

GMO's Market Outlook: "Disappointingly Overvalued"

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Opportunities across US and foreign assets classes are unattractive, according to Ben Inker, the head of asset allocation at the Boston-based global money manager Grantham, Mayo, van Otterloo & Co. (GMO). Neither the equity nor fixed income markets hold the potential for investors to earn acceptable inflation-adjusted returns, Inker said.

Inker delivered the keynote address at a conference on the global outlook and investment strategies held at Babson College on March 25.

Markets were "desperately overvalued" in mid-2007, prior to the financial crisis, Inker said. Since then, they have gone from "very interestingly cheap" in March of 2009 to today's level, which he called "disappointingly overvalued."

I'll discuss Inker's forecasts for various asset classes, but first let's look at GMO's unique approach to investing.

Don't look like an idiot

Asset allocation is at the core of GMO's approach to investing, because GMO believes that is how it can achieve a unique competitive advantage.

Inker said that his firm does not believe in efficient markets or that prices "fully express all of the market's knowledge about the future cash flows of assets."

But there are ways that markets are reasonably efficient, he said, and one of the ways is "career risk."

"The market tends to be priced in a way that if you want to try to outperform, you have to take a risk of looking like an idiot," Inker said. To outperform, you have to deviate from your benchmark, and that increases the risk of underperformance and, in the extreme, looking like an idiot and getting fired.

As a result, markets exhibit herd-like behavior, which in turn encourages momentum and other self-reinforcing behaviors, such as money flowing into whatever strategy has been doing well, Inker said. That merely ratchets up valuations within better-performing asset classes and sectors, he said, creating a self-fulfilling prophecy.

Valuations can increase, but not forever. Ultimately what brings them back in line are replacement costs, Inker said. If you can build a plant less than what it would cost to buy



one in the market, companies can and will raise capital, thereby driving down market prices. “Replacement cost holds everything,” Inker said. “It is the gravitational pull of the market.”

The trouble is that there are no reliable guidelines for how long that will take, Inker said, and he noted that GMO typically invests too early when it sees undervaluation.

For asset allocators, that amplifies the career risk. For example, if you move from equities to cash because you are unsatisfied with the opportunities in stocks, it will be obvious to clients the bet you are making. If that bet is wrong, Inker said, your clients will too easily assume you are an idiot and fire you.

“The good news is that in the investment business there are very few people who do real asset allocation and actually move money around in an aggressive way,” Inker said. “It’s a tough thing to do and survive. The nice thing about it, and the reason why we do it, is because this means it’s an inefficiency that is not going to get arbitrated away anytime soon.”

The empirical results

GMO does asset allocation perhaps better than any other firm and, according to Inker, its success is based on a faithful reliance on reversion to the mean.

Inker provided some historical data based on GMO’s research into bubble formation and destruction. GMO defines an asset class bubble as an event where prices move two standard deviations above their mean, which statistically should occur once every 40 years. Statistics dictate that only once every 1,600 years should such events be followed by a reverse move down two standard deviations. But, Inker said, those moves downward occur nearly all the time.

Inker said that many other approaches to investing simply don’t work. For example, investing in those countries with higher GDP growth – assuming you knew in advance what those growth rates would be – would have failed over the 30-year period beginning in 1980. There was a negative relationship between GDP growth and market performance. Moreover, market performance was negatively correlated with a number of other variables, including REO, ending P/E ratio, or the change in P/E ratio.

“The single most important piece of information you could have known other than return was what was the starting P/E,” Inker said. The cheapest five markets outperformed the expensive markets by over three percent a year for 30 years.

Inker discussed how asset class valuations coupled with an analysis based on reversion to the mean drives GMO’s portfolio construction process.



Inker said that GMO expects equities to earn approximately 5.7% after inflation and government bonds a little less than half that. Equities won't earn that much year-after-year, but eventually their valuations will move up or down to the level implied by those valuations.

Today, equities are priced to deliver 3.8%, based on normalized P/E ratios, using earnings averaged over the trailing 10 years. It is only a matter of time, Inker said, before reversion to the mean will drive valuations back to the level implied by 5.7% returns. If that happens immediately, which Inker does not predict or expect, investors would suffer a 29% loss. More likely, he said, it will take six or seven years for that to happen, which translates to an expected return of 0.2% annually on the S&P over the next seven years.

Some asset classes offer better returns. Non-US developed market equities are priced to deliver 1.9% returns and emerging markets are priced to offer 4.5% annually. "But from our perspective the world is not a very exciting place for investors right now," he said. "There just aren't any assets where reversion to the mean would cause a gain."

Indeed, the only asset class that Inker said offers attractive returns is managed timber, which is priced to offer 6% annually after inflation. Before you go out and look for timber-based assets, though, consider Inker's warning: To earn this return, you can't use ETFs or public securities; you have to buy forests and manage them yourself, as GMO does. Moreover, you have to be willing to lock your money up for at least 10 years. Even at that, Inker said today's prospective returns of 6% are a "bare minimum" of what investors should expect.

Today's valuations

Inker showed a series of graphs that compared the volatilities of various asset classes to their expected returns. Normally, a regression line through the points on this graph would have a slope of 0.6 – that is, you should get 0.6% more return annually for every additional unit of risk you incur.

In the middle of 2007, however, that line tilted in the wrong direction; taking on more risk decreased expected return. Inker said the market was indicating that investors should take as little risk as possible.

By March of 2009, at the bottom of the market, the slope was approximately two times its normal value. At that time, he said, you wanted to figure out how much risk you were willing to take and get there.

Today, the slope is 0.3, approximately half its normal value. The question Inker posed is whether investors should go to cash, since they are not getting adequately paid for taking risk.



“This is where the life of an asset allocator gets very difficult,” he said. “Unfortunately right now we are not exactly sure what the right thing to do with our clients’ money is.”

Normalized P/E ratios are not extraordinarily rich, Inker said. He said the market is typically valued at 15 times earnings, and today it is priced at a ratio of 18.

A bigger issue, though, is that corporate profits are “unsustainably high and are going to come down,” Inker said. He said that we have just witnessed the fastest recovery of corporate profits in history, and they are already well above the average for other post-recession periods.

Analysts have forecast that profit margins are going to get to a level never seen before in history, Inker said. One reason is that capacity utilization in the economy is very low, and when it has been low in the past margins have expanded.

Inker doesn’t believe increased utilization will drive profits higher in this environment. Profits are defined in economic terms as the sum of net investments and dividends, less savings by the rest of the economy. The latter two terms tend to be fairly stable over time, and changes in net investments are what have caused profits to rise and fall, he said.

In the last 20 years, though, higher profits have been more a result of the government running a 9% deficit, Inker said, than of higher investment. Inker said that from 1952-1986 profits and capacity utilization had a positive correlation of 0.57; since 1987, however, that correlation was -0.17.

Even if net investment were to triple – which Inker said isn’t actually that hard to do – and if the government went to a “sustainable level of deficits, there just isn’t enough money out there for corporations.”

Bonds offer disappointing prospects for other reasons. Government yields are now at 60-year lows, Inker said. The last time yields were this low was in the 1940s, and bonds then were a “spectacularly bad investment for length of time longer than most professional careers,” he said. Indeed, for the next 40 years, bond investors suffered worse returns than cash investors.

Portfolio construction

GMO constructs portfolios for its clients in two distinct ways. Some clients give it a benchmark and charge GMO with outperforming it. In those cases, Inker said, it is “hard to be excited” about owning stocks, and yet he said they were only 4% underweight in equities.



A quarter of those equities are in high-quality companies, which Inker defined as firms with high and stable profitability across the economic cycle, as well as low debt. Inker said emerging markets are the next favorite piece, and that GMO has been buying Japanese stocks in the last month.

Within fixed income, Inker said there are few traditional government bonds that are worth owning. Most of GMO's holdings are in "dry powder," Inker said, which are assets that will not be impacted if rates go up or the stock market goes down.

In all, these benchmark-based portfolios have about 23% of their money on the sidelines, and Inker expects them to return 4.1% annually after inflation, which is better than their benchmark but not acceptable for their clients.

For other clients, GMO has an absolute return mandate that is not tied to a market benchmark. In those cases, Inker said, it makes a lot less sense to own equities, and GMO has reduced its exposure more aggressively, to approximately 41%.

Unlike the benchmark-based portfolios, those portfolios own a number of hedge-fund like strategies, including 15.1% in "alpha only" and 20% in "multi-strategy" categories. Approximately 18% is held in fixed income.

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