taught us that asset classes can be incredibly mispriced, along the lines of the 35 times inflated earnings for the S&P in 2000? Why would you ignore these opportunities to sidestep trouble? It is surely sensible to be fairly static when pricing is normal or even halfway normal, but when very large mispricings occur, should we not reasonably move away from extremely overpriced assets toward more attractive ones? Markets are very mean-reverting over longer horizons, and sophisticated clients always proclaim their patience. Asset allocation based on serious action at the extremes and inactivity the rest of the time has a good record and can be done quite simply. Let me give you an example of the power of asset allocation that is very close to home: GMO has a solid implementation edge in our broad range of equity funds and in emerging debt, which has equity-like features. Our average equal-weighted alpha for all equity funds is around 2.0% per year, after all costs, and cap-weighted is somewhat higher. This is one of the best records for a broad range of funds. Yet, despite our very decent implementation edge, in our 16-year-old Global Balanced Asset Allocation Strategy, over 80% of the total outperformance of the benchmark and over 60% of the reduction in volatility has come from moving the mix of assets, rather than from our implementation. (For the record, the total is about +2.9% a year over the benchmark, with a 22% reduction in volatility for an efficiency rating – return compared to volatility, or Sharpe Ratio – that is 3.5 times the benchmark, or .49 compared to .14). Asset allocation is simply much easier than adding alpha to a fund, since there is more to sink your teeth into. Counter-intuitively, asset classes are more inefficiently priced than stocks. There is a large and relatively efficient arbitrage between stocks, and the career risk of picking one stock versus another is quite modest. In contrast, when picking one asset class against another, it is painfully clear when mistakes have been made. This immense career risk makes it likely that there will always be great inefficiencies, for investors are reluctant to move money across asset boundaries. Consequently, there is great advantage to be had in getting out of the way of the freight train, rather than attempting to prove your discipline by facing it down. The advantage is in both higher return and lower risk.