

Jeremy Grantham Guarantees Gold will Crash

By Robert Huebscher

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Jeremy Grantham, the investor celebrated for his ability to spot and exploit bubbles in asset classes, guaranteed yesterday that the current bull market in gold will end. His proof? He bought some – for his own account – at the end of last week.

His tongue-in-cheek comment was part of a discussion about relative value in various segments of the market. Indeed, Grantham is bullish on two asset classes – which I'll address in a moment – but gold is not among them.

Grantham, the Chairman of the Boston-based investment firm Grantham Mayo Van Otterloo (GMO), spoke at the CFA Institute annual conference in Boston, where he delivered the keynote address.

Finding value in asset classes

Mean-reversion is the unifying concept behind Grantham's approach to asset class valuation. "We have a very simple approach to all assets," he said. "Everything goes back to normal."

For this approach to work, one must have a clear idea of fair value and a way to determine when prices deviate from it. Price-to-earnings ratios are one of the variables Grantham looks at to determine whether an asset class has deviated from its fair value. Specifically, he uses Shiller's "normalized" PE ratios, which averages earnings over at least 10 years. "PEs that are not normalized are worth nothing," he said.

Using those PE ratios, Grantham regularly forecasts returns over seven-year time horizons, which he said was "as close as possible to the periodicity of the market." He has performed this exercise 28 times since 1994 – forecasting returns for major global asset classes – and claims that he has a perfect record of predicting returns using this "simple-minded" (his words) technique.



Grantham combines his PE forecasts with those for other variables to arrive at projected return for an asset class, as in this example for the S&P 500, for the seven years beginning 4/30/10:

Loss from PE Contraction	Gain from Margin Increase	Gain from Sales Growth	Dividend Yield	Total Return
-5.7%	+0.4%	+3.8%	+2.3%	=0.3%

Long-term PE ratios have averaged 14 and they are currently 22.7. Grantham expects them to go to 15, and that translates to a 5.7% reduction in projected return. Similarly, profit margins have averaged 4.5%. They are currently 5.8% and Grantham generously expects them to increase to 6%, giving rise to a 0.4% increase in total return. Sales growth per share has been 1.8% and is now 1.9%; he expects it to increase to 3.6%, contributing 3.8% to total return. Including the dividend yield of 2.3% produces a total return of 0.3%.

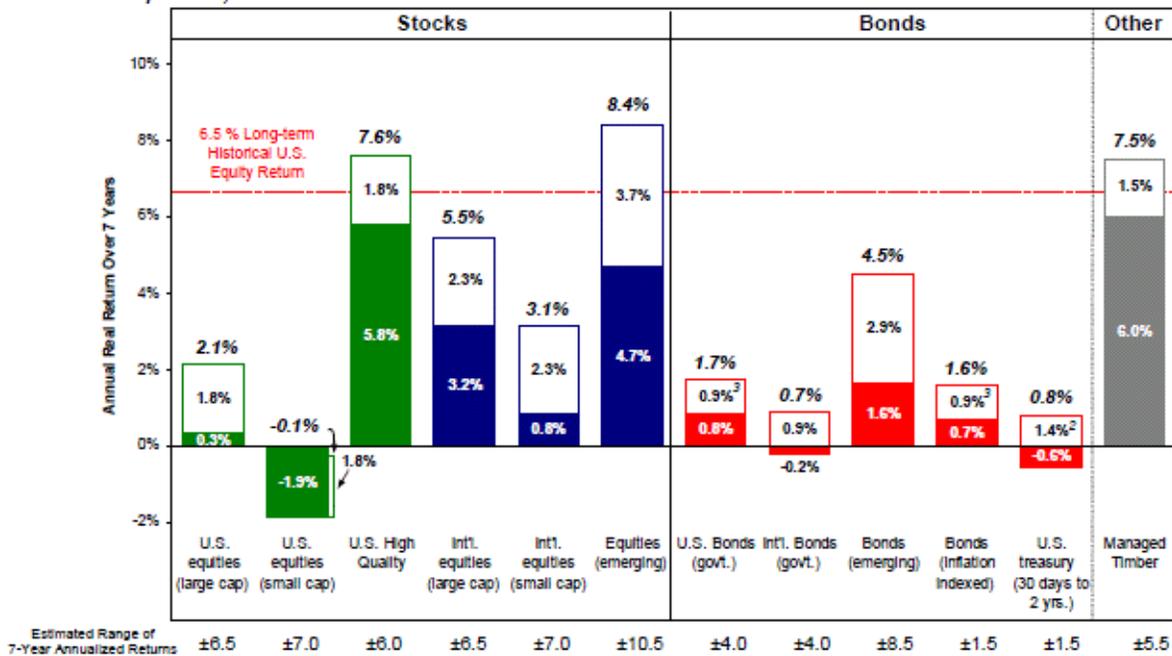
This methodology, he said, should be used to rebut optimistic forecasts for market returns. “When someone comes up with a bigger number, get them to fill in the individual components,” he said – you may disprove their analysis.

Those components are rolled up into a comprehensive forecast, which is below and is also available via GMO’s [web site](#):

GMO 7-Year Asset Class Return Forecasts*

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

As of April 30, 2010



Estimated Range of 7-Year Annualized Returns

*The chart represents real return forecasts¹ for several asset classes and an estimate of net 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. Actual results may differ materially from the forecasts above.

GMO

¹ Long-term inflation assumption: 2.5% per year.
² Alpha imported from management of global equities.

³ Alpha imported from management of global bonds.

Source: GMO

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He predicted a real (inflation-adjusted) return of 0.3% for the S&P 500 (shown above as large-cap US equities). That, of course, follows a decade of negative returns.

Small-cap stocks offer the worst prospective returns, -1.8% inflation-adjusted.

But US high-quality stocks still offer attractive opportunities, with a forecasted inflation-adjusted return of 5.8%. He defined those as stocks with low debt and consistent returns, typically highly rated by S&P. They include the “usual suspects,” he said, such as Johnson & Johnson, Microsoft and Coca Cola. He said there is “no chance” this asset class is not undervalued.



Opportunities in emerging markets and timber

The two asset classes Grantham singled out as truly attractive were emerging markets and timber, which boast projected inflation-adjusted returns of, respectively, 4.7% and 6.0% annually.

Emerging markets are entering a bubble, according to Grantham, who called them his "favorite" asset class. He likened the opportunity in emerging markets to bubbles in the Japanese and NASDAQ markets, when PE ratios went to three-times that of markets in the rest of the world.

The IMF has forecasted 6% annual GDP growth emerging markets, whereas GMO has a forecast of only 2.25%. Based on the gap between those numbers, Grantham has "no doubt a strong simple-minded flow" of funds into emerging markets will follow, pushing valuations higher.

Grantham advised giving emerging markets "the benefit of the doubt and to own a little." He said he now has a 15% allocation in his personal foundation.

Commodities are Grantham's other candidate for entering a bubble, but he said that emerging markets are "much easier to play." Within commodities, timber is the only asset he said he could accurately analyze, and he projects for it 6.0% inflation-adjusted returns.

Grantham said timber is one of the safest asset classes outside of TIPS, and he prefers it to sovereign debt, which is exposed to inflation risk (which Grantham called a big risk worldwide). Timber has proven to be an enormous holder of value, he said, and even worked on an inflation-adjusted basis in the 1930s and 1970s. In the crash of 2008, it lost nothing. "It is a nice contra-cyclical asset class," he said.

At the other extreme is fixed income, which Grantham called "horrible." "It is not capitalism," he said. "It is an administered rate."

The negative inflation-adjusted yields in the short-term bond market are artificial and, if it were not for Fed intervention, he said they would rise 100 to 200 basis points. Those low rates are "just a way of stuffing the pockets of banks and hedge funds," he said, because of their ability to invest with a near-zero cost-of-capital.

Grantham suggested that shorting fixed income would be a wise investment, although he said it would be difficult to do.



French and Fama are wrong

In a retort to the two highly prominent efficient-market proponents, professors Ken French and Eugene Fama, Grantham cited his firm's track record of accurately projecting asset class returns. He reviewed GMO's projections for the 10-year period beginning 9/30/1998.

At that time, his best projected returns (10.9%) were for emerging market equities, and they returned 12.5%, on an inflation-adjusted basis. He projected that emerging market debt would return 7.8% and US REITs would return 6.5%. Their actual returns were 6.5% and 9.2%, respectively.

US large-cap stocks (the S&P 500) were projected to return -1.1%, and their actual return was 0.1%.

Those projected and actual returns are unexplainable in an efficient market framework. The S&P 500, a risky asset class, should not under-perform cash, bonds and a range of other asset classes, but it did. Emerging markets had a correlation of 0.5 to the S&P 500, so their projected returns should resemble each other, yet they differed by nearly 12.0%.

Grantham acknowledged that markets are efficient at the individual stock level because of "career risk." Analysts, he said, rarely lose their job making recommendations based on individual securities. "Keep your nose clean, work hard, and generate a few recommendations," he said, and it will be years before you are fired.

As you move up the asset class tree, though, there are fewer places to hide. The ultimate decision one must make is whether to be in cash or to be in the market, and that is where careers are made or lost. Grantham cited several examples of courageous managers who, in course of the dot-com bubble, lost their jobs because they refused to give in to market mania.

At this stage, Grantham said the market was "fairly overpriced," but did not specifically say the extent to which he was fully invested.

He expects the Fed to keep its "foot to the floor" with low interest rates at least until the November elections and probably into 2011, unless the economy shows clear signs of organic recovery. He assigned a 25% probability to an outcome resembling economic recovery.

Continued negative real interest rates will provide the fuel to propel bubbles in asset classes such as emerging markets and commodities.

As for gold, you might not want to make any decisions based on Grantham's recent purchases, but you should take his cynicism seriously. "I hate gold. It does not pay a



dividend, it has no value, and you can't work out what it should or shouldn't be worth," he said. "It is the last refuge of the desperate."

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