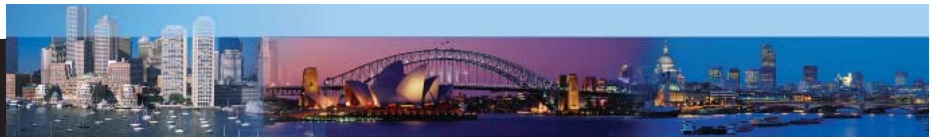
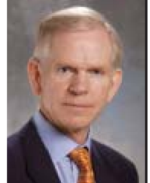
GMO

QUARTERLY LETTER



May 2011

Part 2: Time To Be Serious (and probably too early) Once Again



Jeremy Grantham

The Bottom Line

Lighten up on risk-taking now and don't wait for October 1 as previously recommended. But, as always, if you listen to my advice, be prepared to be early!

A word on being too early in investing: if you are a value manager, you buy cheap assets. If you are very "experienced," a euphemism for having suffered many setbacks, you try hard to reserve your big bets for when assets are very cheap. But even then, unless you are incredibly lucky, you will run into extraordinarily cheap, even bizarrely cheap, assets from time to time, and when that happens you will have owned them for quite a while already and will be dripping in red ink. If the market were feeling kind, it would become obviously misvalued in some area and then, after you had taken a moderate position, it would move back to normal. That would be very pleasant and easy to manage. But my career, like most of yours, has been filled with an unusual number of real outliers. That certainly makes for excitement, but it also delivers real pain for even a disciplined value manager. Following is a snapshot of some of those outliers. In 1974, the U.S. market fell to seven times earnings and the U.S. value/growth spread hit what looked like a 3-sigma (700-year) event. U.S. small caps fell to their largest discount in history, yet by 1984 U.S. small caps sold at a premium for the first time ever. By 1989, the Japanese market peaked at 65 times earnings, having never been over 25 times before that cycle! In 1994, emerging market debt yielded 14 points above U.S. Treasuries, and by 2007 had fallen to a record low of below 2 points. By 1999, the S&P was famously at 35 times peak earnings; in 2000, the value/growth spread equaled its incredible record of 1974 (that I, at the time, would have almost bet my life against ever happening again). Equally improbable, in 2000, the U.S. small/large spread beat its 1974 record and emerging market equities had a 12 percentage point gap over the S&P 500 on our 10-year forecast (+10.8 versus -1.1%). Further, as the S&P 500 peaked in unattractiveness, the yield on the new TIPS (U.S. Government Inflation Protected Bonds) peaked in attractiveness at over 4.3% yield and REIT yields peaked at 9.5%. Truly bizarre. By 2007, the whole world was reveling in a risk-taking orgy and U.S. housing had experienced its first-ever nationwide bubble, which also reached a 3-sigma, 1-in-700-year level (still missed, naturally, by "The Ben Bernank"). Perhaps something was changing in the asset world to have caused so many outliers in the last 35 years. Who knows? The result, though, for value players, or at least those who wanted to do more than just tickle the problem, was overpriced markets that frightened them out and then, like the bunny with the drum, just kept going and going.

Well, those dramatic opportunities certainly hooked me, and I jumped enthusiastically into every one and was, of course, too early. Some of them went from looking like 1-in-40-year opportunities to 1-in-700!

So, I have had a long and ignoble history of being early on market calls, and on two occasions damaged the financial well-being of two separate companies – Batterymarch and GMO. On the other hand, at long and bloody last (in the figurative, not the British, sense), the big bets we made have all been won, with quality and cash still pending. But, as I like to say, we often arrive at the winning post with good long-term results and less absolute volatility than most, but not necessarily with the same clients that we started out with. Our bets have been part of the public record for the last 20 years and before that the bets (including those made while I was at Batterymarch) were so big that no one could have missed them: while at Batterymarch in 1972, betting (two years too early) on small cap value against the "nifty-fifty" IBM types (and with 100% of the portfolio!); betting against Japan three years too early in 1986 (as in zero percent Japan

against 60% in the benchmark!); betting against the Tech bubble, two and a half years too early, and against the recent Housing and Risk-taking Bubble, much less painfully but, once again, two years too early. But, what I really want to emphasize today is my current opportunity to be two years too early once again by betting against the broad U.S. market.

As readers know, driven by my increasing dislike for being early by such substantial margins, I have been experimenting recently with going with the flow. In defense of this improper behavior, rest assured that it was motivated not by chasing momentum, but by my growing recognition of the immense power – sometimes the thoroughly dangerous power – of the Fed. Nowhere is this power more clearly revealed than in the ease with which it can move asset prices, particularly stock prices, and nowhere is this revealed more clearly than in Year 3 of the Presidential Cycle. I will not inflict on you once again the amazingly lopsided results of the Cycle, but will take this opportunity to introduce my new pet variant of Year 3 power: "Sell in May and go away." This nugget came up recently, so we tested it. Bingo! In the first seven months of the third year since 1960, Year 3 has returned 2.5% per month for a total of 20% real (after inflation adjustment). In contrast, the second five months after May have delivered an average return of 0.5% per month, as does the fourth year of the cycle. Now, 20% is perilously close to the total for the whole 48-month cycle of 21%. This means, of course, that the remaining 41 months collectively return a princely 1%. This offers a brilliant, lazy investor's rule: "Sell in May of Year 3 and go away for 41 months." Whoopee! The unfortunate caveat is that there are only 11 entries for this analysis so it may well be pure luck. Still, it's intriguing, especially if you like sitting on the beach for 41 months.

In addition to entering Year 3 last October, we also had Bernanke's QE2 … a kind of underlining of the seemingly eternal promise of a bailout should something go wrong, as if Noah had been sent not just one rainbow, but two! So, even though the market was substantially overpriced by last October 1, I found myself atypically writing that it was likely that the market would race up to the 1400 to 1600 range on the S&P 500 by October 1. Of course – I hasten to add – I emphasized the caveat that more serious, risk-averse, long-term investors would not want to play fast and loose with a market then worth only 900 on the S&P. I also added that GMO played pretty strictly by the value book for our clients, shading only a little here and a little there. But I personally (no doubt driven mad by the too-early syndrome) took a little more risk in honor, as it were, of the Fed's behavior. Behavior I, of course, completely disapprove of. But that's an old story.

Well, believe it or not, the third year has behaved perfectly for the first seven months. At the end of April, the S&P had offered up 21% in total return. And the market at 1360 needs just a 3% rise to reach my lower limit of 1400 in the five months remaining.

All of this has occurred as if everything is normal: as if the economy is recovering strongly, as if the housing market has started to regroup after an unprecedented two years flat on its back, and, most importantly, as if special and exogenous shocks have not tried to tag-team Year 3. Yet, all of those presumptions are at least partly wrong. In fact, it is beginning to feel like an unfair contest. One minute we have the Year 3 effect chugging along, with us Pavlovian investors responding faithfully to the Fed. The next minute we are dealing with not one, but two, exogenous shocks: the Tunisia-Egypt-Libya-Yemen-Syria shock and the dreadful tsunami shock. In general, exogenous shocks famously have little effect after the first few days (or occasionally weeks) of exaggerated psychological sell-offs. The painful exception to this rule is, unfortunately for us now, an oil shock. (Happily, there have been only two bad ones – in 1974 and 1979 – as well as two or three scares.) An oil shock is like a tax on business and a tax on consumers. It quickly transfers wealth to often undesirable government coffers and poses a "recycling" of wealth problem. It will usually depress consumer demand quite quickly as gasoline prices rise; it will usually depress GDP growth, generally a little later; and it will always unsettle business confidence. The stock market, perhaps anticipating this, has declined rapidly and severely when it has sensed a serious oil crisis.

Yet this time the market bounced back with the Year 3 effect winning handily. But doesn't the current situation there clearly reduce any certainties about the Mediterranean Arab world (which have, in any case, never been that high)? Can't this crisis clearly spread to Saudi Arabia or other Gulf states sooner or later? For once, in my opinion, the short-term effect is underestimating the potential for trouble – a real testimonial to the Year 3 confidence (and speculation) effect.

Immediately after the market bounced back from the oil shock, it was met by the Japanese disaster. Bear in mind that catastrophes of this type historically have particularly little negative long-term effects on markets. They do, however, have a greater impact than the so-called broken window effect: disasters can galvanize politicians, governments, and the general public far beyond the short-term job-creating replacement effort. Immediately after 9/11, I wrote that the actual GDP effect (as compared to the human cost) would be negligible and that the Fed's response would almost certainly cause the economy to be stronger than it would otherwise have been. I think, with hindsight, that this was correct. But, and this is a big "but," the Japanese damage is unprecedentedly high and some of it will be long-lasting. More importantly for the rest of the world, Japan has long tentacles and we are now rediscovering just how interconnected and interrelated the world has become. The Japanese are important, near-monopoly suppliers of certain small parts, without which whole production lines can be brought to a standstill. And the global industrial system does not have the resilience it once had: the Japanese have taught us all to have lean and mean "just-in-time" inventories, just in time for deliveries to be cut off, revealing one of the troubling vulnerabilities of that approach.

In reaction to this second shock, the market shook its head like a prizefighter after having taken a thunderous right to the chin, and rallied back once again to its high. But we have at least another round to go as we must now face what might be called "the Bill Gross" effect. Bill invites us to consider the consequences of QE2 ending on June 30 and, perhaps with more impact, lets us know that he at least is nervous enough to completely bail out of U.S. government bonds, not wanting to find out who will replace the Fed as the most recent buyer of last resort.

As if even that wasn't enough, the relentless rise in resource prices is beginning to act as an economic drag as a primary effect and, as a secondary effect, it is causing inflation pressures to increase, particularly in developing countries. This inflationary pressure is being met in those countries by efforts to cool economies down, notably by interest rate increases. These more restrictive moves in developing countries might soon begin to affect business confidence in the developed world. But, even given all of this, the S&P merely wobbles a bit and then moves on to new recovery highs, helped perhaps by (finally!) some better news on hiring. The U.S. market's strong performance under these pressures leads us to the question as to whether it would have been even higher had it not had to absorb these several blows? I would guess it might be up to 5% higher had it been left alone, and no one will ever prove me wrong!

So, we have four factors working against the Fed effect (or 4¼, counting my more lightweight "sell-in-May" factor, which suggests that all of the normal Year 3 exceptional performance may have been delivered already). With these headwinds, I do not feel the same degree of confidence that I did, which was considerable, that the Fed could carry all before it until October 1 of this year. A third round of quantitative easing would very probably keep the speculative game going. But without a QE3, there seem to be too many unexpected (indeed unexpectable) special factors weighing against risk-taking in these overpriced times. I had recommended taking a little more risk than was justified by value alone in honor of Year 3, QE2, and the Fed in general. Risk now should be more reflective of an investment world that has stocks selling at 40% over fair value (about 920 on the S&P 500) and fixed income, manipulated by the Fed, also badly overpriced.

Although the taking of some "extra" risk by riding the Fed's coattails has been profitable for six months, I admit to being a bit disappointed: I really felt the market had the Fed's wind in its sails and would move up deep into the 1400 to 1600 range by October 1, where it would be, once again, over a 2-sigma 1-in-44-year event, or, officially, a bubble. (At least in a world where GMO is the official.) At such a level, I was ready to be a real hero and absolutely batten down the hatches, become extremely conservative, and be prepared to tough out any further market advance (which, with my record, would be highly likely!). The market may still get to, say, 1500 before October, but I doubt it, especially without a QE3, although the chance of going up a little more by October 1 is probably still better than even. And whether it will reach 1500 or not, the environment has simply become too risky to justify prudent investors hanging around, hoping to get lucky. So now is not the time to float along with the Fed, but to fight it. Investors should take a hard-nosed value approach, which at GMO means having substantial cash reserves around a base of high quality blue chips and emerging market equities, both of which have semi-respectable real imputed returns of over 4% real on our 7-year forecast. The GMO position has also taken a few more percentage points of equity risk off the table.

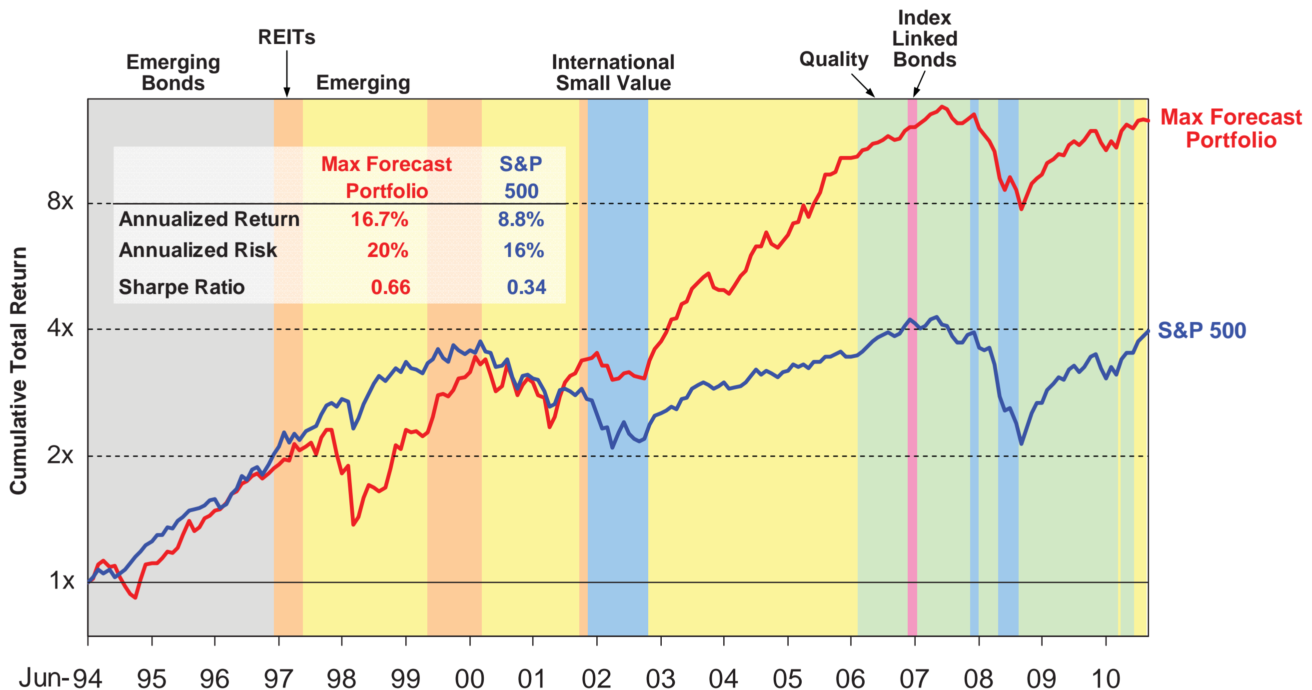
Japan

GMO also has, in asset allocation accounts where it is appropriate, increased exposure to Japan, which we had thought, pre-troubles, was relatively attractive. More precisely, we had thought it was at least average if nothing much changed, but that it represented some free options on several promising changes: improved attitude to shareholders, more focus on improving profitability, and, in particular, less casual capital overinvestment. There are some favorable signs that a change could be beginning. The tsunami also presented a typical short-term overreaction. The ensuing write-down of assets may equal the equivalent of up to 5% of Japan's GDP (which would be far more than usual), but even such a large cost would lower the present value of Japanese stocks by substantially less than that, let alone the 20% discount that was offered. Critically, the recent disasters may, just may, act as a psychological and economic shock, which, 30 years from now, may be seen as a turning point for the better.

Yet More on GMO Forecasts

I miss not having an exhibit so this is it. It shows a very crude way of using GMO's forecasts from their starting point in 1994. It assumes that every month, with nerves of steel and no committee to report to (Heaven indeed!), you put all of your money in the single asset class with GMO's highest forecast with no transaction costs. You then change 100% every time a new asset comes to the top of the list, which happens to be about once a year, a turnover level that actually seems acceptable. Obviously, such a strategy would not be tolerable for much more than 5 or 10% of one's money, rebalanced each year. Anyway, doing so generates a knock-out annualized performance of +16.7% (increasing your money 13x over this period) using the respective asset class benchmarks. Returns using GMO funds

Asset Allocation the Simple Way: GMO Max Forecast Theoretical Portfolio



	Max Forecast Portfolio	S&P 500
Annualized Return	16.7%	8.8%
Annualized Risk	20%	16%
Sharpe Ratio	0.66	0.34

Hypothetical performance is not predicative of future results. The results reflect performance an investor would have obtained had it invested in the MANNER DESCRIBED BELOW and do not represent returns that any investor actually attained. Hypothetical results are calculated by the retroactive application of a model constructed on the basis of historical data and based on assumptions integral to the model, which may or may not be testable. General assumptions include: GMO weighting the previous month's top asset class based on GMO's 7-year asset class forecast with a 100% weight and re-balanced each month. Changes in these assumptions may have a material impact on the hypothetical returns presented. Certain assumptions have been made for modeling purposes and are unlikely to be realized. No representations and warranties are made as to the reasonableness of the assumptions.

Hypothetical performance is developed with the benefit of hindsight and has inherent limitations. Specifically, hypothetical results do not reflect actual trading or the effect of material economic and market factors on the decision-making process. Since trades have not actually been executed, results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity, and may not reflect the impact that certain economic or market factors may have had on the decision-making process. Actual performance may differ significantly from hypothetical performance.

Hypothetical results are adjusted to reflect the reinvestment of dividends and other income and, except where otherwise indicated, are presented gross of fees, and do not include the effect of hypothetical transaction costs, management fees, performance fees, or expenses, if any.

Source: GMO, Standard and Poor's *As of 2/28/11*

are complicated by the need to account for transaction costs, but they would be approximately 2 percentage points a year higher. Although the portfolio is, not surprisingly, volatile, the Sharpe Ratio (risk over return) is way above that for the S&P. This is not a recommendation and we have never run a strategy on this basis. It is here just for fun (and, of course, to get in my one exhibit).

Quality

Careful readers will remember that I mentioned the odd characteristic that usually, late in very substantial bull markets, boring blue chips start to win as investors get nervous but can't bring themselves to stop dancing. Well, since March 31 the S&P is up by 2%, the Russell 2000 is down by 1%, and our Quality Strategy is up by 5%![1] I know that one swallow ordinarily doesn't make a summer, but I wish this time that it would.

Longer-term Recommendations: No Change

My very long-term personal recommendations remain the same: forestry and good agricultural land, "stuff in the ground," and resource efficiency plays. The caveats on entry point risk have recently been mentioned.[2] Should commodities crash in the near term because of good weather, problems in China, or both, I think it will create another "investment opportunity of a lifetime," much like the several we have had in recent years.

Post Script: Financial Skullduggery

As a postscript, I would like to recommend one movie and one magazine article. The movie, "Inside Job," was directed by Charles Ferguson and won this year's Oscar for best documentary. It covers the financial crash and in it you will see some of the highest-quality squirming in the history of film. I cheered and booed the cast of characters, the first time I've done so since my Saturday morning movie club when I was seven. In my opinion, it is nearly spot-on and absolutely priceless, but just a little hard on Martin Feldstein, who seems an innocent bystander. The rest deserve what they get. Ferguson's Oscar acceptance speech basically asked, "Why has no one gone to jail?" Good question.

Matt Taibbi, the *Rolling Stone Magazine* journalist of vampire squid fame, has written a jaw-dropping piece on some of the sloppiness of the Fed's bailout money. (More Fed transparency seems an excellent idea to me too.) It tells, among other things, of some "Wall Street wives" getting loans of some $220 million from the Fed, and using the borrowed money to make investments guaranteed by the Fed – essentially risk free. Why, you may well ask? The chutzpah of these powerful guys is admirable. Their ethics less so. At least they are nice to their wives; probably their dogs, too.[3] GMO has not checked the data in any detail.

Finally, the recent Senate report on the financial crash quoted me, to my extreme satisfaction, on this very topic of ethics – a theme that has resonated with Carl Levin, Tom Coburn, and their obviously hard-working staff (it's 650 pages long). The quote is taken from my pleadings of last summer for banks to get out of proprietary trading, which I believe is unethical, unnecessary, a conflict of interest, and costs institutions, including our clients, a ton of dough. The quote (one whole paragraph!) is on page 637.

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1 Data is as of May 4, 2011.

2 Jeremy Grantham, "Time to Wake Up: Days of Abundant Resources and Falling Prices Are Over Forever," 1Q 2011 *Quarterly Letter*, April 2011. (Available at www.gmo.com.)

3 Matt Taibbi, "The Real Housewives of Wall Street," *Rolling Stone Magazine*, April 12, 2011.

Performance data quoted represents past performance and is not predictive of future performance.. Returns are presented after the deduction of management fees and incentive fees if applicable. Net returns include transaction costs, commissions and withholding taxes on foreign income and capital gains and include the reinvestment of dividends and other income, as applicable. A GIPS compliant presentation of composite performance has preceded this presentation in the past 12 months or accompanies this presentation, and is also available at www.gmo.com. Actual fees are disclosed in Part II of GMO's Form ADV and are also available in each strategy's compliant presentation. The above information is based on a representative account within the strategy selected because it has the least number of restrictions and best represents the implementation of the strategy. The information above is supplemental to the GIPS compliant presentation that was made available on GMO's website in April of 2011.

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