

Seeing Beyond Today

In December 2008, near the depths of the worst bear market since the 1930s, we awarded the Sigma Nostradamus Award to GMO LLC, an investment firm with an outstanding record in market prediction (we post all past newsletters on our website). Given the recent emotion-inducing moves in the market, we return to the theme of the value (or lack thereof) of market prognostication. You can hardly read a magazine or watch TV these days without some pundit issuing a confident prophecy about the near-term twists and turns of the financial markets.

Almost all such guesses about the future are worthless. This makes it particularly maddening that most investors seem to believe the key to investing is successful prediction. There is no accountability for the most prominent market prognosticators, though – you never see a text box under a talking head on CNBC telling you that their previous market prediction was completely wrong. On Wall Street, pundits start every day with a clean slate. If we knew how often they were wrong, how much money we would have lost following their forecasts, we would not pay attention and CNBC would lose advertiser revenue.

GMO goes beyond the entertainment and sales features of most predictions; they actually care about being correct. Each month, they estimate inflation-adjusted returns for multiple investment classes over the next seven years, looking at historical averages for price-earnings ratios, profit margins, real sales growth, dividend yields and other fundamentals compared to current levels. They then forecast returns assuming, with some minor adjustments, that those parameters returned from current levels to “normal” over the seven years.

There are three reasons we pay attention to GMO’s forecasts but almost nobody else’s. First, unlike most pundits, the firm bases its forecasts on a consistent quantitative methodology, not subjective guessing. Second, GMO holds itself accountable – it publishes its forecasts, and you can go back and check the record. Jeremy Grantham, one of GMO’s founders, regularly discusses the reasoning behind current predictions and the failures, as well as successes, of past forecasts. Third, the predictions are long-term, in line with the time horizon for most investors, even if it is out of line with the attention span of most investors.

In our previous newsletter, we detailed GMO's September 1998 projection near the height of the technology bubble. GMO thought then that for several years into the future, the S&P 500 return would be zero. This proved to be extraordinarily prescient. In a delicious ironic twist, however, clients severely *punished* GMO for its sin of being correct. Few in late 1998 could imagine a long-run return of zero for a stock market that essentially had gone straight up for 16 years. Clients therefore concluded that the only other possibility was that the folks at GMO were a bunch of fruitcakes. Relatively quickly, the firm lost clients representing over 40 percent of its assets under management. GMO was akin to Cassandra, cursed to be correct but not believed.

*"...the wisest prophets make
sure of the event first."*

-- Horace Walpole, 1785

We decided to bring things up to date by evaluating the GMO predictions released in October 2004 for the period just ended on September 30, 2011. We looked at their projected returns for nine investments – large and small U.S. stocks, large and small foreign stocks, emerging market stocks, Treasury bonds, foreign government bonds, emerging market bonds and Treasury bills.

GMO again did remarkably well in their estimated ranking of the returns on the nine investments. The two they forecast to have the top returns, emerging market stocks and emerging market bonds, in fact had the best returns. The three they forecast to have the worst returns, U.S. large and small stocks and Treasury bills, in fact were the poorest performers. GMO projected a negative real return for the S&P 500 for the seven years. Given the prevailing optimistic investor sentiment in late 2004, this seemed outlandish, but GMO was correct. Despite their being a little optimistic about the relative returns of large foreign stock returns, this 2004 forecast was another astonishing showing. GMO is a giant in the world of mostly-wrong-most-of-the-time pundits.

In their most recent predictions for investment returns through September 2018, GMO is once again swimming against the current of popular opinion. Based upon fund flows, investors believe foreign stocks are dangerous, perhaps understandable given that the European debt crisis dominates the headlines. If there still are typesetters for newspapers, they could save themselves a lot of work each day just by always having ready two headlines: "Stocks Higher on European Debt Hopes" and "Stocks Lower on European Debt Fears." Nevertheless, GMO believes foreign developed and emerging market stocks will be the *highest* returning investments over the coming years. For the S&P 500, the projection is an unexciting 3.1 percent real return after assumed inflation of 2.5 percent. Investors have fled equities, flocking to bonds and cash, but GMO projects negative real returns on all fixed income and cash investments other than emerging market debt.

GMO is not always right, and their future record may not be as good as in the past. Their approach is only one small input in our investment process. We stay away from the prediction sweepstakes, preferring instead simply to take advantage of the opportunities the financial markets present to our clients. Our point in revisiting GMO's contrary thinking and noteworthy record is to remind you that being right and feeling comfortable are often incompatible in investing. Baby boomers may remember the 1960s mantra "if it feels good do it." A simple inversion of that phrase may be the start of investment wisdom. Very often, what feels good (e.g. buying technology stocks in 1998 or "safe" real estate in 2006) proves unprofitable, while what feels scary (e.g. buying stocks at the bottom of the bear market in early 2009 or last year's correction) results in good returns. We wish the Europeans well, but what seems important in the daily news is almost certainly insignificant to your long-term investment success. What produces comfort today may not generate joy tomorrow.