



Jeremy Grantham: This Time is Different

By Michael Edesess
March 20, 2012

Jeremy Grantham is a paradox. A man who has said many times, “*This time it’s different* are the four most dangerous words in the English language,” is now saying – loud and clear – this time [it really is different](#).

What does he think has changed? For a long time, prices of commodities – natural resources, fossil fuels, agricultural products, minerals, and metal ores – were stable or falling. Now, Grantham says, thanks to population growth and increasing scarcity, the rate at which we are using up our resources is intensifying and could make economic progress unsustainably expensive.

It’s not that solutions are impossible, says Grantham in his most recent [February 2012 quarterly letter](#), but a particular failing of capitalism – its propensity toward short-term thinking – is severely impairing our ability to adapt.

If we are unable to cope with this challenge, will it prove to be capitalism’s fatal flaw?

Of course, short-term thinking is not necessarily inimical to long-term solutions, and it may be hasty to say that it is inherent in capitalism. Perhaps it is only an aberration, a mutation of capitalism brought on by poorly designed incentives. Similar perverse incentives, it could be argued, might cause a firm such as Goldman Sachs – to use the exemplar of capitalism *du jour* – to neglect long-term relationships with their “muppet” clientele, as well as cause the rest of us to undervalue our long-term relationships with the Earth’s resources.

Is such short-sightedness inherent in capitalism, or antithetical to it?

These are very big questions – ones we would all do well to ponder. On one side of the search for answers are those who think that, of course, we are running out of resources and “business as usual” cannot continue; on the other are those who believe that, of course, business as usual will solve our problems. I am substantially in sympathy with Grantham’s surprising position in this debate – which is hard to ignore – but the counterarguments are also compelling in their own right.

Malthusians vs. cornucopians

Grantham would probably accept the label “neo-Malthusian.” Thomas Malthus was an English scholar who argued that population increases exponentially, while resources



increase only arithmetically. Therefore, he said, if limits are not placed on population growth, the Earth will run out of resources.

Malthusians are preoccupied with exponential growth and the power of compounding. They are constantly at pains to point out that compounding creates growth faster than almost anyone realizes. Grantham is no exception in sounding such alarms – in an anecdote in his [April 2011 quarterly newsletter](#) (which I find difficult to credit), Grantham says that he posed a question about compounding to a group of Ph.D. mathematicians and they got it wildly wrong. (Perhaps they were only Ph.D.s in finance?)

The problem with Malthusianism – and neo-Malthusianism – is that almost every time a Malthusian thinker has predicted disaster within a certain time frame, those predictions have turned out to be wrong – including Malthus' own. For example, in 1968 biologist Paul Ehrlich predicted wrongly that in the 1970s widespread famines would kill at least 100 million people. Challenged by business professor Julian Simon, Ehrlich then went on to bet – in partnership with two other scientists – that the inflation-adjusted price of a basket of five commodities would increase from 1980 to 1990. That turned out to be ludicrously wrong – the prices fell by more than half. (Grantham notes, however, that if the bet had been extended to 2011, Ehrlich et al. would have won by a large margin.)

In opposition to Malthusians are what are often called “cornucopians,” who believe that human ingenuity will always lead us to new resources and innovative ways to use them – much faster than they will run out. For example Stanford economist Paul Romer [has written](#):

“Every generation has perceived the limits to growth that finite resources and undesirable side effects would pose if no new recipes or ideas were discovered. ... And every generation has underestimated the potential for finding new recipes and ideas. We consistently fail to grasp how many ideas remain to be discovered. The difficulty is the same one we have with compounding: possibilities do not merely add up; they multiply.”

Reversion to the mean?

Grantham's position in this debate is inconsistent with his investing philosophy.

Reversion to the mean is Grantham's investing watch-phrase. He believes that market parameters will revert to their means in the long run, which usually means within his forecasting horizon of seven years. For example, if equity price-earnings ratios depart appreciably from their norms, then we're either in a bubble or a panic, and prices will return to normal within that timeframe.

This simple philosophy has stood Grantham's investment management firm, GMO, in good stead. He is esteemed for having avoided several investment bubbles. (Also, one senses



that at his firm, clients would never be thought of “muppets” or easy marks.) Even in his February 2012 quarterly letter – after expounding on the short-term thinking of capitalism, and its inability to realize that a sea-change is coming – Grantham reveals GMO’s 7-year equity forecasted returns (an attractive 7% real for non-US equities), which are calculated based on the assumption of reversion to the mean.

It is incongruous that Grantham projects future equity returns in the normal way, while at the same time forecasting that everything is about to change. Perhaps seven years and 50 years (his long view of choice for illustrations of intergenerational inequities) are not comparable time periods, and Grantham’s apocalypse is penciled in for some time between 2019 and 2062? Or maybe he just believes that we will muddle through – there are intimations of that in his writing – but only because we will, in the end, heed warnings like his.

Or perhaps his new “reversion to the mean” has a yet longer time horizon, over which both human civilization and the planet will revert to the status quo that prevailed not that long ago, before we began to plunder the Earth’s resources in earnest.

“Your Grandchildren Have No Value”

In his February letter, Grantham reiterated and expanded on warnings that he has enunciated before – in particular that corporations have too high a discount rate, which causes them to engage in short-term thinking and ascribe negligible value to the welfare of future generations. This discounting of our children and grandchildren troubles Grantham, who asked his readers, “Shouldn’t the value, and hence cost, of a child’s life in 50 years be identical to the value and cost today?”

Perhaps, in the abstract; but let’s try to apply the principle. You are confronted with a child today – perhaps even your own child – who has suffered a dreadful accident, and it will cost \$100,000 to repair the damage. On the other hand, if you used that \$100,000 to purchase carbon offsets, you might save the lives of five hypothetical children who might otherwise perish 50 years from now because of flooding or drought caused by human-driven climate change.

Which would you choose? Which would anyone? Is the life-saving surgery an irrational, indulgent, or short-sighted purchase? Of course not. There’s far too much uncertainty when we project the effects of our actions 50 years (or even 7 years) into the future; for all you know, the supposed children your offsets would save might be the progeny of today’s child, whose life you are sacrificing. The short term, in other words, might be the progenitor of the long term after all.

This idea is not limited to children. It can be true of technologies too. Any technology developed now – in response to investors’ and entrepreneurs’ search for the highest return on investment – might plant the seed for further innovation that is as yet unforeseeable,



which in turn may solve the supposedly unsolvable problems we envision better than any solution we can currently fathom.

The discount rate

In the last few years a vigorous debate has been raging among economists about the discount rate. This debate arose in the wake of the [Stern Review](#), a study commissioned by the British Chancellor of the Exchequer and led by Nicholas Stern, a former chief economist of the World Bank. The Review's purpose was to examine the evidence on the economic impacts of climate change and explore the economics of stabilizing the level of climate-forcing greenhouse gases in the atmosphere.

The Stern Review's conclusion was firm and unambiguous: "The benefits of strong, early action on climate change outweigh the costs." Other economists, however, such as Yale's William D. Nordhaus, have challenged this conclusion. [Nordhaus says](#) that standard economic models conclude that an optimal policy would be a tax of \$30 per ton of carbon rising to \$85 by the mid-21st century, while the Stern Review's conclusions imply a tax of \$300 per ton today.

Virtually the entire difference between the Stern Review's results and Nordhaus's arises from the difference in their assumed real discount rates. Stern used a low discount rate of 1.4%, while Nordhaus prefers one in line with the much higher competitive long-term returns on capital available in today's marketplace.

Unfortunately, Nordhaus – like most economists – argues for the higher discount rate in terms that are mostly understandable only to other economists. The Stern Review's arguments, on the other hand, are based on intergenerational equity considerations that anyone can comprehend. The Nordhaus argument, essentially, is that for each unit of climate change reduction we purchase, we will have to give up a unit of something else that will improve life – including, for example, some investments in technologies that might, in the future, wind up doing a better job of mitigating climate change.

Grantham's position

Grantham's position in this debate can be easily inferred, given his argument for a zero discount rate when comparing the value of a child now and one 50 years from now, and given the fact that Professor Stern currently chairs the London School of Economics' [Grantham Research Institute on Climate Change and the Environment](#), which is funded by Grantham's Foundation for the Protection of the Environment.

Grantham deserves substantial praise for funding this work. The potential warming effects of greenhouse gases [have been known](#) for more than 100 years. It is only in the last several decades, however, that greenhouse gas concentrations in the atmosphere have climbed to levels unprecedented for hundreds of thousands – if not many millions – of



years. The last time such a transformation took place in our atmosphere was when photosynthesizers, such as phytoplankton, arose, absorbing carbon dioxide and charging the Earth's atmosphere with large quantities of free oxygen for the first time. These revolutionary photosynthesizers seem to have experienced a population bubble and crash, leaving behind the gigantic deposits of organic matter – we now know them as fossil fuels – that we were so lucky to discover a short 200 years ago.

Increasing greenhouse gas concentrations pose potential dangers that we need to take very seriously and research carefully, and we need to be prepared to take action as necessary. We do, for example, research, take seriously, and [prepare for the possibility](#) of a comet or asteroid someday colliding with the Earth. We monitor the skies, and we formulate, test, and refine possible means to deflect it – such as setting off nuclear explosions in its vicinity in space. Equally – though it is a much more difficult and complex task – we need to research, take seriously, and prepare action against the potential danger of climate change. Grantham is appropriately appalled at the obliviousness of many people in business to the threat.

Is short-term thinking the problem with capitalism?

It is a separate question, however, to ask if capitalism necessarily causes the kind of short-term thinking problem that Grantham blames for our inattentiveness to environmental change – and I don't believe it does.

What does cause the problem is something else that Grantham identified in his [February quarterly letter](#): “In the last 20 years, corporate ownership began to look odd. The nominal owners [had]... little or no interest in corporate affairs, with the result that corporate officers appeared to own the companies and behaved accordingly.” Corporate officers are playing with other peoples' money. They have an incentive to maximize not the company's long-term value but their own short-term material gain. In other words, it's an agency problem, not the result of myopic capitalism run amok.

Long-term capitalist investors like Grantham, Warren Buffett, and many others do think long term. I do believe there is a problem – let us hope, temporary – with capitalism, but it is not that its discount rate on future welfare is too high. It is that certain individuals within the capitalist structure currently have big incentives to ignore the future, and – for now – they are at the controls.

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