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Jeremy Grantham: 'We add nothing but costs'

By Pauline Skypala
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Jeremy Grantham likes to quote Paul Volcker's observation that the only truly useful financial innovation in the past 20 years is the cash machine. The rest, says Mr Grantham, was only of benefit to the guys who came up with it, and who paid the price when it all went wrong? "We did."

Mr Grantham, founder and chief strategist at GMO, the Boston-based institutional fund manager, is uncomplimentary about his industry. The bankers, and former Federal Reserve chairman Alan Greenspan, are the main villains of the piece, but the investment industry is not blameless. He made this clear in his last quarterly letter, published in January, and revisits the topic when we meet in late March.

The business is a zero-sum game, he points out, and "we collectively add nothing but costs". Costs have grown because there is no fee competition, due to the agency problem and the information advantage the agent has over the client. Growing complexity has increased the client's dependence on the industry.

The increase in fees has been at the expense of long-term growth. "If we raise our fees from 0.5 per cent to 1 per cent, we actually raid the balance sheet. We take 0.5 per cent from what would have been savings and investment and turn it into income and GDP. In other words, you're taking money that would have become capital and chewing it up as bankers' bonuses."

Mr Grantham rejects the idea this misallocation of capital to fees creates useful extra liquidity. "What does the liquidity buy us as a society? Serious investment is about long-term holding. It's about making bets about what will happen in the nextseveral years. The rest is some form of speculation."

It is not surprising Mr Grantham takes such a stance. His business has suffered hugely in the past from his determination to take the long-term view and steer clear of market bubbles. GMO spent 1998/99, "which was the greatest bull market in American history, going from $30bn (£19.5bn, €22.6bn) to $20bn assets under management". That takes some doing, he points out, "because every day your asset base is trying to go up and ours was going down".

Curriculum Vitae

Jeremy Grantham

Born: 1938
1961: Sheffield University, (BA)

1966: Harvard Business School (MBA)

1961: Economist, Royal Dutch Shell

1969: Co-founder of Batterymarch Financial Management

1977: Co-founder and chief investment strategist, GMO

It was a shocking experience, as the firm had previously managed to avoid losing business in tough times. “We lost all that money for making the right bets for the right reasons and winning the bets. Still, we lost more money than our competitors.”

The firm has since seen it all come back, and more, reaching $155bn under management at the peak in 2007, and $107bn at the end of 2009. But Mr Grantham is just as committed to avoiding overvalued assets, and points to the firm’s forecasting record to back up his view that overpaying is a mug’s game.

GMO has 30 completed forecasts, having started in 1994 doing 10-year forecasts before transferring to seven-year ones early this decade. “You could ask the question, how many are better than random? And the answer is 30.” The forecasts rank asset classes in order of expected real return, and Mr Grantham is particularly pleased with the 10-year forecast ending December 2009.

This had US Reits (real estate investment trusts) at the top of the list followed by emerging market equities, and the S&P 500 at the bottom in 11th place. In the event, emerging market equities did best, returning 8.1 per cent a year after inflation (the forecast was 7.8 per cent), Reits were third with 7.4 per cent (10.0 per cent), and the S&P was last with -3.5 per cent (-1.9 per cent). The ranking of the assets in between was almost spot on. The probability of getting that right by chance was 1 in 550,000, says Mr Grantham.

GMO

Established: 1977

Assets under management: $106bn

Number of employees:
519

Offices: Based in Boston, with offices in London, SanFrancisco, Singapore, Sydney and Zurich

Clients: Mostly institutions

Ownership: Privately held company

It is one in the eye for the efficient market people, who Mr Grantham likes to tease. “They would have looked at the forecast and said it was preposterous, with the risky asset – their terminology for the S&P – underperforming cash, bonds and the kitchen sink. Why would people take a risk to underperform?

“Then they would have looked at the gap between emerging [and developed market equities] and said, this is utterly crazy; they’re correlated these things.”

The element they leave out of the equation is value. “If you are really cheap you do much less badly in a bear market than you expect, and much better in a bull market.”

Which raises the all-important question: is anything cheap at the moment? “Now that’s a problem,” replies Mr Grantham, because of the fast move by markets last year off their lows. He advises investors to be “prudent and cautious” and recognise that US and European markets have moved from being very cheap to decently expensive again.

The US market is thoroughly expensive, he adds, with one exception – the boring quality franchise companies like Coca-Cola, Microsoft, or Johnson & Johnson. These companies are selling at a discount despite being “beautifully positioned” to survive the seven lean years to come, as the US deals with its debt mountain and trade imbalance with China.

We move on to the subject of asset price bubbles. Mr Grantham sees Ben Bernanke, chairman of the Federal Reserve, following the same path as his predecessor. It is a little harder for him to stoke the next bubble, given the burnt fingers people are still nursing, but by keeping rates very low, “he is teasing us into not putting money into cash”.

Mr Grantham’s candidates for potential bubbles are emerging markets and commodities. The former is a no-brainer: “it’s correct; they will have better GDP [growth]”. He does not think valuations will go as high as in Japan or on internet stocks, but a 50 per cent premium is possible. “Let’s say the market at 15 [price/earnings ratio] and these guys at 22.5.”

Should investors try to grab a piece of that, or steer clear? Mr Grantham would personally like to join in, “as an individual”. But he is not certain it is a good policy. The question is, “if you want to buy bargains, when do you knowingly overpay a bit, because you see a queue of people outside ready to buy?

“We haven’t settled that internally. We like the idea of exclusively playing the long-term winning bets. Why mess around with the secondary considerations?”

The question is even harder to answer with regard to commodities. The story here is “we’re running out of everything” but it is a long-run story beyond the time horizon of most clients. Investors can probably make money, “but the tricky problem is overpaying upfront. The price has shifted.”

Those with a genuine 10-20-year horizon “should own people who own the resources”, because there is no money in processing, only in ownership.