GMO

QUARTERLY LETTER

October 2008

Silver Linings and Lessons Learned

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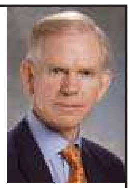


Summary and Conclusions

When asked by *Barron's* on October 13th if we would learn anything from this ongoing crisis, I answered, "We will learn an enormous amount in a very short time, quite a bit in the medium term, and absolutely nothing in the long term. That would be the historical precedent."

That is unfortunately likely to be the case. But over the next several years at least, there are many silver linings and valuable lessons to be learned. We have had a generally unattractive and difficult investment environment for the past 10 years. For most of that time we have also had a negative savings rate.

We have had a bloated financial industry feeding off the real world and a breach of the social contract with the increasing maldistribution of income (encouraged by tax changes!) in favor of the very rich at the expense of ordinary people. We also had unnecessary flaunting of this new great wealth. To cap it off, we had blinkered, narrow-minded leadership by the government and financial corporations. Well, much of this is ending. Some undesirable elements will disappear for a long time and some will just be moderated, but it is truly the end of an era and a rather disgusting one in my opinion, speaking as a thrifty Yorkshireman. We can now re-assess a lot of our thinking about investing, particularly market efficiency, outlier risks (boy, did Nassim Taleb get that one right!), and theories of diversification and longer-term asset allocation.

A very weak global economy is not without partially offsetting benefits: We can temporarily forget about consumer inflation and particularly enjoy the advantages of lower oil prices as reflected in lower heating oil and gas prices. Falling metal and agricultural prices will also help relieve some of the pressure on otherwise squeezed consumers. In a global crisis like this, the U.S. finds itself unexpectedly cast in the role of a safe haven. The dollar is as strong as a horse and yet our trade deficit still makes progress from earlier sustained dollar weakness, helped by new tumbling oil prices and falling consumption of other imports. Chief among the many benefits of this crisis are unprecedented opportunities for investing in some fixed income areas where some spreads are so wide as to reflect severe market dysfunctionality. As of October 18th, we also have moderately cheap U.S. and global equities for the first time in 20 years. (You really have to put the dates in these days!) Probably quite soon, global equities too will offer <u>exceptional</u> opportunities after the additional pain that is likely to occur in the next year. We at GMO are already careful buyers. We are reconciled to buying too soon, but we recognize that our fair value estimate of 975 on the S&P 500 is, from historical precedent, likely to overrun on the downside by 20% to 40%, giving a range of 585 to 780 on the S&P as a probable low. The world faces unavoidable declines in economic activity and profit margins, so this overrun is unlikely to be much less painful than average, although you never know your luck.

All We Have To Thank Is Fear Itself

Thankfully, pure fear – approaching blind panic – finally induced some real action on the part of the authorities. This more decisive phase, injecting money directly into the banks as well as supplying liquidity in many forms, was initiated in the U.K. by Prime Minister Brown, the previously profligate Chancellor of the Exchequer. European governments managed somehow to grind their teeth and overcome their natural reluctance to follow Perfidious Albion anywhere. This, in turn, apparently encouraged the U.S. to jump on board with this more direct approach.

This was a game-changing event that has probably saved us from tipping into the pit. There will unfortunately be considerably more financial pain where the recent pain has come from: more global bank failures, more massive write-downs from credit cards and leveraged debt, and, increasingly now, the typical corporate defaults that follow a very weak economy. And the economies of most countries will surely be very weak. In the U.S., the downturn is likely to rival 1982 or worse, and almost everywhere it is likely to be a much longer downturn than normal.

Also high up the list of silver linings and lessons learned is the Fed's apparent change of heart on the topic of bubbles in asset pricing. The breaking of the tech bubble set up the excess stimulus of 2001–03, which in turn created the housing bubble as surely as if a law had been passed that all house prices had to be marked up 50%. And now at last, there are signs of hope: signs that Bernanke is reconsidering: "Obviously, the last decade has shown that bursting bubbles can be an extraordinarily dangerous and costly phenomenon for the economy *(Ed.: the man's indisputably a genius),* and there is no doubt that, as we emerge from the financial crisis, we will all be looking at that issue and what can be done about it." So all the unnecessary suffering inflicted on us by short-sighted policies dictated by academic economists may not have been entirely in vain!

However it is definitely not a done deal. Few academics change their minds, and few scientific theories founder on the simple facts. "Science advances one funeral at a time" is how Max Planck expressed his belief in academic flexibility, but a suggestion that we use firing squads would seem mean-spirited. Already, Fed members are making the obvious point that interfering with investment bubbles as they grow by using the "blunt instrument" of raising rates would likely "in the short run curtail some economic growth!"[1]

But interfering with bubbles forming would not destroy growth, only postpone it, which is undesirable enough. Bubbles breaking, in contrast, reveal the destruction of wealth produced by the extreme misallocation of capital that has sucked so much investment into certain areas – dotcom start-ups, overbuilding of housing, hiring multitudes of real estate agents, and designers of elaborately structured financial notes, for example. And if the bubbles precipitate a true credit freeze-up, then some inputs into really useful investments may be lost forever: factories not built, education postponed indefinitely, and man hours wasted in unemployment. If we collectively become more leery of asset bubbles and their inevitable downsides, it will be a giant step forward. I am not too confident of the authorities, especially the Fed, but I am pretty confident that at least the rest of society will take the formation of asset bubbles much more seriously. We'll take what we can get.

Another potential lesson learned might be our realization that capital markets don't always work for the best. My friend and former partner Paul Woolley, now retired from GMO, set up a center at the London School of Economics a year ago bearing the tantalizing title: "The Woolley Centre for the Study of Capital Market Dysfunctionality." (Fortunately for the title, his friend Wilde could not find the funding money.) I must confide that his investment timing at GMO was seldom this perfect, for in one year he has gone from suspicious eccentric to enlightened visionary, and long lines of luminaries are queuing up to be involved. We have collectively had a touching faith that capitalism – just because it's the only effective driving force behind economic growth – is basically flawless, and any controls are bound to be counter-productive. Pure Ayn Rand capitalism obviously cannot deal with social issues of the tragedy of the commons variety, such as climate change. It cannot turn corruptible and greedy types into the reasonable and honest types that our readers represent. It cannot begin to address social justice. And apparently it does a lousy job at dealing with asset bubbles and the ensuing economic and credit problems. Society's attitude on this topic will change and, with a little luck, an increase in enlightened regulation will increase the public good. I for one am optimistic. The American ship of state (among many) appears to move forward by lurching too far in one direction and then like a super tanker with an amateur at the helm, overcorrecting. (And, oh my, have we had some real amateurs at the helm recently!) For the past eight years, we have had a darned good lurch, and we need some correction. Somehow, in the <u>long run</u>, the ship seems to zigzag its way roughly in the right direction. The Jim Grants of the world and other very sensible people, as well as the usual right-wing suspects, will say that increased regulation has a dismal record, and they are right. But so does totally unregulated capitalism, apparently. We will have to muddle our way to an acceptable mix, and we can be sure of only one thing – that it won't be highly efficient. But it may be acceptable enough, and we must hope that it is.

[1] Gary Stern.

Still at the meta level, I would like to bring up the hope that as a result of our current misfortunes we will re-examine how we pick our leaders. It would seem for starters that a lack of prejudicial bias would be helpful. If you're looking for an open mind, why would you pick Robert Rubin or Hank Paulson for a job at Treasury that might, just might, involve decisions on the life and death of their beloved Goldman Sachs? And in the case of Paulson, why pick one of the five leaders of financial firms who lobbied hard at the SEC against increased reserves for investment banks? Why would you pick an Ayn Rand extremist like Alan Greenspan to be the Fed Boss when he openly deplored increased regulation in almost any form and thought untrammeled capitalism was the bee's knees? Wouldn't an open mind be better? Or Ben B, whose reflex is so clearly to believe in market efficiency? He believes it so profoundly that he <u>prejudged</u> important data such as the very dangerous housing bubble of the last few years. He seemed to believe that since no such extreme inefficiency <u>should</u> exist, then it did not exist. Not a good idea.

On this same topic, why would we not insist on a proven record of excellence on a relevant topic for the really important job? Ben B has an excellent record as an academic economist, but has had little contact with the messy, real world until now. And as for Alan! He had a proven record. It was proven for years that he was a very mediocre, lightweight commercial economist. He sat on a few politically connected committees, met the right people a lot, and, hey presto, had the second most important job in the land.

Lower down on the pecking order, I think we have learned not to value CEOs so highly. We have seen their limitations when under novel stresses, and we have examined how their reward system was out of kilter with the ordinariness of their talents. The boss of Lehman did an honorable and long service in my opinion, and I have no doubt he tried hard. But frankly, Lehman even in its heyday was a B player and, in its last few months, a D player. It is probably unfair to weigh too heavily his lack of skill down the home stretch and the pain he inflicted on many by holding out too long. He was obviously very unlucky to be picked out as a sacrificial lamb. But even before the unraveling, did he really deserve to have accumulated a $650 million holding in Lehman – all wealth that would otherwise have accrued to stockholders – in addition to immense annual rewards for basically doing an average job? I believe society will reconsider the merits of such remuneration and the structure that enables it.

Surely we will also reconsider the merits of having such an overdeveloped financial industry whose share of corporate profits had risen from 10% in 1982 to 27% last year. Some of these people – ideally my better competitors – could find something else to do with more redeeming social value. They could be doctors or, perish the thought, actually make something.

The permanently bullish spin put out by the financial industry – like real estate agents in heat – has also been revealed, and I hope we can expect some serious reaction. <u>Permanent bullishness does not serve the clients well</u>. The ridiculous bullishness of bottom-up earnings forecasts has long been a joke among serious investors, but we still see them everywhere. The bullish bias pervades the industry right up to Paulson and the other Wall Street CEOs. Estimates even from more seasoned cool types, such as those at the IMF, and economists in general have their economic forecasts creeping downward while looking nervously over their shoulders: they are desperate to avoid getting too far ahead of the pack and committing Keynes' key crime of being wrong on their own. Thus, estimates of global growth in GDP are still +3% for the world and +9.2% for China. In a crisis, the estimates always lag on the upside, and this does not help. Similarly, but worse, the earnings estimates for the S&P have stayed ludicrously higher than were likely given the rolling crisis. For example the IBES earnings estimate for the S&P over the next 12 months is still $98.5 a share. At even normal margins it would be $71, and at margins 20% below normal it would fall to $56. With any luck, the usefulness of standard industry advice will be reconsidered and routinely adjusted for congenital bullishness.

Perhaps it is also time to reconsider the fixed asset allocation approach – what I used to refer to as the "watch the locomotive coming" effect. It is fine in theory to urge ordinary investors to grit their teeth in the face of losses and show patience. But in the real world, many perfectly normal investors who take huge losses simply cannot bring themselves to stand the pain. Holding firm and waiting the 15 or 20 years for earnings to catch up is great advice for a computer, but computers don't invest, and humans are … well, very human. They will often sell out near lows and lock in enormous pain. This is a great opportunity to re-evaluate the merits of moving more assets – if only marginally – away from dangerously overpriced asset classes toward relatively cheap ones before the great bear markets do their usual thing. I don't mean to recommend racing around on a day-to-day basis as some tactical asset allocators do. What I do recommend is an occasional significant response to outlier events both at the bull and bear ends of the spectrum. This, of course, runs into major career or business risk. But, that's life.

It will also be a silver lining if we get rid of some of the gilded-age excess on the part of the titans of industry, especially in the financial world. They should have kept their heads below the trench (see The Blackstone Peak and the Turning of the Worms, July 2007), and they certainly did not. They jumped way up, begging for a sharpshooter to notice them, and they were indeed noticed. It will now surely cost them in hostile legislation in some form or other.

One of the biggest silver linings will be in increased household savings. Now it is clear that the increased wealth was only temporary. It was paper wealth based on very overpriced assets. The losses will have to be repaired the hard way by deferred gratification – lower consumption and higher savings. The tragedy here is that since more than 10 years of normal savings were sacrificed to the grand illusion of paper wealth, it is unlikely that all of the lost savings can ever be made up. People will simply retire poorer than they might have done.

It will be pointed out that increased savings will depress consumption and lower GDP growth in the near term. This short-termism has been the logic in the past behind Bush and others who overtly encouraged consumption and therefore personal debt. But in the long term, which economies grow the fastest: China with 40% savings, or the U.S. and U.K. with negative personal savings? High savings and investment rates, of course, encourage growth, and we have to absorb the short-term negative effects of what had become over-consumption if we want to be a healthy economy. The recent crisis in credit and assets is a slap in the face, a rude wake-up call, and we will move to a better balance. The problem here is the timing. Although we need this re-adjustment to greater savings for the long term, if we get there too quickly – since one person's extra saving is another person's unexpected loss of top-line revenue – we risk getting caught in a downward spiral that breaks animal spirits. This is the nightmare that kept Keynes up at night in the 1930s. So it has to be slow and steady, at which level the extra capital spending and increased industrial capacity creates its own offsetting stimulus.

The research science world is no doubt sighing with relief at their silver lining: the prospect of once again recruiting some of the best PhDs who had been lining up to work for Goldman or a hedge fund (and even, I must admit, a few for GMO). There they designed the cleverly repackaged mortgage paper so admired by Greenspan, or developed quant equity models and "stat arb." Now they will have to waste their time once again designing nuclear facilities and second generation biomass projects. Oh well.

A real lesson will also have been learned on the "Let's all look like Yale" front. (See Immoral Hazard, April 2008.) Yes, diversification is a great idea <u>other things being equal</u>, but if the demand is so trendy that it overwhelms either the liquidity of small asset classes, or the talent involved in hedge funds, private equity, and other fields, then there is always likely to be a problem squeezing through the door together. And that's before someone shouts, "Fire! Fire!"

The great buying pressure from funds aspiring to look like the great endowment funds facilitated second-rate, overpriced private equity deals. (See Appendix to Letters XII: Evaluating the Usefulness of Private Equity Managers, July 2007.) Because these deals were typically overpriced in the last three years, excessive leverage had to be used to even tease out the possibility of a decent return. This, in turn, guaranteed that in a profit margin squeeze all the equity would be lost. The flood of money also allowed for over-funding of first-rate hedge funds and the start-up of thousands of second-rate funds. Real investment talent has always been scarce, and does not jump out of the ground just because there's a massive demand. Nuclear physicists do not immediately become investment talents even with IQs of 150.

The hedge fund industry is just an extension of our larger zero sum game. It adds collectively no value, it just reshuffles the existing pool of wealth <u>minus the higher fees</u>. Last year, in its prime, it offered mainly in place of real value added, or alpha, a <u>simulated</u> alpha that was dependent on rising asset prices, falling interest rates, or easy credit. All three in many cases. The existing alpha did not increase to meet the increased demand but probably shrank under the competition, and then the shrunken alpha was spread more thinly over more capital. And all that was needed for this phony alpha to be seen as wearing no clothes was a steady return to more normal conditions. Lord knows, it did not need to be stripped naked in the city square so abruptly! Fate really can be cruel.

All of these new, recently sexy alternative investment areas will now be re-evaluated: their illiquidity and their tendency to pick up nickels in front of steam rollers will be fully taken into account. Value at risk (V.A.R.) as a reliable measure of risk will hopefully be taken out and shot at dawn. In short, we will all live in a more realistic, if less exciting, world.

What I Learned

This experience has, not surprisingly, reinforced my faith in mean reversion – that all bubbles break and that it is best to study the data, make up your own mind, and screen out general opinion. It has underlined the importance of mixing with the right people: I never realized how many sensible people there were sprinkled through our business. We are certainly grateful for their input and reinforcement in nerve-wracking times. One <u>never has enough confidence</u>. That little voice is always there suggesting that, since there are so many of them, there may be something to their arguments. So you go long the Yen and short the financials but <u>never enough</u>. It was rammed home to us that some of the best bets were very technical and we needed help. So we got help and we hired good people, <u>but much too slowly</u>, while opportunities of a lifetime slipped through our fingers, leaving us with merely a decent profit. We have learned that in the future we need to have expertise – or at least moderate competence – in almost every aspect of the global capitalist system. It's not easy, but we have learned the hard way – missed opportunities that did not last long and would not wait for us – that it is necessary. Above all, we learned to <u>never, ever</u> trust the competence of government officials.

The Gold Lining

Topping off all of the offsetting virtues of this ugly last year is the arrival of cheap assets. All too easily we forget that you can compound wealth rapidly only by having cheap assets. For those with a long horizon, it is always better to have assets fall in price so that the compounding returns are higher. For an unparalleled 20 years, global equities, especially U.S. equities, have been overpriced. Now, finally, they are cheap and likely to get cheaper. Likely, I believe, to set up a once-in-a-lifetime investing opportunity (or maybe twice in a long career).

How Low Is Low?

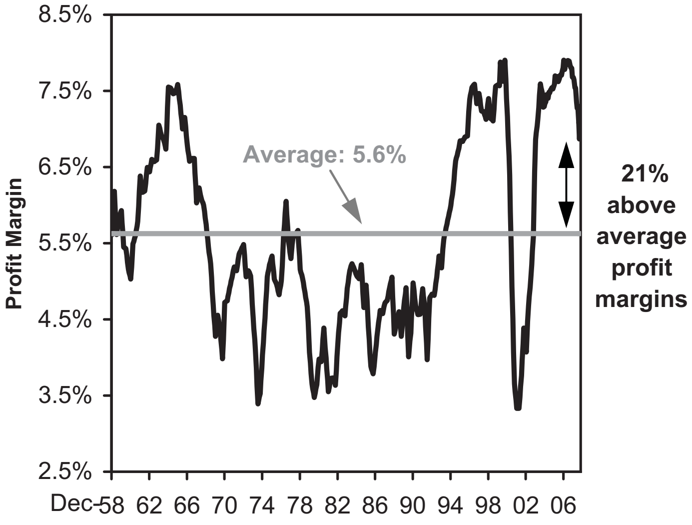
We have a pretty good fix on fair values. For the S&P 500 we believe it is about 975 ±25. This is calculated, as always, by the simple technique of assuming that at fair price we will have a normal P/E ratio, and that profit margins will also be normal. We also showed two weeks ago how typical it is for great bubbles to overrun badly. Usually we don't invest our money on estimated likely overruns, but instead filter our money in slowly and hope to get lucky. After all, if stocks are attractive and you don't buy and they run away, you don't just look like an idiot, you are an idiot. Still we are informed by our work on overruns. So where are we this time? History says a 50%+ overrun has characterized the aftermath of the three important equity bubbles. I believe we could also come at this from a very different angle: We could work out what we think the likely range of profit margins is going to be in a severe recession, and then look at what multiples have historically been applied to earnings that are equally depressed.

In a rational world, low profit margins would be multiplied by a high P/E and vice versa to normalize for the economic cycle. In a Bernanke/French and Fama world, the correlations would be -1. High margins would always be exactly offset by low P/Es and vice versa, so that the market would always sell at fair value or replacement cost. The market would thus always be efficient, and that chunk of the financial establishment that urges the buying and holding of index funds regardless of price would unarguably be correct. In the crazy real world, in contrast, we can't even get the correlation sign right: it is positive .32, which means that high margins are multiplied by high P/Es and vice versa. Remarkably, this is particularly true at the extremes where the correlation rises. Thus in 2000, the equity bubble that Alan could not see forming sold at the highest P/E in history (35) multiplied by the highest margins in history! 1982, in contrast, sold at 8 times depressed margins. This double counting makes the market far more volatile than it needs to be by driving prices far above and far below efficient price levels.

Exhibit 1 shows our series on U.S. profit margins. This is a pretty dependable mean reverting series so you can be extremely confident that margins will come back to normal. What is easy to forget is that, of course, they spend half their time below normal. In the global conditions that we expect, S&P margins should fall below their normal

Exhibit 1

Profit Margins for the S&P 500



Source: GMO, Standard & Poor's As of 9/30/08

levels by 20% to 40%. In 1982 and 1974, which were respectively quite severe recessions, profit margins fell by 36% and 39% below normal.

Given the extreme current difficulties in the financial and economic scene, margins 36% to 39% below normal would not seem especially Draconian, but let's be slightly friendly and predict only a 28% overrun this time. These diminished margins have typically been reflected in a below average P/E as discussed above. The historical expected P/E for profit margins depressed by 28% would be 15% to 20% below average; let us assume 17% below. This would give us a market selling at 83% of its normal P/E on profit margins that would be at 72% of their normal. This computes (.83 x .72) to be almost exactly 60% of fair value. Our current fair value estimate for the S&P 500 of 975 modified by a likely overrun of 40% would yield a price of about 585 in an environment of a quite severe economic and profit recession. If the global economy surprises on the upside, however, and somehow profit margins hang in, the result would of course be far less severe. Our conclusion, though, that the S&P is likely to bottom out in the 600 to 800 range within the next two years can unfortunately be seen as not particularly pessimistic from a historical perspective.

Finally, a Single Piece of Advice for the Government

I have never been a fan of the hysteria that has surfaced on all sides in recent years at a hint of recession, and the panic to throw public money at the economy. Mild recessions have several long-term advantages discussed in earlier Letters, but in recent years we seem to have lost interest in the long term.

However, this time it's different. This is the Real McCoy crisis, and we must welcome all the stimulus we can get. It is easy, though, to end up employing people to build mildly useful parks or, in the Japanese style, nearby useless bridges to nowhere. Government stimulus can have a decent (even high) return in the long run. It absolutely doesn't have to be a series of boondoggles. Let me suggest that the magic word this time is not "plastics" but "alternatives." Massive spending on energy and, better yet, energy savings will create jobs, stimulate the economy, produce a good long-term economic return, reduce dependence on depleting Middle Eastern oil, curtail carbon dioxide emissions, and set, for once, a real example for other countries. From the simplest – better insulation and more efficient machines – through the new alternatives – solar, wind power, and second generation biomass – to the potentially massive investments in new nuclear plants and efficient energy transmission, this could be in total a long range bonanza for the U.S. in economic and broader respects. Such a program could offset the risks of a Japanese-style drawn-out recession. It would be potentially an epoch-defining change, and one of which, like the Marshall Plan, future generations might be proud.