

The Man Who Saw Tomorrow

People want to believe successful investing depends upon prediction, despite abundant evidence that most predictions are worthless. Market pundits all seem to express themselves confidently, but most have little in the way of results to justify that confidence. No matter how impressive their credentials, interviewees saying, “I don’t know” does not make for riveting television or journalism. Financial media are mostly entertainment; predictions are mostly marketing.

Almost all predictions are short term ~ next week, next quarter, next year. A seven-year prediction will fail to hold the interest of viewers and readers who may be agonizing over what to eat for lunch. Another factor enabling the prediction game is that there is no accountability. If, as an interviewer, you had the gall to say “Fred, last year what you told us proved to be totally wrong,” viewers will switch the channel and you will have trouble booking guests for your program. If the futility of most predictions was understood, there would suddenly be a lot of open airtime and unfilled print space.

Predictions need not be pointless, however, if predictors can forgo the desire to be entertaining. Our Nostradamus Award goes to Jeremy Grantham, head of GMO, one of our favorite investment managers. GMO regularly estimates inflation-adjusted returns for the next seven years. The firm looks at historical averages for price-earnings ratios, profit margins, real sales growth, dividend yields and other fundamentals compared to current levels, and then forecasts returns assuming, with some minor adjustments, that those parameters returned from current levels to “normal” over the seven years.

GMO’s projections used to extend ten years into the future. At the end of September 1998, their 10-year forecast for the S&P 500 index of large U.S. stocks was for an annualized real return of -1.1 percent per year. In late 1998, after 16 years of a huge bull market, in the thick of the technology bubble, the forecast of negative long-term returns on U.S. stocks made many people think Grantham was a nut. GMO, having had few clients fire them over the preceding 20 years, lost clients representing 45 percent of its assets under management in 1998 and 1999 while the market continued to soar. Nobody wanted to hear a negative prediction, and many clients and

consultants concluded that GMO and Grantham just did not understand the new, technology-driven world.

Ten years later, the annualized real return for the S&P 500 was zero. Ten years *and four trading days* later, the predicted return exactly matched the -1.1 percent forecast. In 1998, Grantham was not bearish on everything – GMO’s forecast for emerging market returns far exceeded the consensus of other firms. That prediction turned out to be correct as well. Grantham admits that hitting his prediction exactly was a fluke, but he stands by his methodology.

“The future is something which everyone reaches at the rate of 60 minutes an hour, whatever he does, whoever he is.”

– C. S. Lewis

So this forecast may have been right, but why do we think its success is more than mere luck? First, unlike so many of the year-end predictions to which we are all subjected, GMO bases its forecasts on a consistent quantitative methodology, not qualitative guessing. Second, GMO subjects itself to accountability – it publishes its forecasts, and you can go back and see how they have done. Grantham regularly discusses their failures as well as their successes. Third, the predictions are long-term, in line with the investment timeframe for most people,

even if it is out of line with the average investor attention span. Even if you are a 65 year-old retiree, your investment horizon stretches over decades – your life expectancy plus the additional years you may live if you do not die when the actuarial table tells you. An annual forecast may be entertaining to many investors, but it is of little use to most.

Perhaps the most important lesson of Grantham’s 1998 forecast is that it illustrates a risk Grantham often discusses, but most investors prefer to pretend does not exist. With every decision or trade, investment managers face investment risk, but they also face *career risk*. The GMO forecast ten years ago was dead right, yet fleeing clients devastated GMO’s business. Client patience is often shorter than the time it may take a reasonable decision to prove correct. Many former GMO clients probably switched to aggressive, technology-laden managers just in time for the bursting of the tech bubble to hammer their portfolios. We all hate to confront our mistakes, so our bet is more of those fleeing clients remain with the new managers than went back to GMO. Grantham was like Cassandra in Greek mythology, correct, but not believed. It would have been far better for GMO’s business for its forecasts to fail conventionally rather than to succeed unconventionally, for GMO to lose client money rather than to lose clients.

A year ago, after a five-year bull market, with many investors relishing the supposed “great moderation” of the business cycle, GMO again predicted negative returns from stocks. Now, with prices cheap after the demoralizing bear market, GMO expects buoyant returns from developed and emerging foreign stocks and healthy, above average returns for U.S. large and small stocks. The expected returns from bonds and cash, however, the assets everyone has been fleeing to recently, are low. Grantham is again out of step with the consensus, with many dismissing him as a foolish bull who does not grasp how bad things are.

GMO is not always right, and their asset class predictions are just one input among many in Sigma’s investment process. If you would like a manager that understands the importance of valuation and time in investing, though, and the ability to see the long view rather than panic over what will happen next week, contact us at (503) 419-3938 or www.sigmainvestment.com.

Sources: GMO, Consuelo Mack WealthTrack, 11/21/08

