

The views expressed in this paper are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank. The Asian Development Bank does not guarantee the accuracy of the data presented.

# **ADB Annual Meeting**

## **Capital Markets: What Does the Future Hold?**

**Jeremy Grantham**

**GMO**

North America | Europe | Asia-Pacific

May 4, 2005

## G.K. Chesterton Says:

“The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians. It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.”

## Mandelbrot Says:

“The whole world of economics is enormously more complex than the world of physics. And therefore the teaching of business schools, including Yale’s, is unrealistic. Even though economics is a very old subject, it has not truly come to grips with the main difficulty, which is the inordinate practical importance of a few extreme events.”

# The Way the Investment World Goes Around

---

Career Risk

**Timing  
Uncertainty**

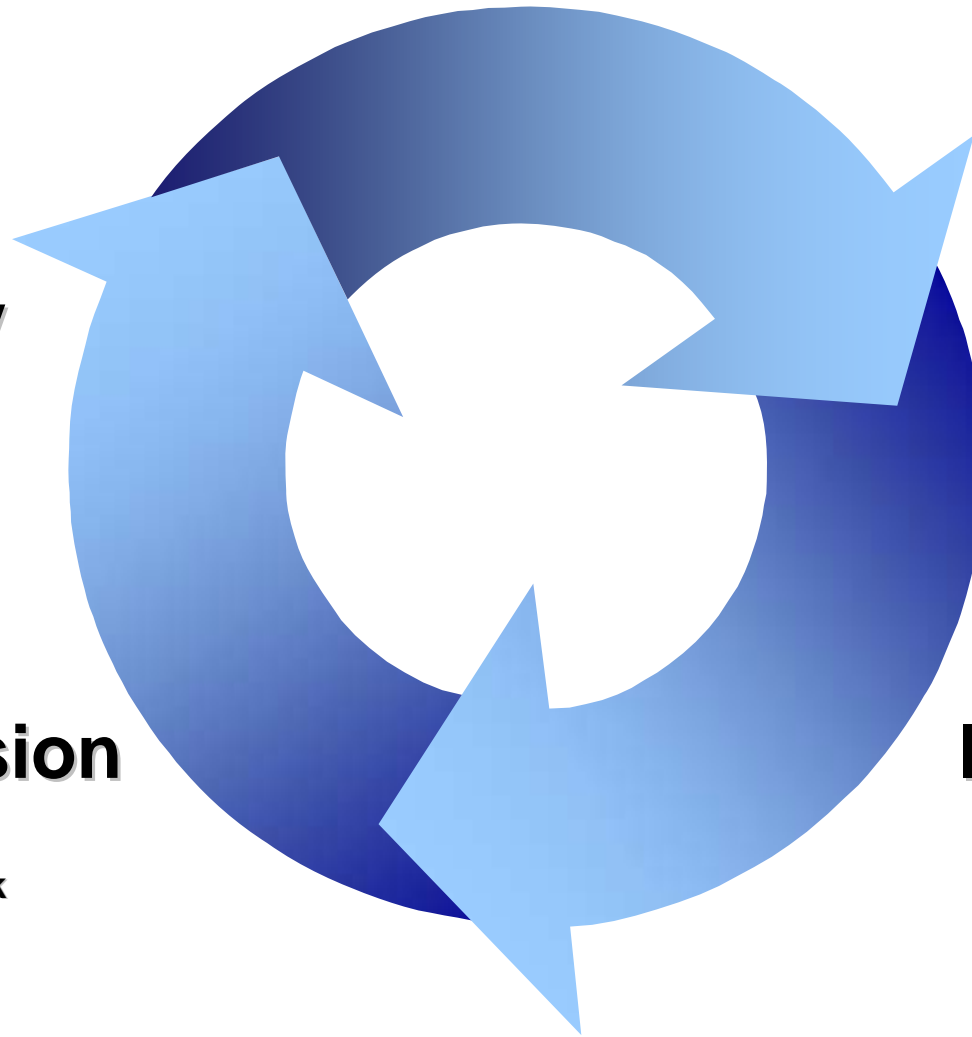
**Herding &  
Momentum**

**Mean Reversion**

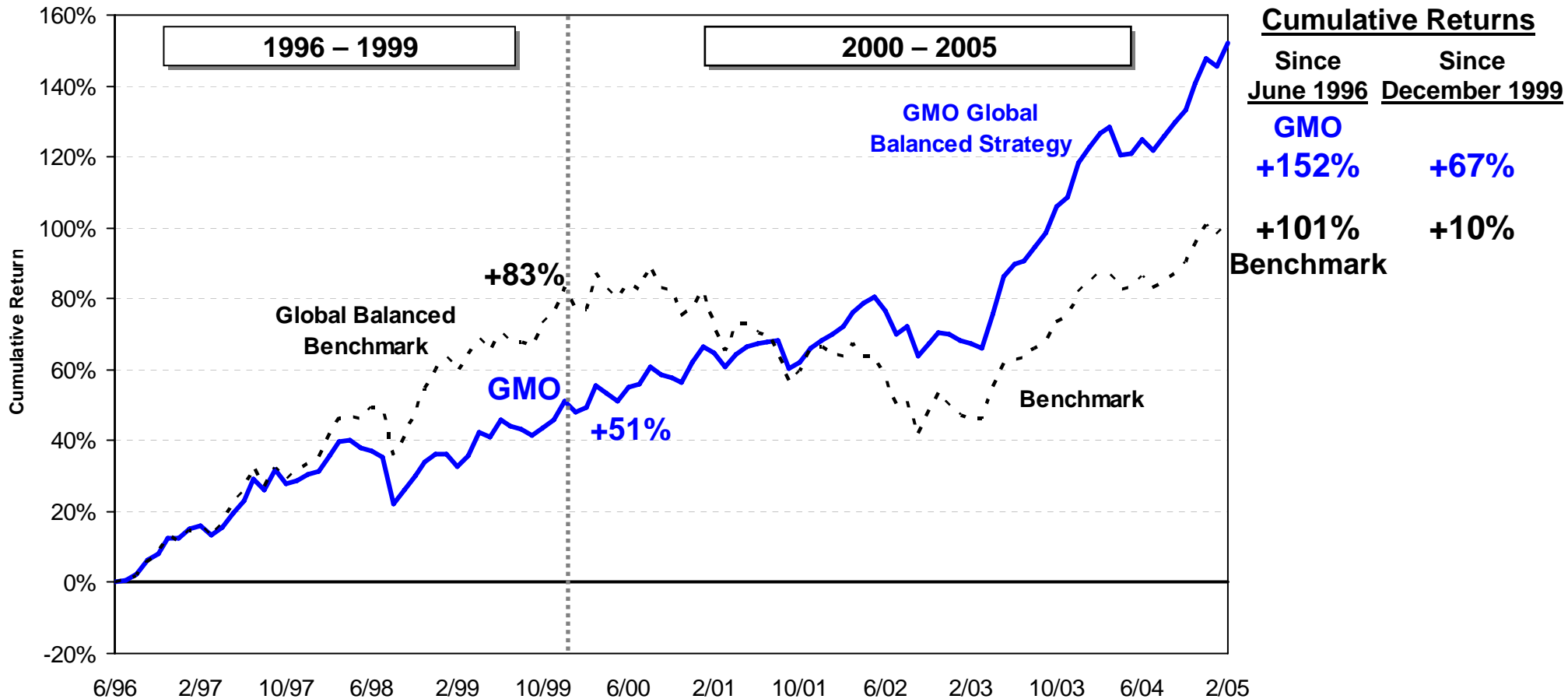
**Market  
Inefficiency**

Risk / Return  
Pulls Prices Back  
to Fair Value

Prices Move Away  
from Fair Value



# Is Risk *Relative-to-a-Benchmark*, or *Absolute*?



	Compound Return	Volatility	Absolute Return Divided by Risk <sup>2</sup>
<b>GMO</b>	<b>11.4%</b>	<b>8.9%</b>	<b>0.86</b>
<b>Benchmark<sup>1</sup></b>	<b>8.5%</b>	<b>12.1%</b>	<b>0.40</b>

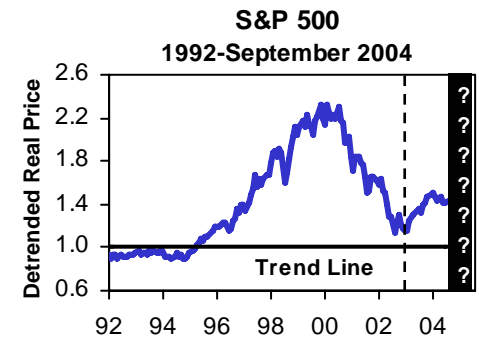
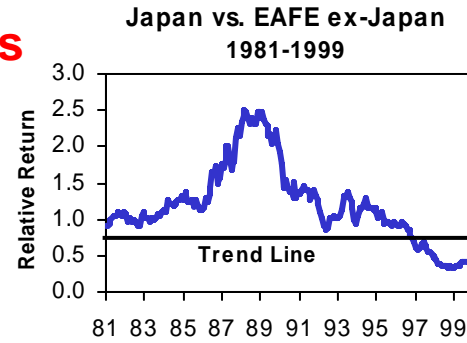
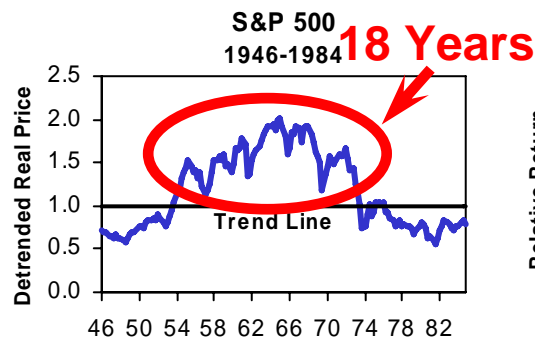
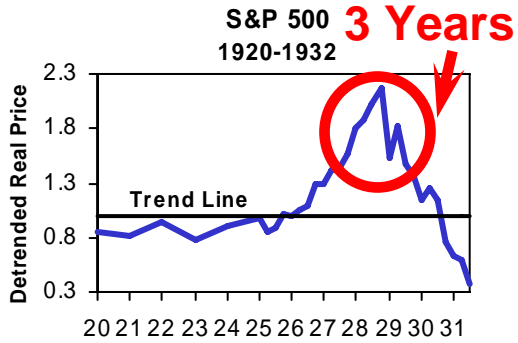
<sup>1</sup> Fund Benchmark = 65% global equities, 35% U.S. fixed income

<sup>2</sup> Sharpe Ratio is the return over the risk free rate per unit of risk.

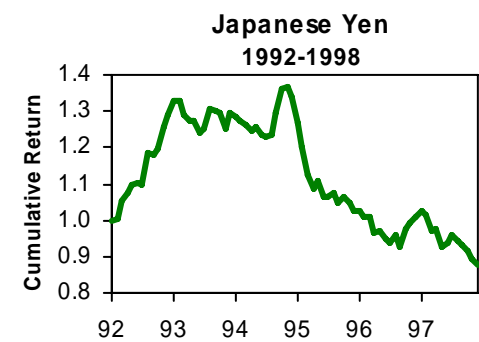
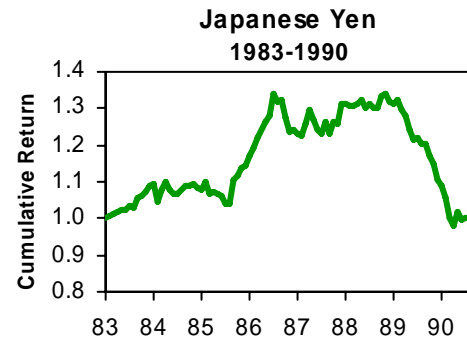
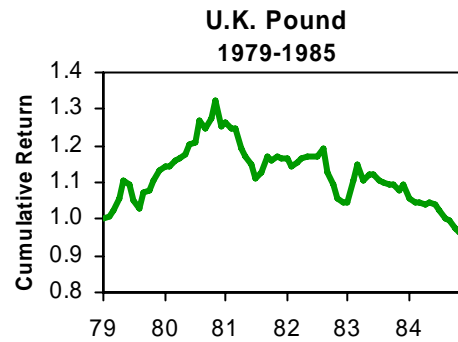
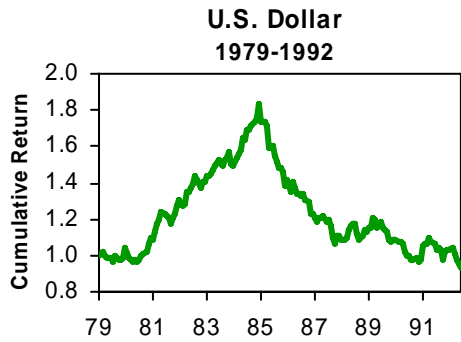
Performance data quoted represents past performance and is net of fees and expenses. Distributor: Funds Distributor, Inc.

# All Bubbles Break: but Not at the Same Speed!

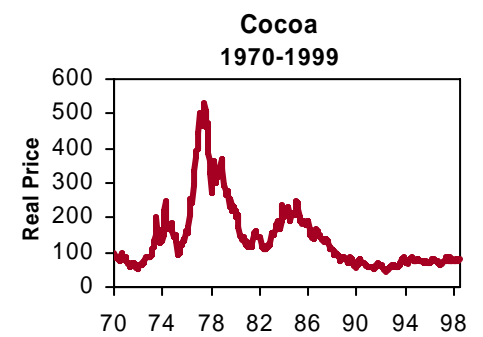
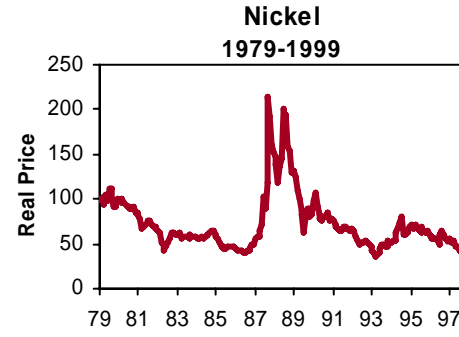
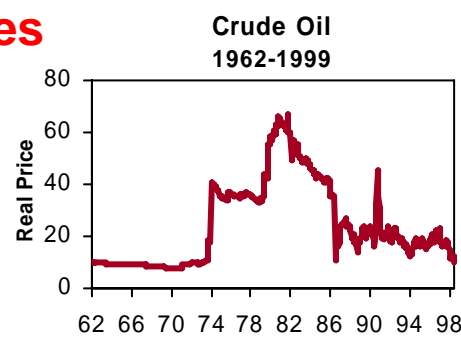
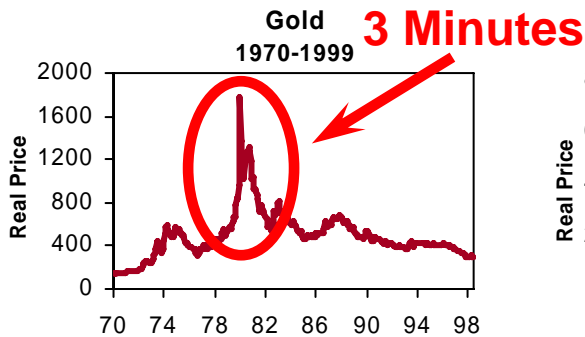
## Stocks



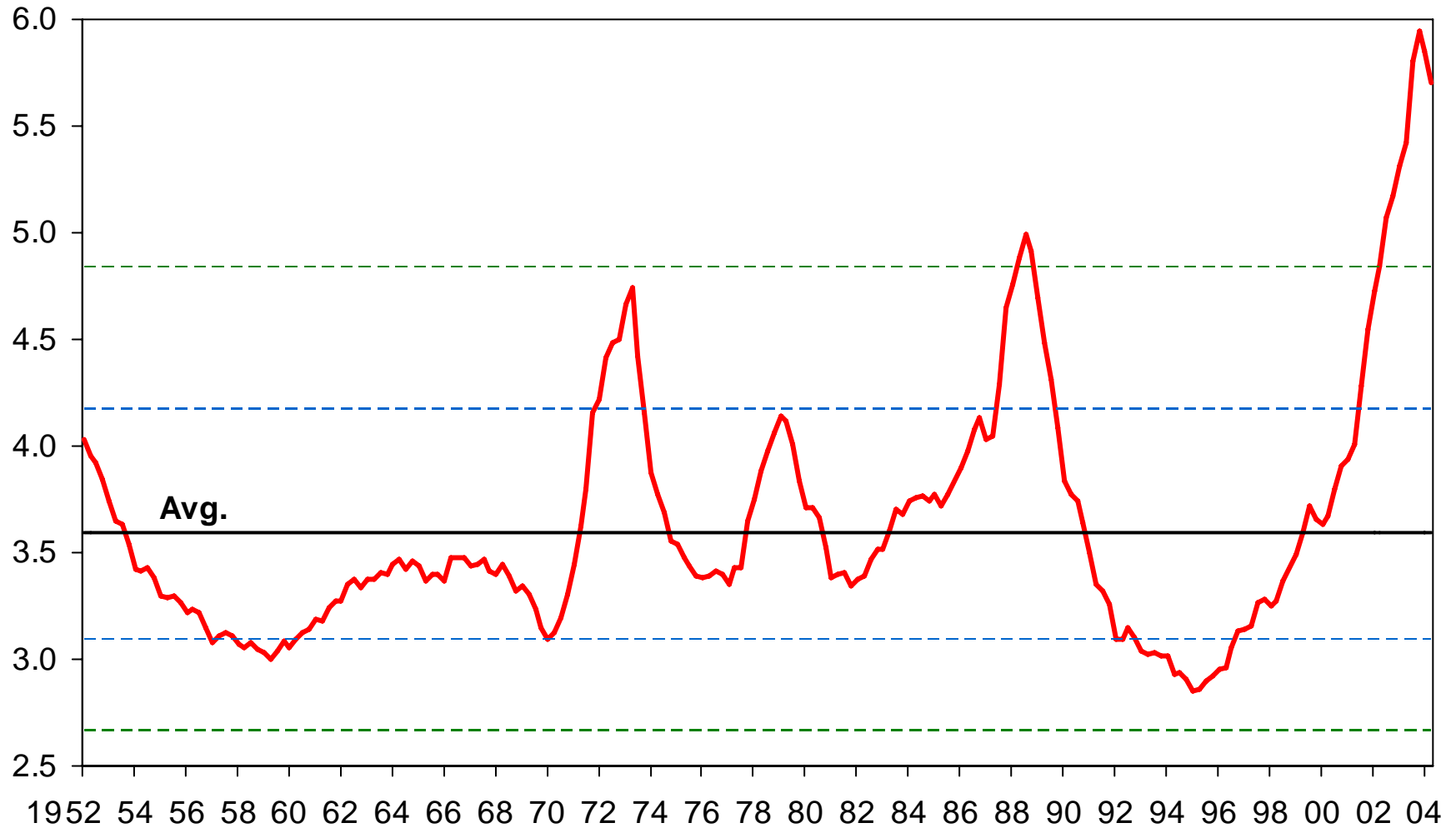
## Currencies



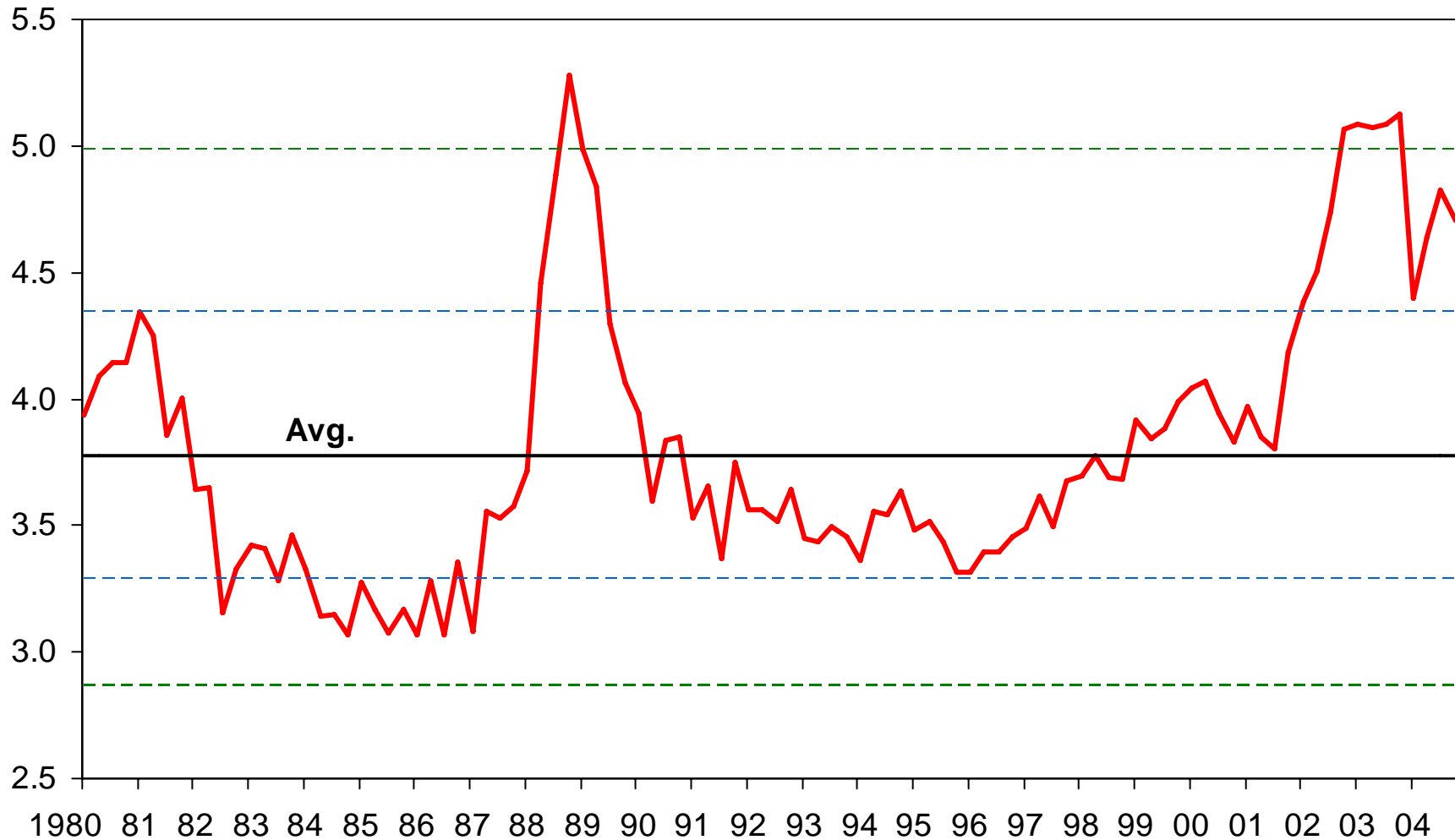
## Commodities



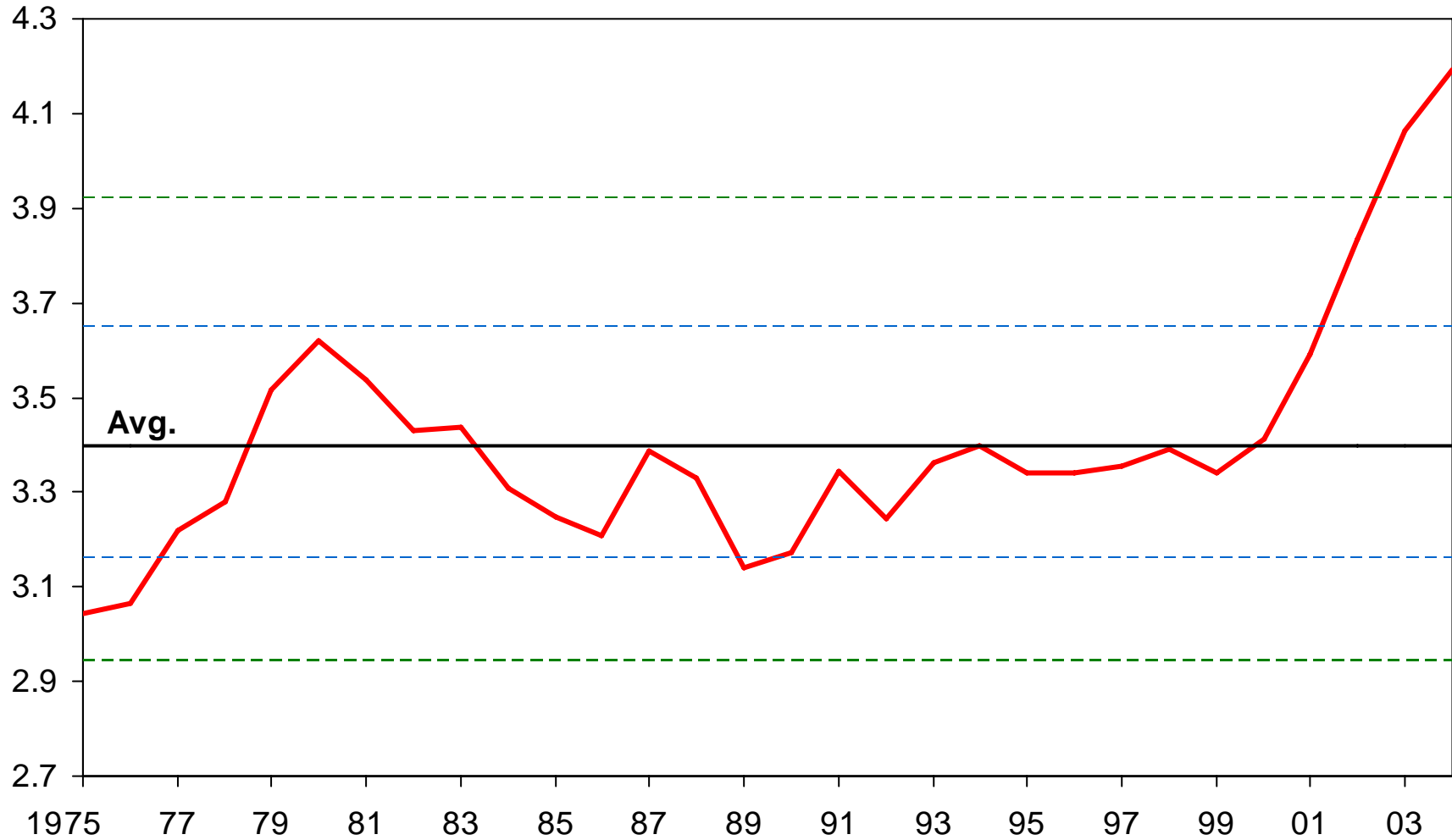
# UK Home Prices as a Multiple of Average Earnings



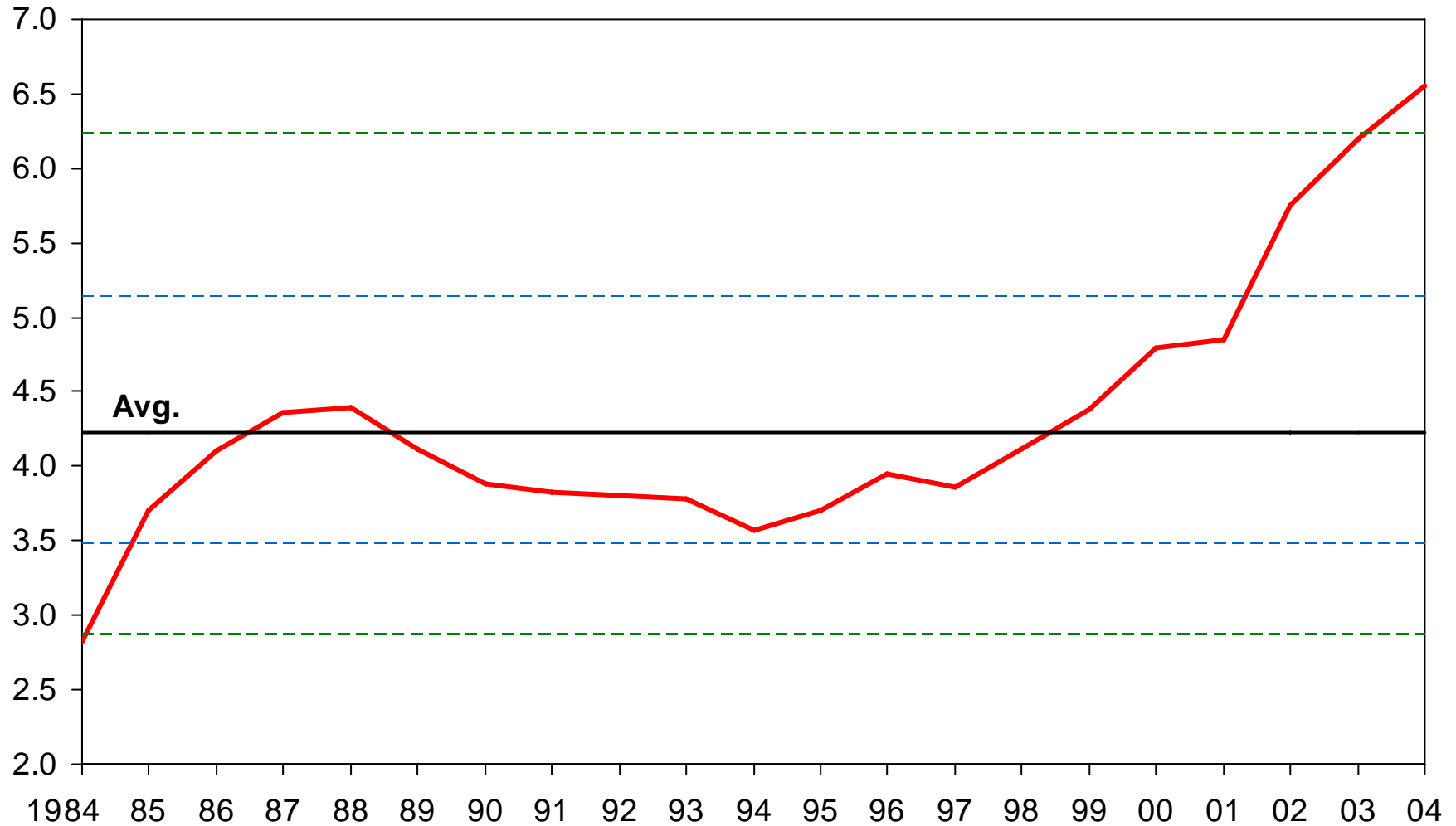
# Sydney Home Prices as a Multiple of Australian Household Income



# United States Median Home Prices as a Multiple of Household Income

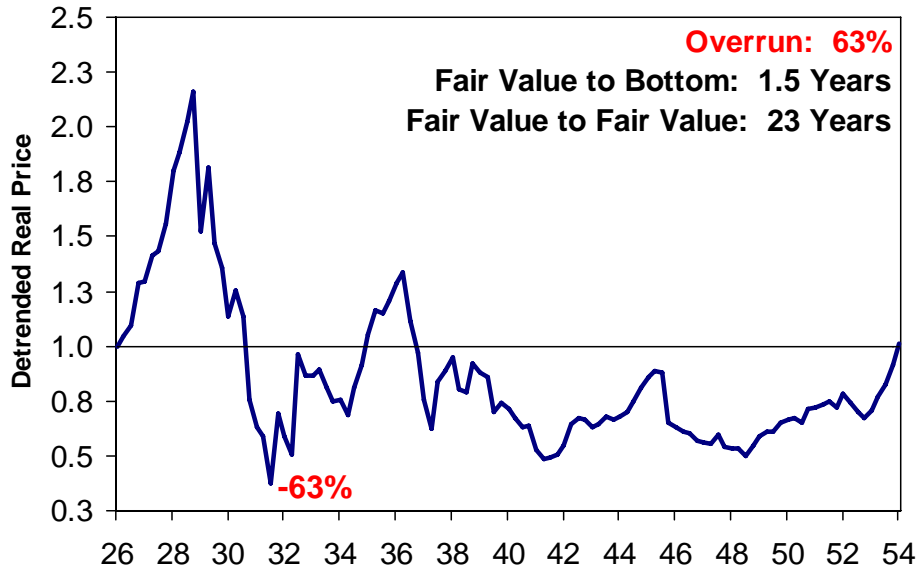


# Boston Median Home Prices as a Multiple of Household Income

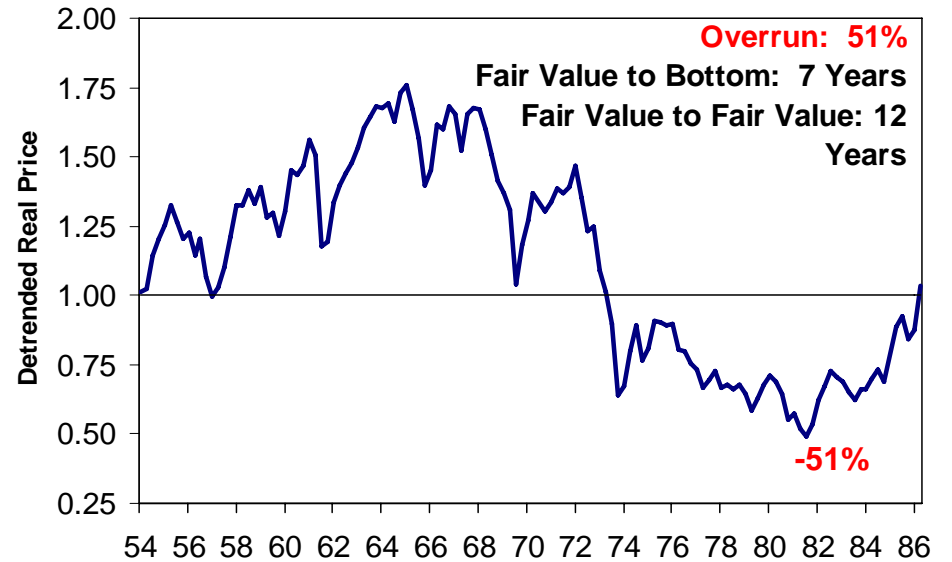


# Overrun: How Low Will We Go?

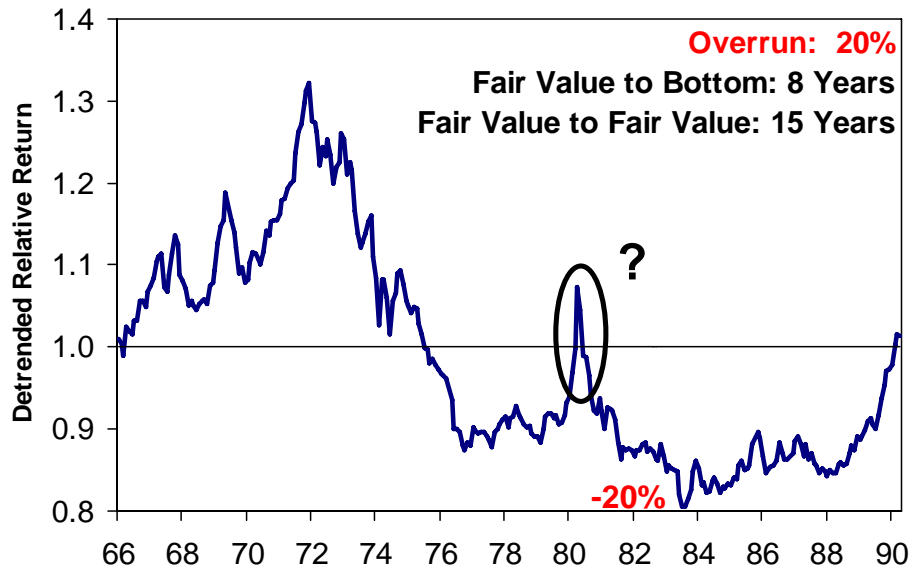
**S&P 500 1926-1954**



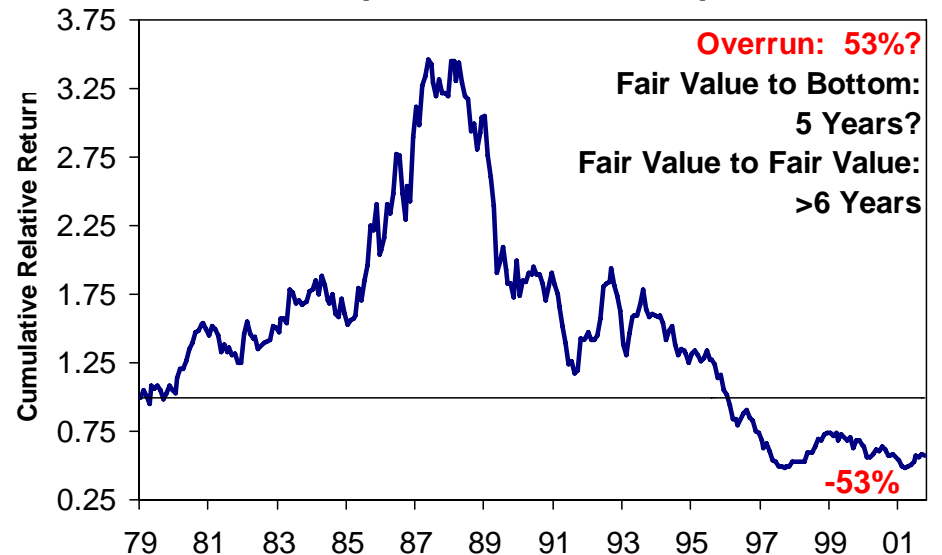
**S&P 500 1954-1986**



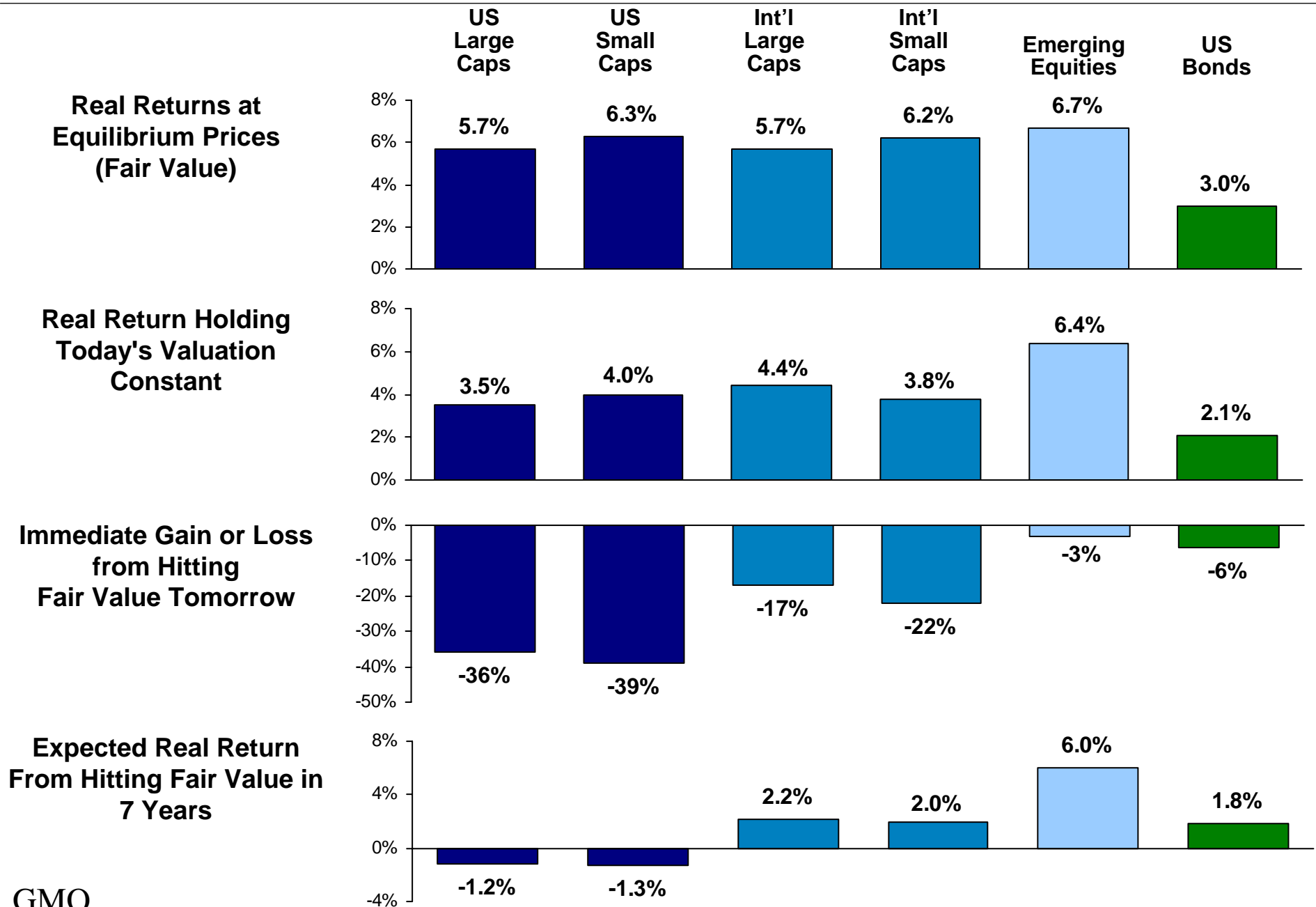
**U.S. Growth vs. Value 1966-1990**



**Japan vs. EAFE ex-Japan**



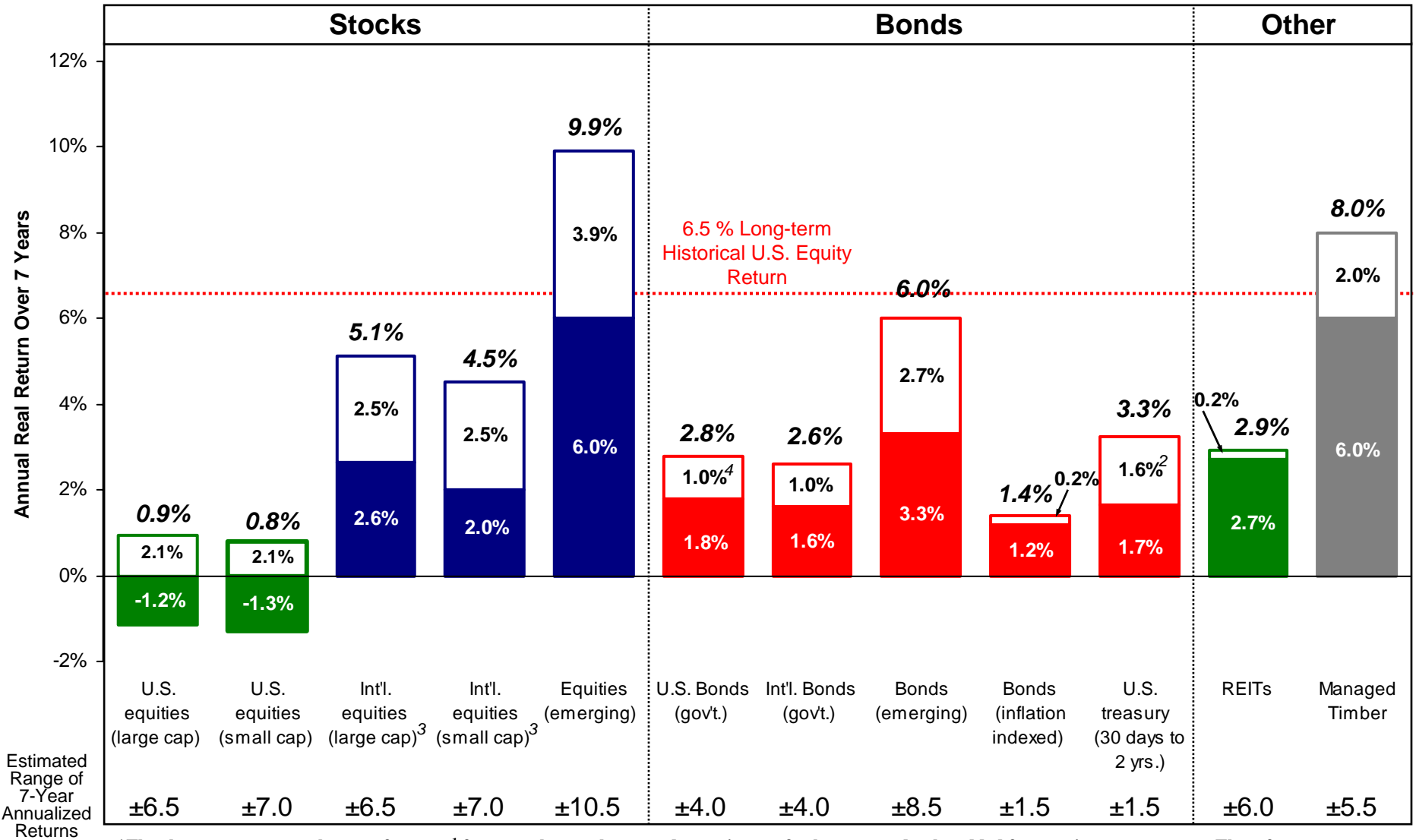
# Equilibrium Returns vs. GMO Forecasts



# GMO 7-Year Asset Class Return Forecast

- Expected Value Added  
 - Real Return (Asset Class Index)

As of March 31, 2005



\*The chart represents real return forecasts<sup>1</sup> for several asset classes and an estimate of value expected to be added from active management. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance.

<sup>1</sup> Long-term inflation assumption: 2.5% per year.

<sup>3</sup> Return forecasts for international equities are ex-Japan.

<sup>2</sup> Alpha transported from management of global equities.

<sup>4</sup> Alpha transported from management of global bonds.

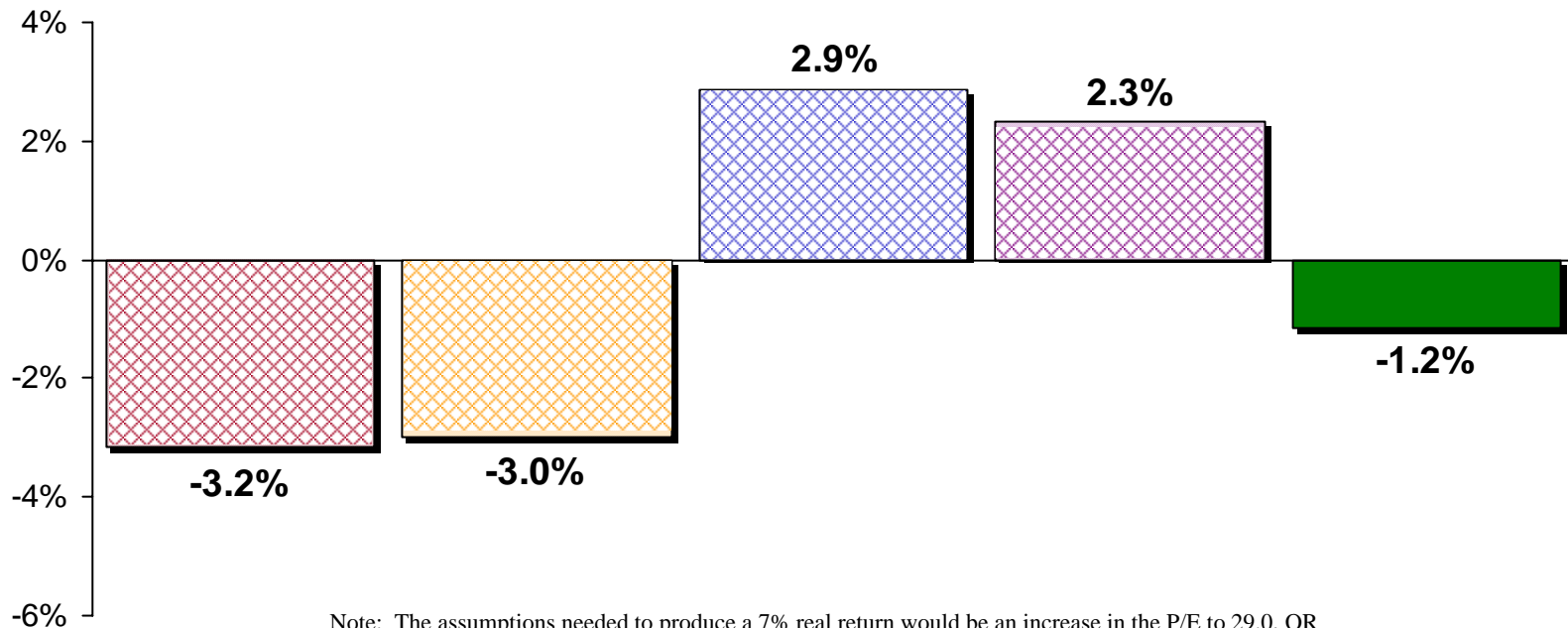
# S&P 500: Building a 7-Year Estimate

## Components of Annual Return of S&P 500, with Regression over 7 Years

	P/E	Profit Margin	Real Sales per Share Growth	Dividend Yield
1926-1999 Averages	14.0	4.9 %	1.8 %	4.3 %
Starting Levels	20.0	7.4 %	1.9 %	1.8 %
Assumption for Next 7 Years	16.0 (Terminal Value)	6.0 (Terminal Value)	2.9 %	2.3 %

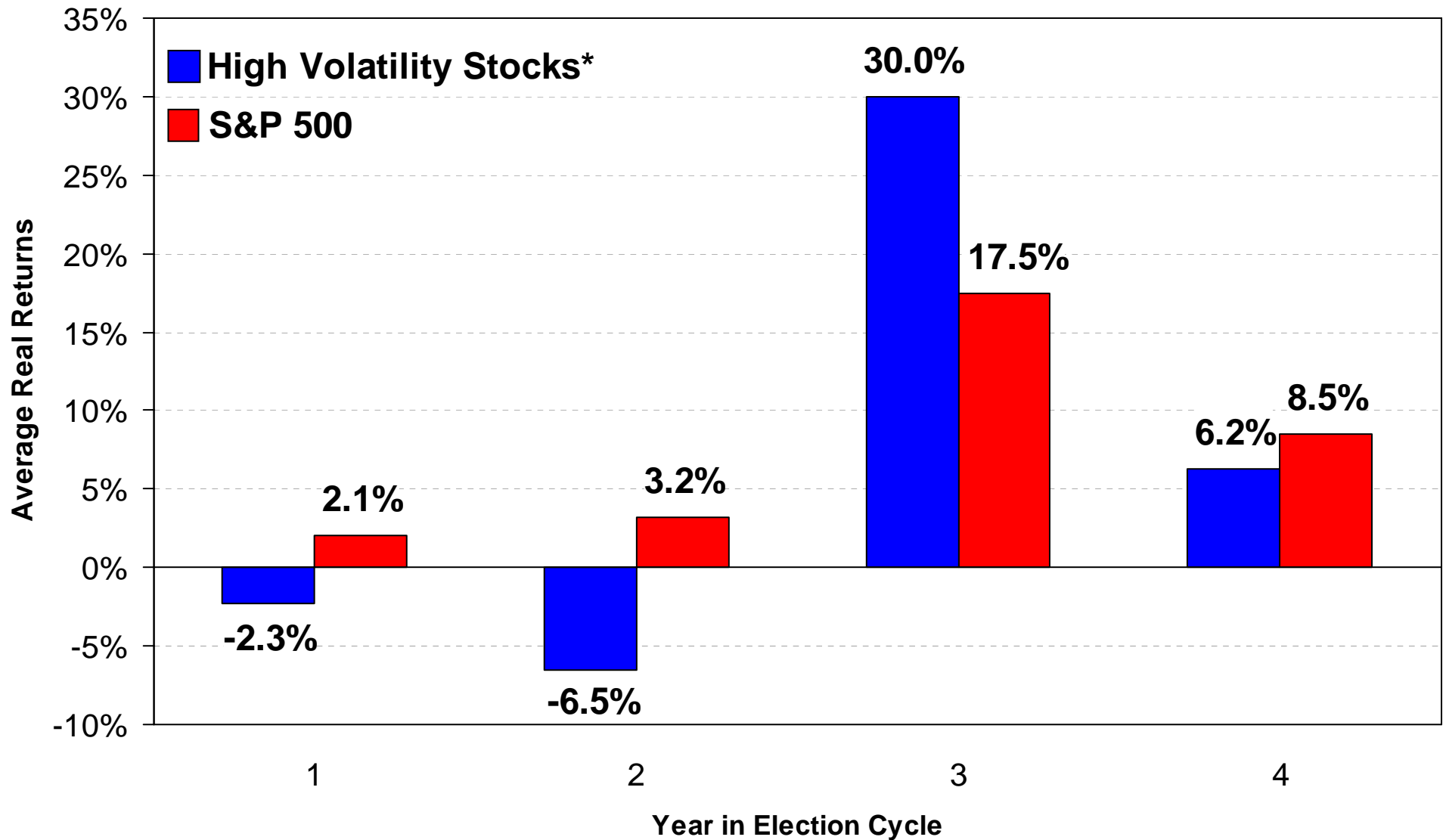
  

Loss from P/E Contraction	+	Loss from Margin Decline	+	Gain from Sales Growth	+	Dividend Yield	=	Total Return
---------------------------	---	--------------------------	---	------------------------	---	----------------	---	--------------



Note: The assumptions needed to produce a 7% real return would be an increase in the P/E to 29.0, OR an increase in the profit margin to 10.4%, OR an increase in real sales per share growth to 11.2%.

# Return of High Volatility Stocks and Market During the Presidential Cycle



# Things That Go Bump In the Night

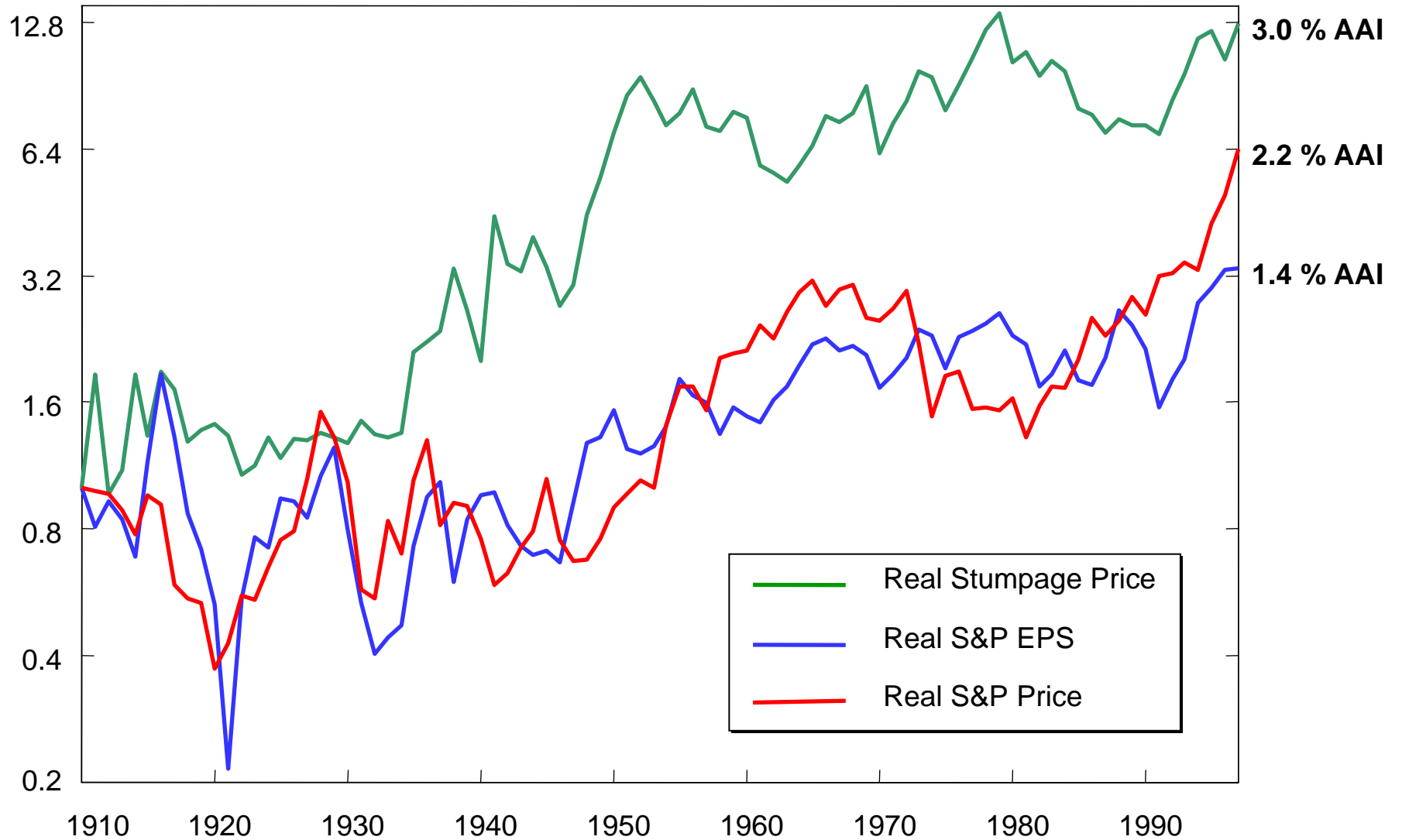
---

Our forecast of -6% real for 2005 is based on nothing unusual going wrong, but an unusual number of things **could** go wrong. Let me count the ways:

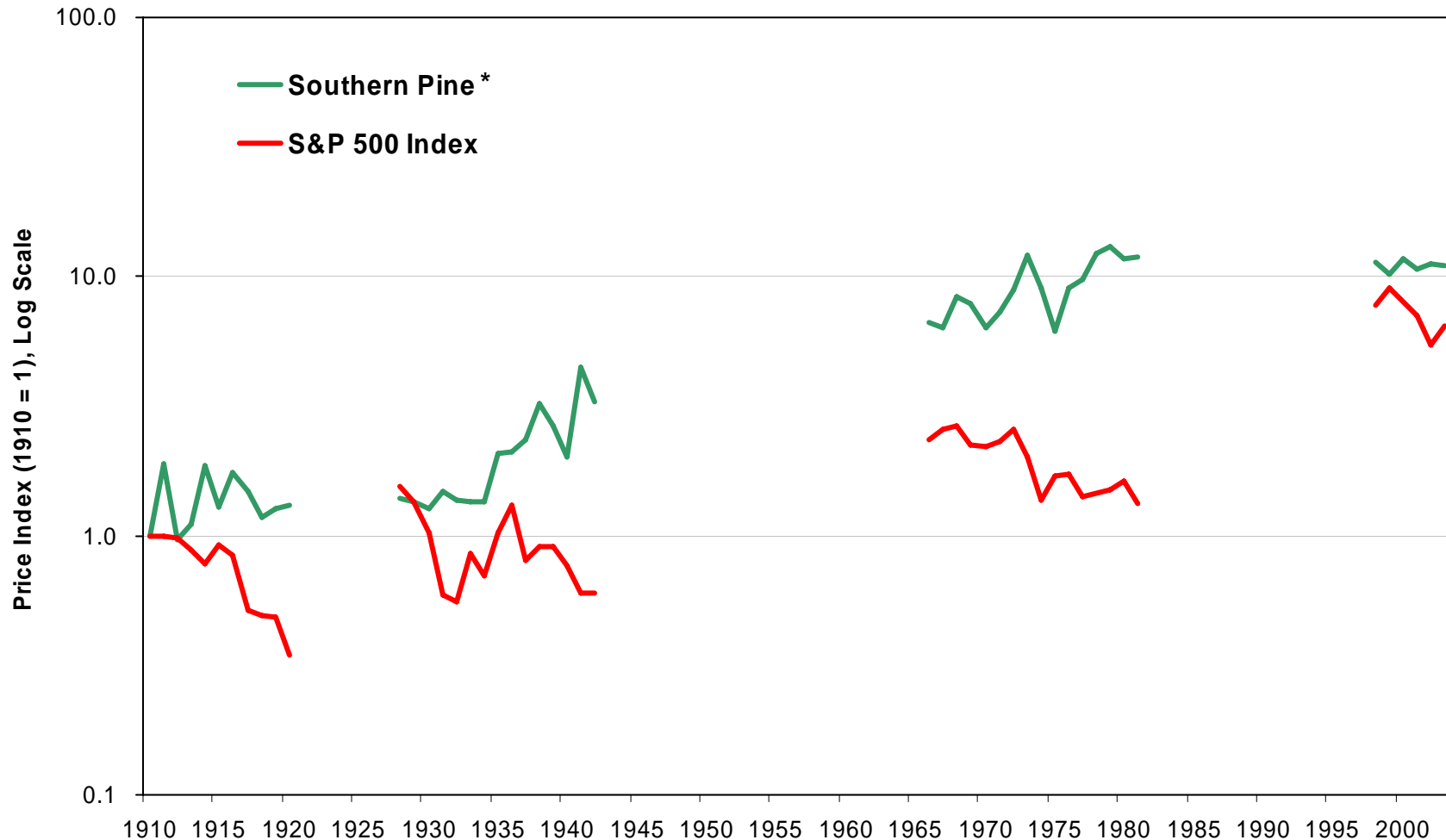
## Possible Problems for the Next 2 Years . . . and Suggested Odds

■ China Stumbles	.15
■ <b>Major</b> terrorism or dramatically bad Iraqi developments	.15
■ Other major political problems (Russia or totally unexpected)	.10
■ Unexpected major economic weakness in Japan and/or Europe	.15
■ Substantial increase in U.S. inflation	.15
■ Major increase in commodity prices including oil	.20
■ <b>Minor</b> or major financial crisis	.30
■ Rapid decline in dollar (over -10%)	.15
■ All other major problems out of left field	.10
■ Odds of <b>none</b> of the above going wrong (assuming above odds were right)	.20

# Real Growth in Stumpage Price vs. S&P 500



# Real Growth in Stumpage Price vs. S&P 500 in Bear Markets



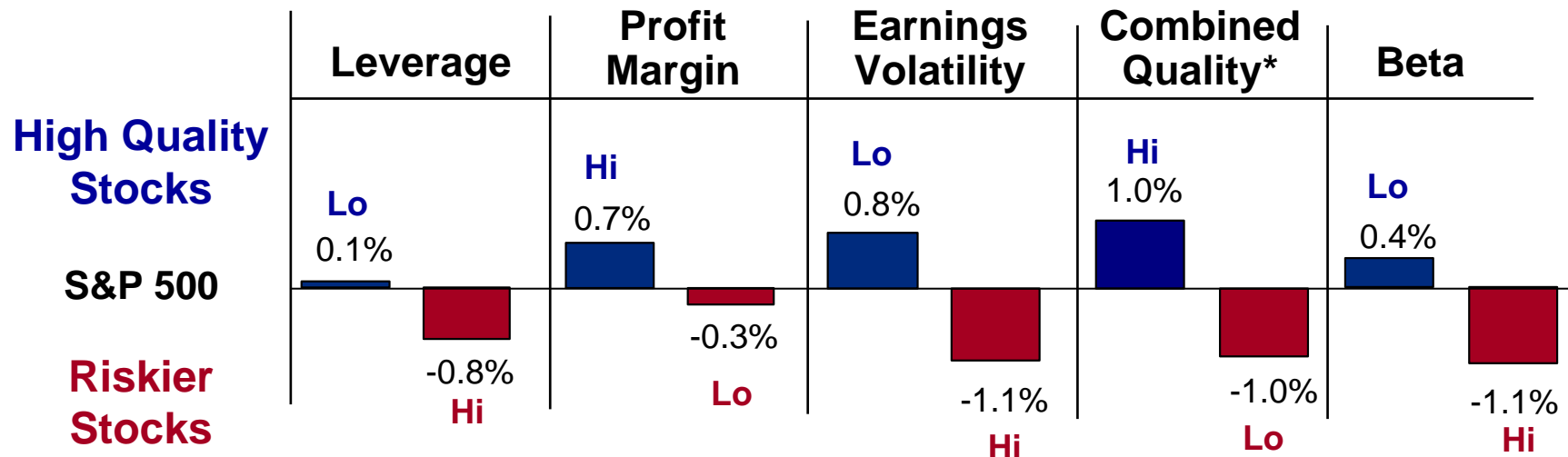
\* Price only. Does not include physical growth, which is the major component of total return.

Source: U.S. Forest Service and Standard & Poors

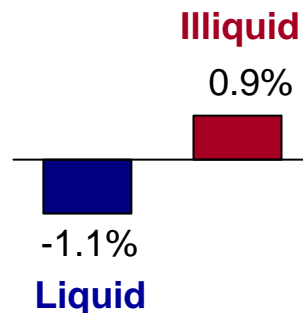
# For Nearly 40 Years, Quality Has Outperformed

Risky Stocks Don't Return More, and Finance Theory Is Wrong: The Insurance Is Free

## Safer Characteristics Tend To Outperform



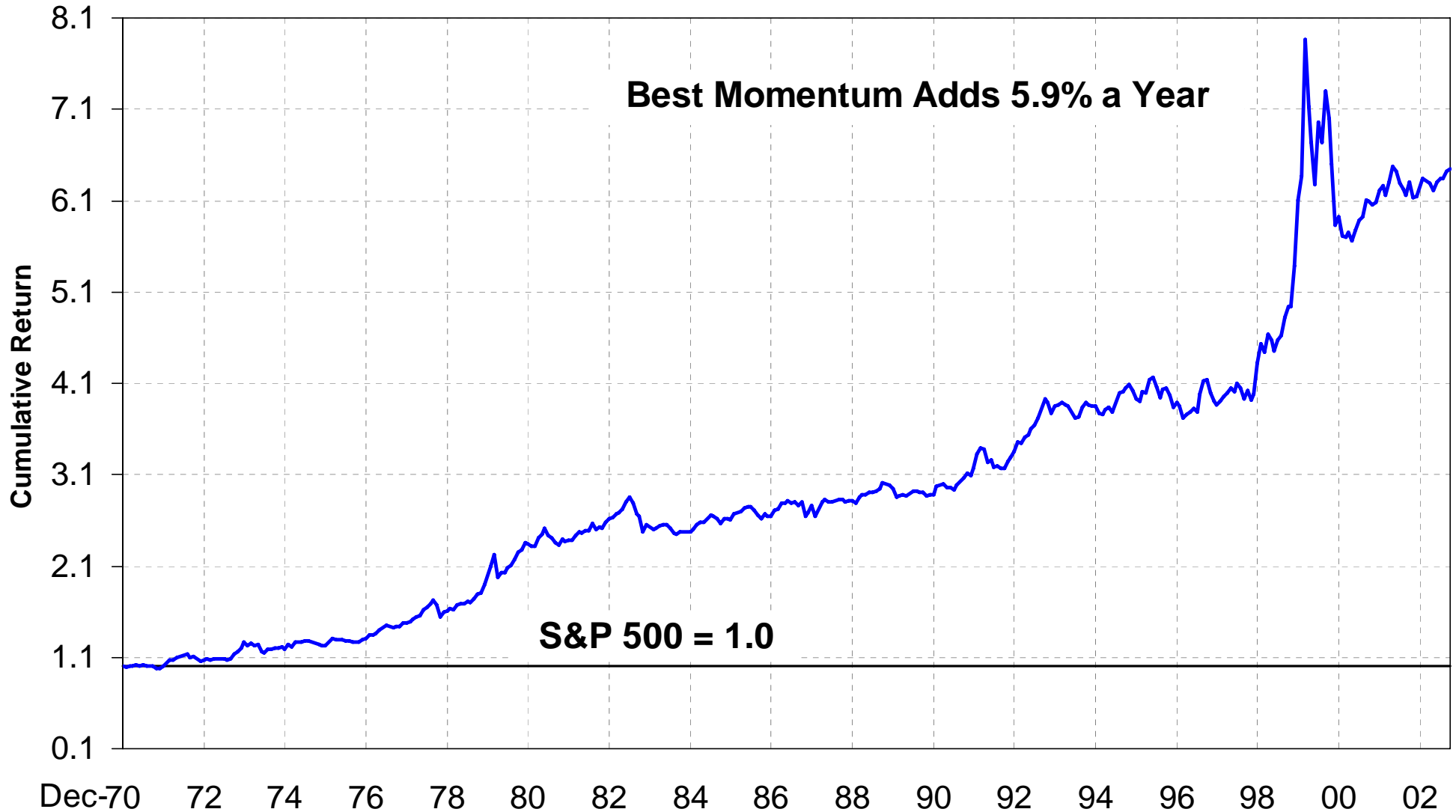
...Except: Liquidity



**Reality: Investors like to gamble but they want an immediate result!**

# Price Momentum\* Lives (and Always Did)

Fama and Malkiel Bite the Dust!



## 6 Types of Bull

---

- 1) **Dow 36,000**: Enough said.
- 2) **Jeremy Siegel**: Price doesn't matter, 7% real returns by divine right.
- 3) **Sloppy P/Es**: Unadjusted for anything, today's market is 15x, next year's very optimistic estimated earnings.
- 4) **Sloppy Growth Forecasts**: S&P 500 long-term growth in earnings and sales per share is 1.8% real. Bull estimates are typically in the 5% to 10% real range.
- 5) **Abby Cohen / Alan Greenspan**: Today's economy is fine and therefore the stock market will be fine.
- 6) **The 'Fed Model Effect'**: yes P/E ratios are quite high but the market is still cheap because interest rates are so low.

## Things Not to Believe – II

**Argument:** “A healthy economy today means the market tomorrow is fine.”

**Problem:** Current strong economy predicts weaker future economy and stock market.

Current Economic Factor	Correlation	
	Economic Factor Over Next 2 Years	Stock Market Returns Over Next 2 Years
Profit Margins	-49.0%*	-4.1%
GNP Growth	-9.4%	-5.2%
Productivity Growth	-1.5%	-10.3%

# Things Not to Believe – III

---

Fair Price = Replacement Cost (The Great Fallacy Detector)

1. Does a change in short-term or long-term rates effect replacement cost? (Fed Model)
2. Does a change in capital gains or other taxes change replacement cost?
3. Does any change in short- or long-term supply and demand – like population profile – change replacement cost?

# The Theory: How the Market Should Work

---

1. Fair Market Value = Replacement Cost (Tobin's Q)
2. Replacement Cost = Normalized or Trend Line P/E × Normal or Trend Line Profit Margins
3. Also true that Replacement Cost =

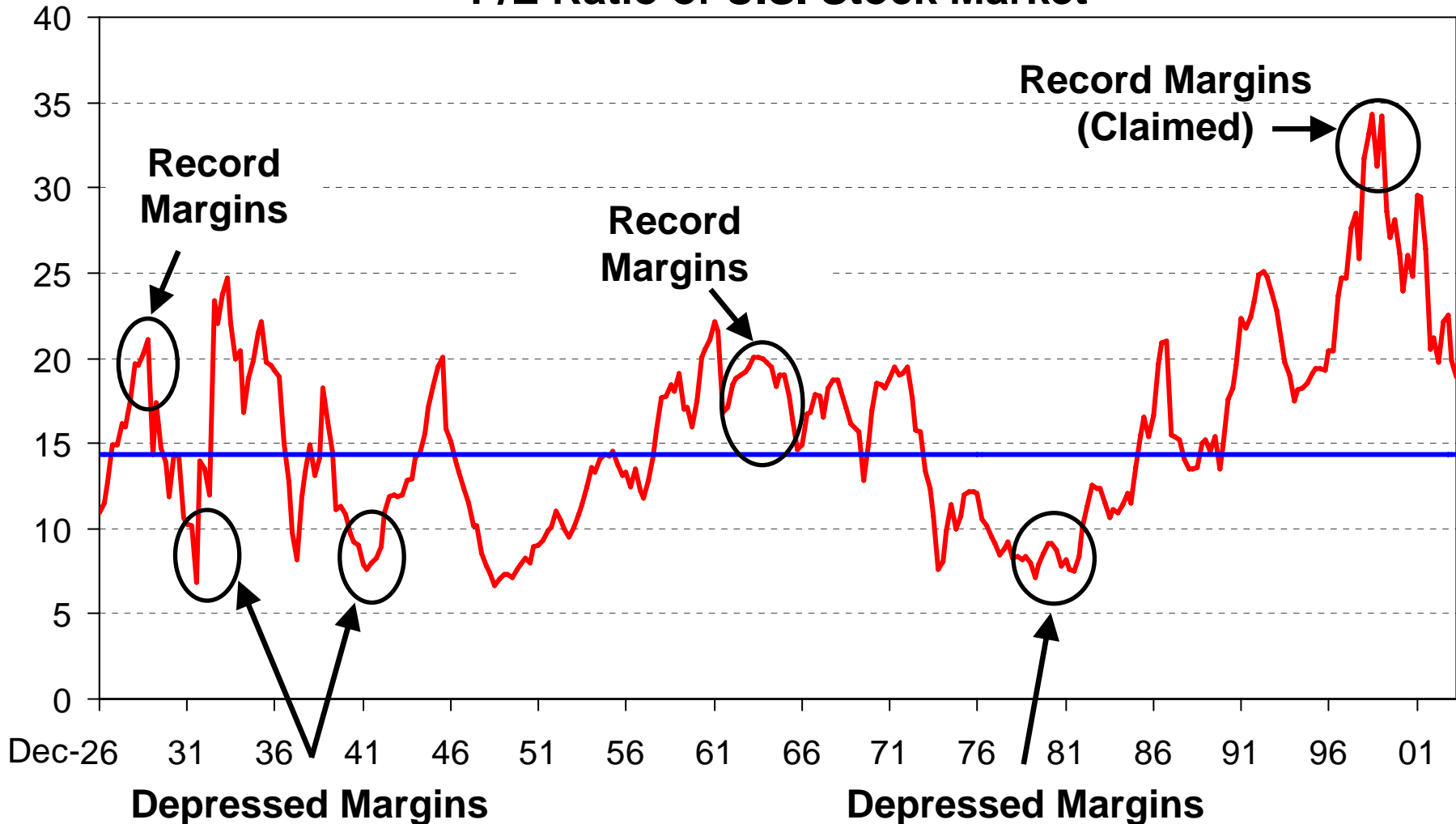
High Profit Margin × Low P/E

**– OR –**

Low Profit Margin × High P/E

# How the Market Actually Works

## P/E Ratio of U.S. Stock Market



**Actual correlation between profit margins  
and P/Es is positive 31.8%**

# Asset Allocation

---

## GMO Core Beliefs and Competitive Advantages

### Mean Reversion Drives Everything

In all capitalist economies, high profit margins attract competitors and *drive down* future returns in highly-valued sectors.

### Markets Are Shockingly Inefficient

Investors *extrapolate* past trends in error, and over-pay for “comfort,” which a contrarian investor can reliably exploit.

### Wait for the Fat Pitch

Big portfolio “bets” should be tempered until valuations move to extremes. Mean reversion can take a long time and patience is an investment virtue.

### Benchmark Risk Is Not Enough: Preserve Capital

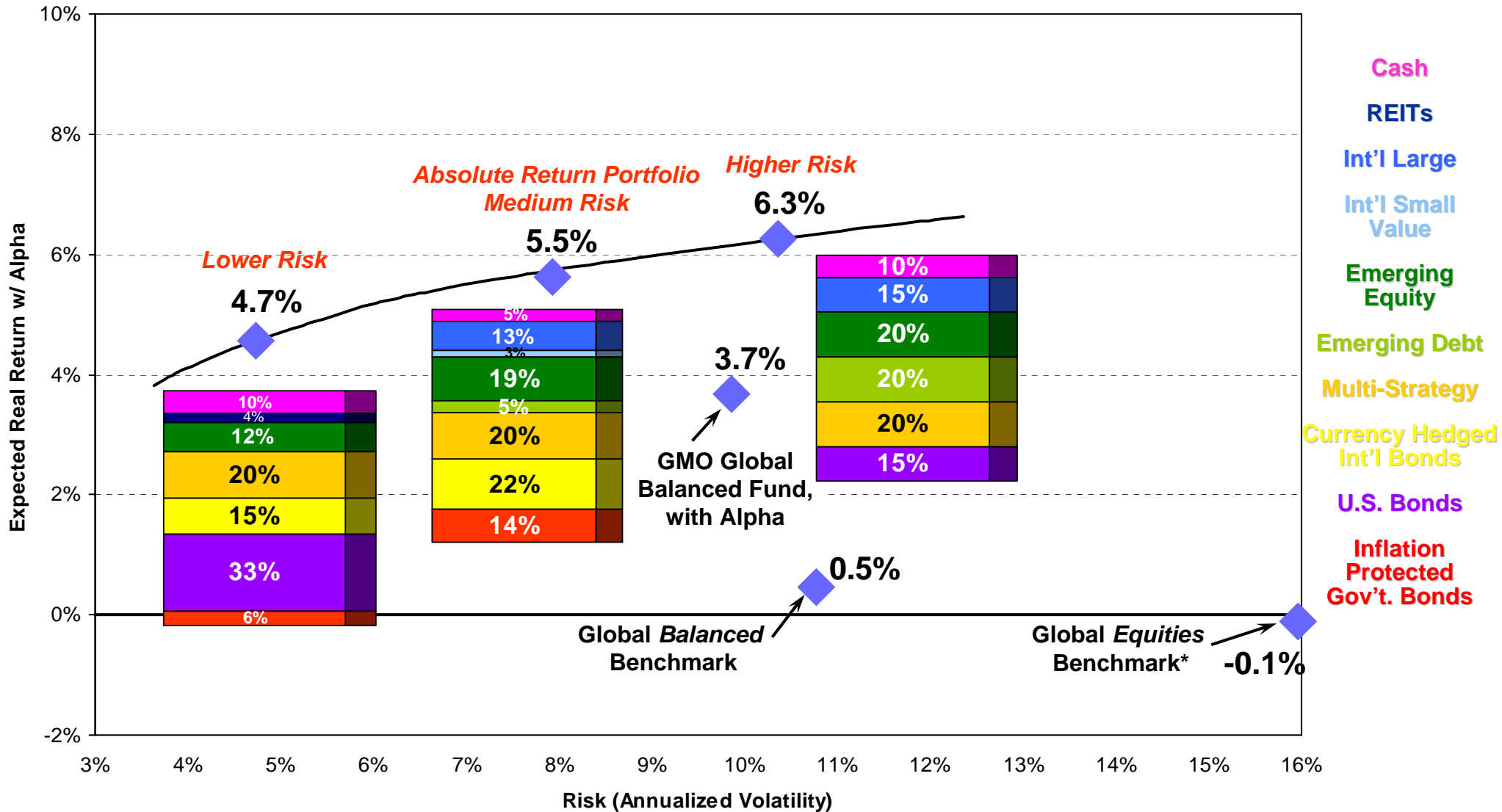
Absolute return makes the assets grow, not relative return. Keep up as best you can during bull periods, but focus on capital preservation in bear markets

### Think Outside the Box

Building a portfolio for high absolute return may require avoiding the traditional building blocks of U.S. equities and bonds. Preventing capital loss should dominate the risk of being “different.”

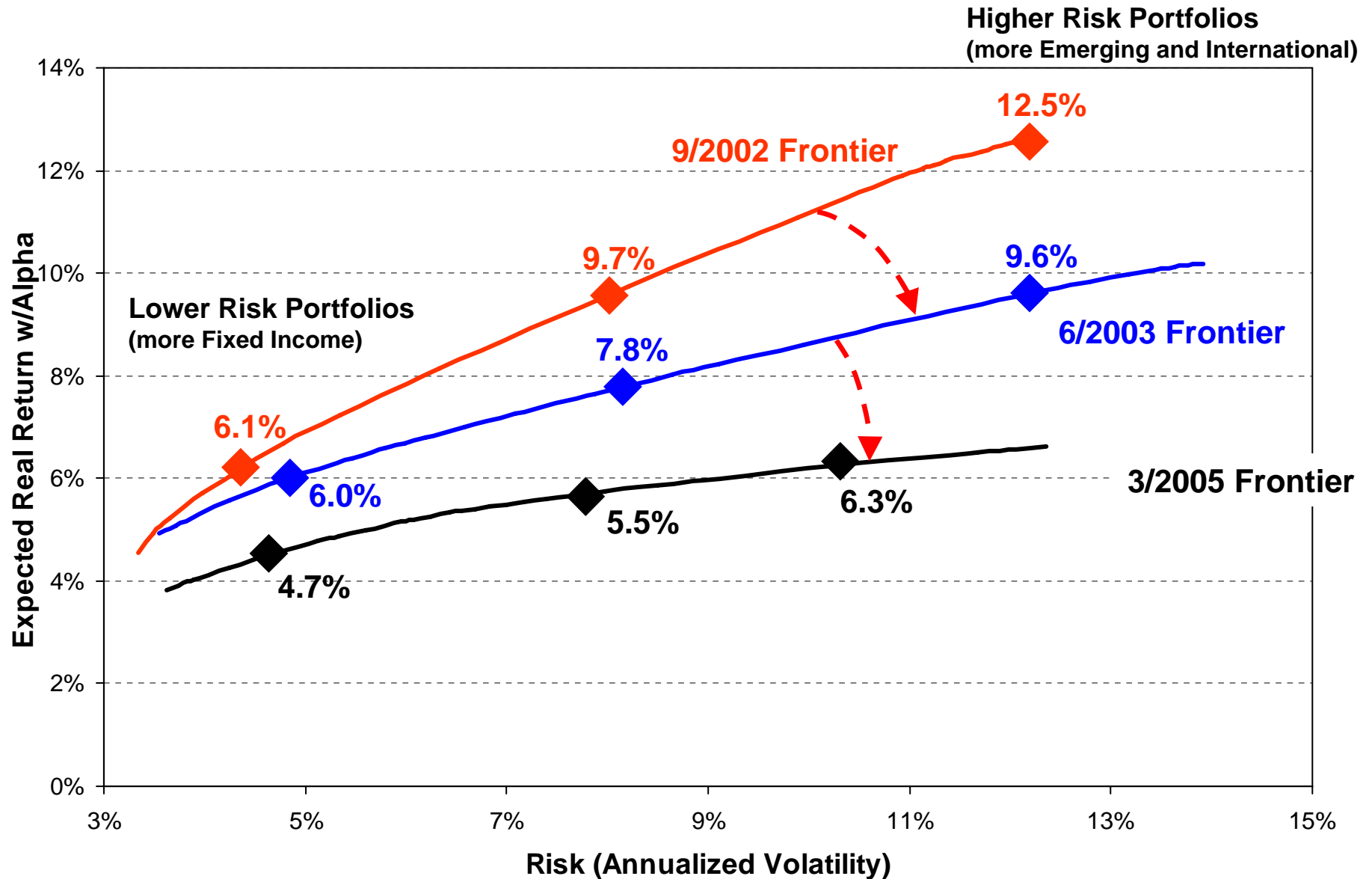
# Absolute Return Portfolios

## Achieving Acceptable Real Returns with Reasonable Risk



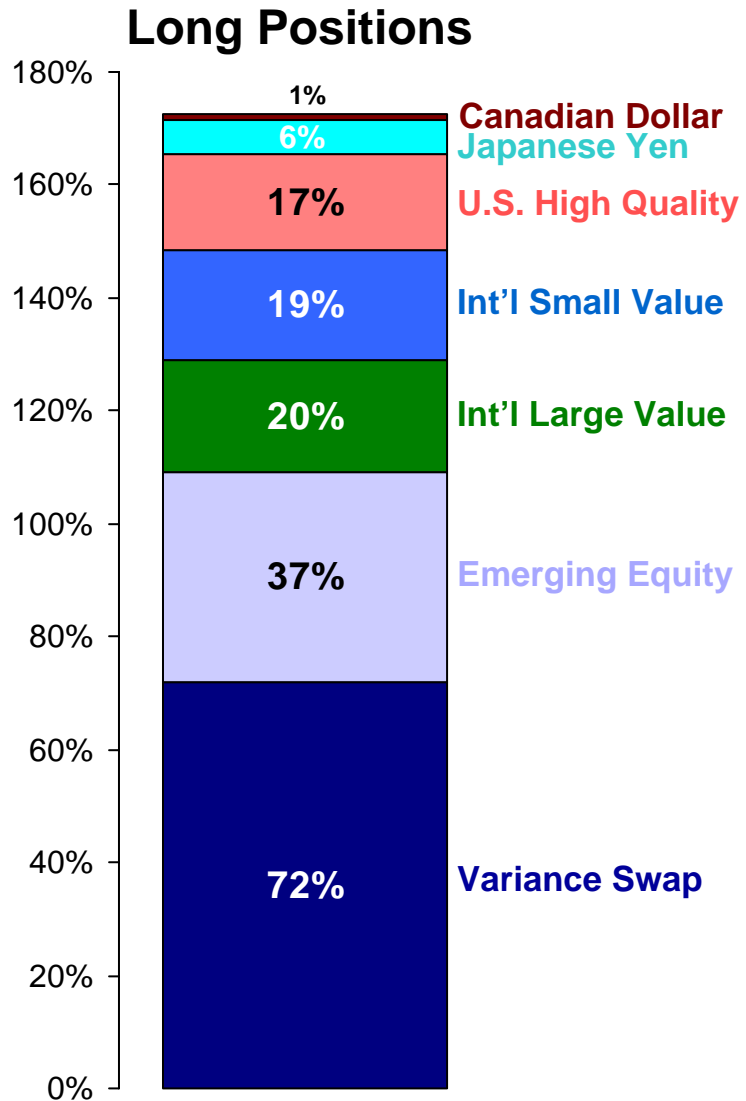
# Absolute Return Portfolios Over Time

## The Return to Risk Is Shrinking

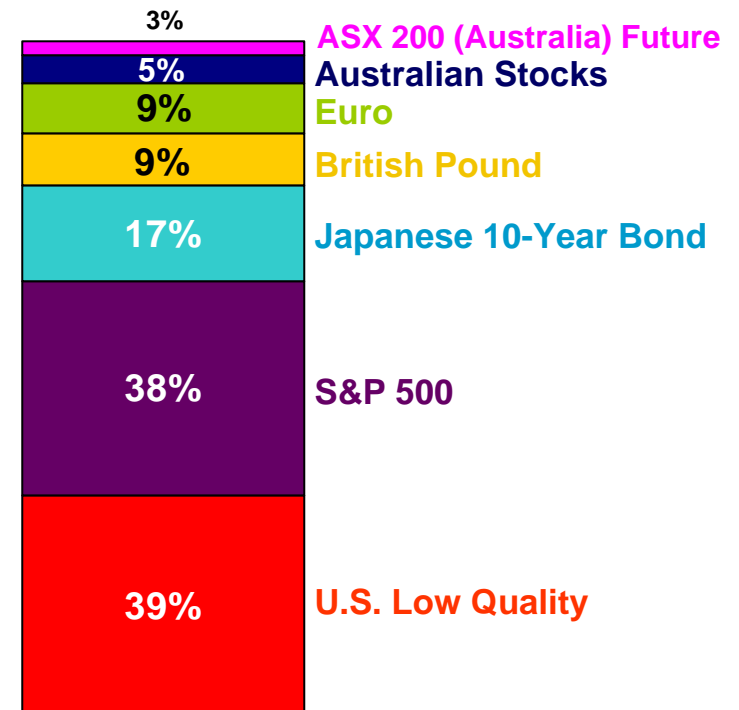


# Mean Reversion Strategy

## Current Portfolio



### Short Positions



# International Equities Have Lagged the S&P 500 Dramatically Since 1990

## Return of EAFE ex Japan vs. S&P 500

