Industry Insights

Debriefing Jeremy Grantham

David Serchuk, 01.23.09, 4:00 PM ET

"I think great thinkers are not drawn to finance." -Jeremy Grantham

Forbes.com: What is one misplaced assumption in business today?

Jeremy Grantham: I think we collectively missed that global profit margins were extraordinarily high and would come down this year and next year and overrun normal, as they always do. And that would pose a real stress on the stock market and on corporate fundamentals.

What is the greatest financial lesson you've ever learned?

I would say that financial markets are very inefficient, and capable of extremes of being completely dysfunctional. I learned that in 1974, '82, '87, '2000 and definitely not excluding 2008.

Why do you keep having to learn it?

It's a question of how much you believe it. I take 2008 as confirmation, not learning. I really had learned it by 2000.

Who is the greatest financial mind working today?

I do think we have a problem here. There is a gap in this area. I would have said, in the old days, Franco Modigliani, but he died a few years ago. In the pretty good character realm, there is Robert Shiller, Andrew Smithers in London, Mark Faber in Timbuktu. That's a list of good people. But for my money lacking the great financial minds.

I think great thinkers are not drawn to finance. There are higher and better uses [for them]. I think Modigliani was a broad-based economist drawn into finance, but it was far from all he did. He was an economist. I am differentiating between economics, the real economy, and the financial world of stock prices and bank debt.

I'm not saying it [finance] deserves the great brains, I'm just saying it doesn't get them. I consider most of the talent in the financial world to be suboptimal. It could be better placed earning its living in the real world.

What is your bold prediction for the future?

Keying off the word "bold," my prediction is that China will be a substantial disappointment. The reason I say "keying off" is that this is far from being a certain prediction. But I have a strong hunch China will disappoint, and maybe been bitterly disappoint.

That's the nature of the hunch, I look at everything and my stomach tells me they've been extraordinaly lucky in the last 15 years. It's hard to separate good luck from talent. I have a suspicion that a lot of what other people see as skill was good luck. And that they have a difficult job, and under this stress their modest talent will be revealed. The modesty of their talent.

What are some ways they got lucky?

They got lucky that the U.S. decided to run a huge trade deficit when they needed to run a huge surplus for political reasons. And it balanced out, as long as we ran an equal deficit. They were presented with the strongest global economy in history in which to sell their cheaper products.

Everyone else seems to be quite happy [with China]; maybe they're right. That's why it's a bold prediction rather than a high-confidence near certainty.

You had mentioned that the Chinese are new to capitalism, so their bench is not very deep.

Are they really so much better that they can handle an economy growing at four times the speed of the U.S. with a lack of experience? It doesn't compute, but we will find out.

What is one question you would ask Alan Greenspan?

What did you do to get the job? Because nothing in your record seems to justify it.

Have you ever talked to him?

No, and I'm happy to leave it that way.

What would you ask Ben Bernanke?

How did you possibly miss the housing bubble? How could you say at the peak of this three-Sigma event--a one in 1,000 year event at the top of 2006--how could you say the U.S. housing market merely reflects a strong U.S. economy? Surrounded as you are by all this statistical help, and with your experience with the Great Depression, how could you miss it? I simply don't get it.

What sort of housing price declines do you see coming in Britain and the U.S.?

In the U.S., we see a modest 5% decline to fair value. So that has really come down, as we said it would, a year ago and two years ago. We said it would come down to trend. It's only 5% away. But bubbles that are two- to three-Sigma bubbles have always overcorrected. There is no precedent to how much it will overcorrect. Using the analogy of other bubbles, we should count on an incremental 10% overcorrection and hope that it isn't worse. The history of other bubbles show the correction could be much worse, but you can count on a 10% overcorrection, or 15% in total.

What about Britain?

Ugh [laughs]. If it happened quickly, it would be entitled to decline by a solid 35%, plus an overrun. So anything up to a 50% decline from the peak. If if happens slowly and gives time for family income to climb that will mitigate it. We usually state that as a 50% decline immediately, or 12 years marking time. My guess it will happen pretty darn quickly. It will be unlikely that they don't drop 40% from the peak over two to three years, starting six to nine months ago. They do a mean bubble.

How cheap are global equities now?

They are decently cheaper than the U.S., particularly as of this afternoon. So you should get an extra 15% for Japan, maybe an extra 20%, over seven years, vs. the U.S. and in emerging markets.

So should people get diversified into international stocks?

Oh, yes. The U.S. may be relatively blue chip in a crunch, but they are priced at a decent premium to the rest of the world's equities, once again.

Please explain your theory of right- and left-brained CEOs, and how we keep choosing the wrong ones at the wrong times to lead American firms.

I think what I call the Great American Executive is always going to be good at dealing with crises after they've occurred. Always moving fast, focused, short-term-oriented at making decisions. Usually they're short-term-oriented decisions. And he has a lot going for him or her. The weakness is that special outlier events are never, ever seen coming. They're just not the kind of people that think along those lines. That's a more creative, right-brained activity.

What I refer to as "the feet on the table with a coffee cup," bullshitting about the 1930s and 1970s--[that type of person] could happen. And you take outlier events very seriously. They are informed by history and know that strange things shock the world at regular intervals. And your impatient, decisive short-term CEO is not tuned in to get that. Nor is he tuned in to listen to anyone in the organization saying they should watch their tails. Also, CEOs are very aware of career risk. If they're too conservative, they are likely to be replaced by a more gun-slinging type from Credit Suisse, as I like to say.

Do the boards share same characteristics of the CEOs?

Yes, and it's a shame. They are made up of CEO buddies and bootlickers. In theory, it's an opportunity to put in more philosophical, right-brained input in a way that the CEO would have to listen--not in the way he can dismiss his in-house think-tank types. You can have members of the board lean on him, and he might listen, or she might listen. But by having similar CEO types and friends dominate, you're not going to get that help. It's a missed opportunity.

What kind of brain do you have?

I think I'm right-brained, incapable of managing my way out of a brown paper bag.

You seem to be doing well so far.

If only you knew. But the right brain is better suited for long-term investing than short-term management.

Ten years ago, you predicted the S&P 500 would be down 1.1%, and you were almost exactly right. What is your prediction for 10 years out?

Now I do seven years. It's as of today, 7.2% real returns per year. That's not bad, but it's pretty ordinarily cheap. It's not extravagantly cheap. A couple of more days like today and we'll be passing through normal. That's annualized real returns, including dividends. But that's a whole lot better than -1.1%.

It is just straightforward arithmetic. We generate the number on assumption that P/E ratios and profit margins will return to normal. It's the same way we did it 10 years ago. It's proven to be a very durable and fairly accurate methodology.