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Grantham's 'Horrifically Early' Calls Challenge GMO (Update1)

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(Adds GMO's fund inflows in 2003-2004 in fourth paragraph.)

By Charles Stein

Feb. 26 (Bloomberg) -- Jeremy Grantham warned in January 2000 that U.S. equities were "more overpriced than at any time in the last 70 years due to the massive overpricing of technology and especially dot-com stocks."

By the end of 2002, the Standard & Poor's 500 Index had fallen 40 percent and technology shares were down 73 percent. The forecast didn't help his firm, Grantham Mayo Van Otterloo Co., because he'd been bearish since 1997. Assets declined 45 percent in the late 1990s as customers sought out better-performing mutual funds that liked the technology stocks Grantham disdained.

Grantham said in an interview that his negative calls are often so early that investors who acted on them gave up gains before prices peaked. He recommended avoiding Japanese stocks more than two years before they started falling at the end of 1989. While his timing doesn't deter fans like former Harvard University endowment manager Jack Meyer, it requires a delicate balancing act by GMO, which oversees $107 billion.

"We lost business like it was going out of style," the 71-year-old Grantham said of his dot-com prediction at a Jan. 28 speech to investment advisers in Boston, where GMO is based. The firm, which he co-founded in 1977, had net mutual-fund inflows of $12.9 billion in 2003 and 2004, according to data compiled by Morningstar Inc.

GMO's funds usually don't fully adopt his recommendations, or hedge their bets, underscoring the difference between being a star strategist and successful money manager. That's true for the fund Grantham works most closely with, GMO Global Balanced Asset Allocation, which oversees $3.1 billion.

Setting Off Alarms

The tension between acting on a long-term vision and keeping clients happy in the short run is a fact of life for all money managers, said Charles Lieberman, chief investment officer at Advisors Capital Management LLC in Hasbrouck Heights, New Jersey, which oversees about $190 million. "The issue is: Are you willing to stick your neck out and how far?" he said in a telephone interview.

The tension is heightened at GMO, where Grantham's warnings of investment bubbles have at times sent customers packing for firms with a more upbeat view of the markets.

"If we are too aggressive, and we don't get it right, we run the risk of being fired," Ben Inker, GMO's head of asset allocation, said in a telephone interview.

Two of Grantham's most recent forecasts were right -- and timely.

Emerging Markets

In 2007, he wrote in his newsletter that all asset classes were overvalued and it was time to sell high-risk securities. GMO's $2 billion Emerging Country Debt Fund, which held high- yielding securities from countries such as Venezuela and Argentina, decided to stick with those investments in 2008.

"Every bet we made turned out to be wrong," Thomas Cooper, the fund's co-manager, recalled in an August interview, pointing out that investors sought out safer securities during the financial crisis. The fund lost 33 percent in 2008, and the following April GMO was fired by the Massachusetts state pension system as manager of $230 million in emerging-market debt.

The fund bounced back, returning 50 percent in 2009. Its 14 percent annual return over the past 10 years made it the best performing bond fund, according to Chicago-based Morningstar.

"Jeremy has been a great long-term investor," said Meyer, who ran Harvard's endowment for 15 years until 2006, when he left the Cambridge, Massachusetts, university, to start Convexity Capital Management LP, a Boston-based fund manager. Grantham was ahead of the pack in the 1990s identifying the value of emerging-market stocks, inflation-adjusted securities and timber, Meyer said in a telephone interview.

'No Justice'

In March 2009, when the S&P 500 index bottomed out at 676, Grantham wrote that fair value for the benchmark of the largest U.S. stocks was 900, or 33 percent higher. By July, with the index above that mark, Grantham concluded U.S. stocks had become too expensive again.

"After 20 years of more or less permanent overpricing, we get five months of underpricing," he told newsletter readers. "There is no justice in life."

The fair value of the S&P 500 is 850, 23 percent below today's 1105, said Grantham. He arrives at that valuation by assuming a long-term average price-to-earnings ratio of about 15 for U.S. stocks and applying it to a long-term average for profit margins.

Grantham is chief investment strategist at GMO, whose assets have risen almost fivefold since 2000. Its more than 40 mutual funds usually require a minimum investment of $10 million and are aimed mainly at institutions such as pension funds and endowments, according to the firm's Web site. The firm also acts as a sub-adviser on several retail mutual funds.

Drawing A Crowd

In his appearance in Boston, Grantham, who is whippet-thin with a full head of gray hair, wore a dark suit and a pink tie with giraffes. Until the past few years, he played in a weekly soccer game to stay in shape.

Over the course of 45 minutes, he poked fun at the investment business and himself. Recalling the five-month period in which he considered U.S. stocks inexpensive, Grantham said, "I refer to it as my very short life as a bull."

After the speech, more than a dozen advisers gathered around Grantham, peppering him with questions about everything from China to the U.S. budget deficit.

"He's got the perspective of someone who has been in the battle for a long time," said Robert Henkel, an adviser from Portsmouth, New Hampshire, explaining why he sought out Grantham for a private conversation.

Current Outlook

Grantham's favorite asset class today is high-quality U.S. stocks, companies defined by high, stable returns and low debt. The allocation fund had 31 percent of its money in that category at year-end, sometimes called blue chips, according to the GMO Web site. In the interview, he said he expects such stocks to return an average of 6.8 percent a year over the next seven years, compared with 1.3 percent for all large-cap U.S. stocks.

Emerging-market stocks may rise about 4 percent annually in the next seven years, as investor enthusiasm for economic growth in developing countries carries the stocks to unsustainable levels, Grantham said.

"Why not go along for the ride?" he said. The MSCI Emerging Markets Index returned an average of 22 percent in the past seven years, compared with a gain of 5.5 percent by the S&P 500 index.

U.S. government bonds will return 1.1 percent a year over the seven-year period, according to the latest GMO forecast. The Bank of America Merrill Lynch U.S. Treasury Master Index rose 4.3 percent from 2003 through 2009.

Grantham said he expects a difficult, not disastrous, period for the economy and investments.

"It will feel like the 1970s," he said. "One step forward, one step back."

'Flaky Little Companies'

Grantham was raised in Yorkshire, England, and has a bachelor's degree from Sheffield University. His father was a civil engineer who died in World War II.

"Yorkshiremen have a well-deserved reputation for a highly developed sense of value," he wrote in a follow-up e-mail. "In other words, they're cheap."

Grantham came to the United States to go to Harvard Business School in Boston. Following graduation in 1966, he spent several years as a self-described speculator, borrowing money to invest in "flaky little companies I hardly knew," he said in the interview.

After he suffered large losses in 1969, "it brought out my deeper instincts to be a contrarian," he said.

Dean LeBaron

That year Grantham co-founded Batterymarch Financial Management Inc., a Boston firm that is now owned by Baltimore- based Legg Mason Inc. At Batterymarch, Grantham and co-founder Dean LeBaron were among the first to offer clients the chance to invest in indexes, according to the book "Common Sense on Mutual Funds" by John Bogle, who started Vanguard Group Inc., the Valley Forge, Pennsylvania-based mutual-fund firm.

In 1997, Grantham and his wife created a foundation to protect the global environment. In 2007, the couple donated $23.6 million to Imperial College London to establish an institute on climate change.

"This is the most important economic and social issue of the 21st century," Grantham wrote in the e-mail.

Grantham, as a member of GMO's asset-allocation team, makes recommendations to the firm's 114 investment professionals. They are free to accept or reject the advice.

GMO Global Balanced Asset Allocation fund returned 6.8 percent annually in the past decade, a performance topped by 4 out of 50 rival funds, according to data from Chicago-based Morningstar Inc.

Focus on Benchmark

The GMO fund attempts to beat its benchmark, a blend of 65 percent global stocks and 35 percent U.S. bonds, by 2 percent to 3 percent a year, according to the firm's Web site. The benchmark returned less than 1 percent a year in the past decade, according to the GMO Web site.

The fund will make "significant" bets, within limits, on asset classes such as emerging-market stocks or real estate, said Inker, who is a co-manager. The fund generally keeps at least 45 percent to 50 percent of its money in stocks, he said.

"We are as aggressive as we can get away with, but not more aggressive," said Inker.

Grantham is best known for his quarterly newsletters, which have appeared since 1999. The publications, which run as many as 18 pages, represent his personal views on the stock market, sprinkled with acerbic comments on subjects such as private equity and Federal Reserve policy. Last October, he compared giving Ben Bernanke a second term as Fed chairman to reappointing the captain of the Titantic.

Newsletter Fans

The newsletters have a following among investors large and small.

Chuck Levin, a financial planner in Wayland, Massachusetts, admires them for their "salient and clear thoughts on investment." Levin doesn't necessarily follow Grantham's advice, particularly when the strategist is bearish on stocks.

"I am not going to tell my clients to put all their money into cash," he said in a telephone interview. "Who has the courage to do that?"

Jack Ablin, who helps manage $55 billion as chief investment officer at Chicago-based Harris Bank, regularly reads Grantham.

"When he gets bullish, that's when you have to sit up and take notice," Ablin said in a telephone interview.

Jeremy Siegel, who has squared off with Grantham in a series of bull-bear debates over the past decade, said Grantham can cost investors money by being so early with his calls.

"There have been periods when he would have kept people out of the market while it was still rising," said Siegel, a finance professor at the Wharton School at the University of Pennsylvania in Philadelphia and author of the book "Stocks for The Long Run."

No 'Permabear'

Grantham dismisses his "permabear" label, saying that in 2000 he was bullish on emerging-market stocks, real estate investment trusts and inflation-adjusted bonds. GMO data show that the three asset classes returned between 4.9 percent and 8.1 percent a year in the 10 years ended Dec. 31. The S&P 500 lost 1 percent a year over the same stretch.

Looking back on more than 40 years in the investment business, Grantham summed up his career this way: "We win all the bets but we are horrifically early," he said.

--Editors: Larry Edelman, Rob Urban

To contact the reporter on this story: Charles Stein in Boston at 1-617-210-4615 or cstein4@bloomberg.net

To contact the editor responsible for this story: Christian Baumgaertel at 1-617-210-4624 or cbaumgaertel@bloomberg.net
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