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The puzzle behind blue chip valuations

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Market behaviour is singularly unfriendly to conventional investors at present. Asset prices, whether of equities, bonds or alternative investments such as commodities, go up and down in lockstep in a Pavlovian response to central bankers tweaking the monetary tap. Yet when prices go down, many investors feel that nothing looks that cheap.

The obvious exception, I would argue, is that of quality stocks in the US and much of Europe, which are not on demanding ratings. As Jeremy Grantham of GMO, the fund management group, argues in his latest quarterly rumination, this is a puzzle. It is as if, he says, there is an extra and unusual force working against them. And he offers two tentative explanations for the phenomenon.

The first concerns population. Because there are more new retirees per new worker than in the past, retirees are selling stocks to pay the bills and are buying more conservative fixed income investments. The stocks they are selling are probably blue chips since they will have sold most of their speculative stocks in the decade before retirement.

The second explanation is that institutional investors have been following the strategy of the Yale Endowment by putting more of their portfolios into private equity, hedge funds, commodities and real estate, while within their equity investments they have been increasing exposure to foreign equities. Hedge funds, of course, are not paid to buy Coca-Cola, while private equity firms do not invest in big companies with hallowed brands. Old fashioned blue chips and government bonds, meanwhile, are being liquidated to pay for this portfolio shift. While the Chinese and other managers of official reserves have filled the bond market gap, no one has stepped into the breach with blue chip equities.

This is fine, as far as it goes, but the puzzle can also be approached from another angle – that of the dwindling number of investors whose strategy involves buying low and selling high. Consider the pension funds. These are natural buyers of equity in the early stages because they are paying out little to pensioners and have a great capacity to absorb risk. Yet when they become mature they shift to lower risk government bonds regardless – well, more or less – of the valuation of equities to secure a safe income match for pension payments. That trend has now been exacerbated by the fashion whereby both mature and immature pension funds switch exclusively to fixed income in the hope of finding a precise match for their liabilities.

Then there are the momentum traders, fund managers who follow short-term trends to minimise their business risk as opposed to maximising clients' returns. Paul Woolley, former GMO fund manager behind the London School of Economics' Paul Woolley Centre for the Study of Capital Market Dysfunctionality, has shown how such

fund management principal-agent issues contribute to mispricing and market inefficiency.

Finally, managers of official reserves are certainly not in business to buy low and sell high. Countries like China that run mountainous reserves are earning negative real returns. While they have been trying to raise returns of late, their ventures into equity have been a tiny fraction of the total and have met with mixed success.

All of this builds a structural bias against equities, and especially quality stocks, into the market. The question is whether and when blue chips might perform again. Certainly they ought to make a comeback. The big move into alternative investments has conspicuously failed to live up to its promise of providing diversification. While a minority of investors in hedge funds and private equity have done well, average risk-adjusted returns have been poor relative to quoted equity. The herd that follows Yale, which is now in the doldrums, may be ripe for a U-turn.

The current account surplus countries like China that are racking up huge reserves should also consider a greater shift towards equity. The snag here is that equity performance over the past 10 years is not a great advertisement for the strategy. In a compelling new book*, Charles Dumas of Lombard Street Research argues on China that the renminbi would have to float freely first, so that Chinese people are not spooked by the possibility they might become victims of future renminbi appreciation.

If that were to happen, and if private pension funds were allowed to flourish, the Chinese would emerge as global equity buyers of last resort. This, as Mr Dumas points out, would be a hugely positive move for global economic and financial adjustment. Yet for it to make sense to the Chinese, they would have to be confident that there was, in turn, another buyer of last resort to finance their pensions. It is not clear who would fill that role. Africa? Latin America? Either way, a bonfire of Chinese capital controls is highly unlikely in the short term. So Mr Grantham's blue-chip puzzle may be with us for a while.

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