

The Longest Quarterly Letter Ever

Investment Advice from Your Uncle Polonius Your Grandchildren Have No Value (And Other Deficiencies of Capitalism) Market Review



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Part I: Investment Advice from Your Uncle Polonius¹

For individual investors setting out on dangerous investment voyages.

1. Believe in history. In investing Santayana is right: history repeats and repeats, and forget it at your peril. All bubbles break, all investment frenzies pass away. You absolutely must ignore the vested interests of the industry and the inevitable cheerleaders who will assure you that this time it's a new high plateau or a permanently higher level of productivity, even if that view comes from the Federal Reserve itself. No. Make that, especially if it comes from there. The market is gloriously inefficient and wanders far from fair price but eventually, after breaking your heart and your patience (and, for professionals, those of their clients too), it will go back to fair value. Your task is to survive until that happens. Here's how.
2. "Neither a lender nor a borrower be." If you borrow to invest, it will interfere with your survivability. Unleveraged portfolios cannot be stopped out, leveraged portfolios can. Leverage reduces the investor's critical asset: patience. (To digress, excessive borrowing has turned out to be an even bigger curse than Polonius could have known. It encourages financial aggressiveness, recklessness, and greed. It increases your returns over and over until, suddenly, it ruins you. For individuals, it allows you to have today what you really can't afford until tomorrow. It has proven to be so seductive that individuals en masse have shown themselves incapable of resisting it, as if it were a drug. Governments also, from the Middle Ages onwards and especially now, it seems, have proven themselves equally incapable of resistance. Any sane society must recognize the lure of debt and pass laws accordingly. Interest payments must absolutely not be tax deductible or preferred in any way. Governments must apparently be treated like Polonius's children and given limits. By law, cumulative government debt should be given a sensible limit of, say, 50% of GDP, with current transgressions given 10 or 20 years to be corrected.) But, back to investing ...
3. Don't put all of your treasure in one boat. This is about as obvious as any investment advice could be. It was learned by merchants literally thousands of years ago. Several different investments, the more the merrier, will give your portfolio resilience, the ability to withstand shocks. Clearly, the more investments you have and the more different they are, the more likely you are to survive those critical periods when your big bets move against you.
4. Be patient and focus on the long term. Wait for the good cards. If you've waited and waited some more until finally a very cheap market appears, this will be your margin of safety. Now all you have to do is withstand the pain as the very good investment becomes exceptional. Individual stocks usually recover, entire markets always do. If you've followed the previous rules, you will outlast the bad news.

¹ Polonius, a character in Hamlet, a verbose, self-important advisor to the King, was clearly intended to be a real loser, but curiously in the end Shakespeare couldn't resist making most of his ponderous advice actually useful and memorable. His famous speech to his son Laertes who is embarking on a dangerous sea voyage to France (from Denmark) is reproduced as an Appendix. (Hamlet makes genocidal if rather unintentional war on the Polonius family, accounting for Laertes, his sister Ophelia, and poor Polonius himself: a clean sweep.)

5. Recognize your advantages over the professionals. By far the biggest problem for professionals in investing is dealing with career and business risk: protecting your own job as an agent. The second curse of professional investing is over-management caused by the need to be seen to be busy, to be earning your keep. The individual is far better-positioned to wait patiently for the right pitch while paying no regard to what others are doing, which is almost impossible for professionals.
6. Try to contain natural optimism. Optimism has probably been a positive survival characteristic. Our species is optimistic, and successful people are probably more optimistic than average. Some societies are also more optimistic than others: the U.S. and Australia are my two picks. I'm sure (but I'm glad I don't have to prove it) that it has a lot to do with their economic success. The U.S. in particular encourages risk-taking: failed entrepreneurs are valued, not shunned. While 800 internet start-ups in the U.S. rather than Germany's more modest 80 are likely to lose a lot more money, a few of those 800 turn out to be today's Amazons and Facebooks. You don't have to be better; the laws of averages will look after it for you. But optimism comes with a downside, especially for investors: optimists don't like to hear bad news. Tell a European you think there's a housing bubble and you'll have a reasonable discussion. Tell an Australian and you'll have World War III. Been there, done that! And in a real stock bubble like that of 2000, bearish news in the U.S. will be greeted like news of the bubonic plague; bearish professionals will be fired just to avoid the dissonance of hearing the bear case, and this is an example where the better the case is made, the more unpleasantness it will elicit. Here again it is easier for an individual to stay cool than it is for a professional who is surrounded by hot news all day long (and sometimes irate clients too). Not easy, but easier.
7. But on rare occasions, try hard to be brave. You can make bigger bets than professionals can when extreme opportunities present themselves because, for them, the biggest risk that comes from temporary setbacks – extreme loss of clients and business – does not exist for you. So, if the numbers tell you it's a real outlier of a mispriced market, grit your teeth and go for it.
8. Resist the crowd: cherish numbers only. We can agree that in real life as opposed to theoretical life, this is the hardest advice to take: the enthusiasm of a crowd is hard to resist. Watching neighbors get rich at the end of a bubble while you sit it out patiently is pure torture. The best way to resist is to do your own simple measurements of value, or find a reliable source (and check their calculations from time to time). Then hero-worship the numbers and try to ignore everything else. Ignore especially short-term news: the ebb and flow of economic and political news is irrelevant. Stock values are based on their entire future value of dividends and earnings going out many decades into the future. Shorter-term economic dips have no appreciable long-term effect on individual companies, let alone the broad asset classes that you should concentrate on. Leave those complexities to the professionals, who will on average lose money trying to decipher them.

Remember too that for those great opportunities to avoid pain or make money – the only investment opportunities that really matter – the numbers are almost shockingly obvious: compared to a long-term average of 15 times earnings, the 1929 market peaked at 21 times, but the 2000 S&P 500 tech bubble peaked at 35 times! Conversely, the low in 1982 was under 8 times. This is not about complicated math!

9. In the end it's quite simple. Really. Let me give you some encouraging data. GMO predicts asset class returns in a simple and apparently robust way: we assume profit margins and price earnings ratios will move back to long-term average in 7 years from whatever level they are today. We have done this since 1994 and have completed 40 quarterly forecasts. (We started with 10-year forecasts and moved to 7 years more recently.) Well, we have won all 40 in that every one of them has been usefully above random and some have been, well, surprisingly accurate. These estimates are not about nuances or PhDs. They are about ignoring the crowd, working out simple ratios, and being patient. (But, if you are a professional, they would also be about colossal business risk.) For now, look at the latest of our 10-year forecasts that ended last December 31 (Exhibit 1). And take heart. These forecasts were done with a robust but simple methodology. The problem is that though they may be simple to produce, they are hard for professionals to implement. Some of you individual investors, however, may find it much easier.

Exhibit 1

10-year forecasts from December 31, 2001 vs. actual as of December 31, 2011*

Asset Class	Estimated Rank	GMO 10-Yr Forecast Dec-01 (% Real Return/Yr)	10-Yr Real Return* Dec-11	Actual Rank
Emerging Market Equities	1	9.4	11.4	1
U.S. REITs	2	9.1	6.8	3
Emerging Country Debt	3	6.8	8.3	2
International Small Cap	4	5.2	6.7	4
U.S. TIPS	5	3.5	5.0	6
Barclays Capital U.S. Gov't. Debt	6	2.9	3.1	8
Foreign Bonds	7	2.6	5.9	5
U.S. Small	8	2.2	4.0	7
EAFE	8 (tie)	2.2	2.6	9
U.S. T-Bills	10	2.1	-0.6	11
S&P 500	11	-1.0	0.4	10

Correlation of rank order: 94.5%

The accuracy of these forecasts does not guarantee that current or future predictions will be accurate either with respect to the ranking of those asset classes over a 10-year period, the absolute levels of real return, or results over shorter periods. The accuracy of forecasted rankings in the asset class forecasts generally varies from period to period.

* Average error ±1.1% Source: GMO As of 12/31/11

10. “This above all: to thine own self be true.” Most of us tennis players have benefited from playing against non-realists: those who play to some romanticized vision of that glorious September day 20 years earlier, when every backhand drive hit the corner and every drop shot worked, rather than to their currently sadly atrophied skills and diminished physical capabilities. And thank Heavens for them. But doing this in investing is brutally expensive. To be at all effective investing as an individual, it is utterly imperative that you know your limitations as well as your strengths and weaknesses. If you can be patient and ignore the crowd, you will likely win. But to imagine you can, and to then adopt a flawed approach that allows you to be seduced or intimidated by the crowd into jumping in late or getting out early is to guarantee a pure disaster. You must know your pain and patience thresholds accurately and not play over your head. If you cannot resist temptation, you absolutely **MUST NOT** manage your own money. There are no Investors Anonymous meetings to attend. There are, though, two perfectly reasonable alternatives: either hire a manager who has those skills – remembering that it’s even harder for professionals to stay aloof from the crowd – or pick a sensible, globally diversified index of stocks and bonds, put your money in, and try never to look at it again until you retire. Even then, look only to see how much money you can prudently take out. On the other hand, if you have patience, a decent pain threshold, an ability to withstand herd mentality, perhaps one credit of college level math, and a reputation for common sense, then go for it. In my opinion, you hold enough cards and will beat most professionals (which is sadly, but realistically, a relatively modest hurdle) and may even do very well indeed.

Good luck. Uncle Polonius

Part II: Your Grandchildren Have No Value (And Other Deficiencies of Capitalism)

The *Financial Times* has had a plethora of recent articles examining possible deficiencies in capitalism. The general opinion is that this is not capitalism's finest hour. The financial crash revealed a chronic weakness in establishment economic theory, whose trust in efficiency of capital markets encouraged deregulation and helped land us in our present trouble. Hyman Minsky's work that suggested that recurrent financial crises were "well-nigh inevitable" could not have been more completely forgotten. Only a handful of the hundreds of senior economists and bankers seemed to see what was coming.

Debt has also proven troublesome, with both governments and individuals allowing debt ratios to become unmanageable at great risk to the economy, while government policies and taxes in particular encouraged the slide rather than moved to control it.

In the last 20 years, corporate ownership began to look odd. The nominal owners – stockholders – typically traded every few months and took on the part of institutions, with little or no interest in corporate affairs, with the result that corporate officers appeared to own the companies and behaved accordingly. Stock option programs transferred ownership from shareholders to managers in giant dollops and were awarded on short-term results. One consequence of this was a distorted incentive that encouraged leverage and other forms of going for broke with other people's money. Boards of Directors demonstrated little timely intervention and typically only found their claws in situations of complete disaster, when it was too late. Total remuneration in the U.S. for senior officers, unopposed by typical boards, rose as a percentage of the average worker's pay from 40 times in Eisenhower's era to over 600 times today, with no indication of any general improvement in talent. Few rewards were carefully related to long-term results. Pretax income inequality rose in most countries and was offset by tax adjustments in very few. In the U.S., oddly, the tax changes accentuated the shift. Such an increase in inequality was caused by all of the benefits of the substantial productivity flowing to a few, while the average hour's pay stayed unprecedentedly unchanged for 40 years! This risks making economic progress both slower and bumpier as the stressed average worker reaches for debt and then, in a crisis, is forced to retrench.

This far from exhaustive list is still impressively long but it seems to me to be basically business as usual, and most of it worse in the U.S. than in other capitalist countries. Scandinavian countries, for example, seem to struggle with their set of problems reasonably satisfactorily. Presumably, economists will slowly digest the lessons of the last few years and will develop realistic and useful theories. We can at least hope. Trial and error, reform, and common sense seem reasonably likely to be a match for all of these problems eventually. They are irritating and debilitating problems today but they will not bring us to our knees. There are some problems, though, that have surfaced seldom or never in the *Financial Times* discussions that very well may. In my opinion, they threaten even our survival and it is these problems I would like to concentrate on.

Capitalism has gone through a Darwinistic series of trials and errors, which still continues. For the time being, capitalism has tuned itself to rapid growth at almost any cost. Circumstances such as the hydrocarbon revolution and the ensuing population explosion have allowed for both high growth and high profit margins to sustain the growth. Sustained high margins have in turn trained capitalists – or corporate executives if you prefer – to set high hurdles for all investments. The 14% hurdle for discount rates that was considered a minimum in the late 1990s, for example, halves the future value of a dollar every 5 years, so that in 10 years today's dollar is worth 25¢; in 20 years 6¢; and in 50 years one tenth of one cent! It is hardly surprising that any event out that far is ignored.

For example, let us say that a firm's current actions are going to cost society at large a billion dollars' worth of harm in 50 years. Further, let us agree that all of the costs will definitely be imposed on the company. The company would feel that pain today as equivalent to only a mere \$1 million hit to earnings. Why should they care?

In contrast, the income of typical individuals is likely to compound at most at 1.5% a year, their risk-free investments at an imputed zero % (today's 30-year bond minus inflation), and an equity investment at perhaps 4%, net of inflation and tax. To take the highest of these three rates, the billion dollar pain at a 4% discount rate is going to feel to the average citizen, who faces the bill in 50 years, not like \$1 million, but like \$100 million. And for some societal

purposes, 4% real is far too high. Surely, for example, shouldn't the value, and hence cost, of a child's life in 50 years be identical to the value and cost today? The reader can easily see how a corporation's outlook on potential future damage might be a painful mismatch with that of ordinary individuals and society at large. The consequences of this not only can be disastrous but probably will be. A few painstaking readers might remember my "Farmer and The Devil" story of last July. In it I showed how a good capitalist farmer had to sign a contract in which the Devil guaranteed a quadrupling of the farmer's income through very aggressive farming practices at the hidden cost of 1% a year of his soil. The farmer would enormously profit and eagerly re-up through the first several 20-year contracts only to end up with no soil, no food, and no people at about 100 years out. Yet each time the farmer re-upped, he did the sensible capitalist thing. In this case, Adam Smith's "invisible hand" failed, and fatally so.

Damage to the "commons," known as "externalities" has been discussed for decades, although the most threatening one – loss of our collective ability to feed ourselves, through erosion and fertilizer depletion – has received little or no attention. There have been no useful tricks proposed, however, for how we will collectively impose sensible, survivable, long-term policies over problems of the "commons." To leave it to capitalism to get us out of this fix by maximizing its short-term profits is dangerously naïve and misses the point: capitalism and corporations have absolutely no mechanism for dealing with these problems, and seen through a corporate discount rate lens, our grandchildren really do have no value.

To move from the problem of long time horizons to the short-term common good, it is quickly apparent that capitalism in general has no sense of ethics or conscience. Whatever the Supreme Court may think, it is not a person. Why would a company give up a penny for the common good if it is not required to by enforced regulation or unless it looked like that penny might be returned with profit in the future because having a good image might be good for business? Ethical CEOs can drag a company along for a while, but this is an undependable and temporary fix. Ethical humans can also impose their will on corporations singly or en masse by withholding purchases or bestowing them, and companies can anticipate this and even influence it through clever brand advertising, "clean coal" being my favorite. But that is quite different from corporate altruism. Thus, we can roast our planet and firms may offer marvelous and profitable energy-saving equipment, but it will be for profit today, not planet saving tomorrow.

It gets worse, for what capitalism has always had is money with which to try to buy influence. Today's version of U.S. capitalism has died and gone to heaven on this issue. A company is now free to spend money to influence political outcomes and need tell no one, least of all its own shareholders, the technical owners. So, rich industries can exert so much political influence that they now have a dangerous degree of influence over Congress. And the issues they most influence are precisely the ones that matter most, the ones that are most important to society's long-term well-being, indeed its very existence. Thus, taking huge benefits from Nature and damaging it in return is completely free and all attempts at government control are fought with costly lobbying and advertising. And one of the first victims in this campaign has been the truth. If scientific evidence suggests costs and limits be imposed on industry to protect the long-term environment, then science will be opposed by clever disinformation. It's now getting to be an old and obvious story, but because their propaganda is good and despite the solidness of the data, half of the people believe the problem is a government run wild, mad to control everything. So the "industrial complex" (or parts of it) fights to increase the inherent weaknesses of capitalism. They deliberately make it ever harder to reach the very long-term decisions that will serve us all. The influence of the Tobacco companies in deliberately obscuring the science to protect profits at a huge cost to society in health costs and lives is a perfect analogy to the energy industries that work hard to confuse the public on scientific measures of damage to health and the environment. Yet it is one that is surprisingly forgotten.

Of all the technical weaknesses in capitalism, though, probably the most immediately dangerous is its absolute inability to process the finiteness of resources and the mathematical impossibility of maintaining rapid growth in physical output. You can have steady increases in the quality of goods and services and, I hope, the quality of life, but you can't have sustainable growth in physical output. You can have "growth" – for now – or you can have "sustainable" forever, but not both. This is a message brought to you by the laws of compound interest and the laws of nature. However, you can try to have both. But many, when given the choice, select "Growth, and to hell with

the consequences.” Alternatively they adopt a hear-no-evil approach to life and listen exclusively to good news. The good news for such people is that there are always a few experts lacking in long-horizon vision, simple common sense, or whose co-operation has been rented, like “expert” witnesses at a murder trial, who can be dragged out to reliably say that everything will always work out fine. (One famous professor went seamlessly from saying tobacco smoking was just fine to saying continuously pumping out greenhouse gases would also be without consequences). The optimists offer as evidence that we will always be in the best of all possible worlds, not our species’ tough million or so years of trial and painful error, but only the last 200 years, when hydrocarbon and other resources have given us a temporary reprieve. This reprieve does not make the finite magically infinite, but the 250 years of the hydrocarbon intermission can feel like forever. Capitalism certainly acts as if it believes that rapid growth in physical wealth can go on forever. It appears to be hooked on high growth and avoids any suggestion that it might be slowed down by limits. Thus, it exhibits horror at the thought (and occasional reality) of declining population when in fact such a decline is an absolute necessity in order for us to end up gracefully, rather than painfully, at a fully sustainable world economy. Similarly with natural resources, capitalism wants to eat into these precious, limited resources at an accelerating rate with the subtext that everyone on the planet has the right to live like the wasteful polluting developed countries do today. You don’t have to be a PhD mathematician to work out that if the average Chinese and Indian were to catch up with (the theoretically moving target of) the average American, then our planet’s goose is cooked, along with most other things. Indeed, scientists calculate that if they caught up, we would need at least three planets to be fully sustainable. But few listen to scientists these days. So, do you know how many economic theories treat resources as if they are finite? Well, the researchers at the O.E.C.D say “none” – that no such theory exists. Economic theory either ignores this little problem or assumes you reach out and take the needed resources given the normal workings of supply and demand and you can do it indefinitely. This is a lack of common sense on a par with “rational expectations,” that elegant theory that encouraged the ludicrous faith in deregulation and the wisdom of free markets, which brought us our recent financial fiascos. But this failure in economic theory – ignoring natural limits – risks far more dangerous outcomes than temporary financial crashes.

Let me pose a simple question. If there were an extra thousand years of oil supply – of onshore traditional oil – available at, say, a production cost of \$200 a barrel in addition to the actual 40 years of mixed-cost reserves that we have today, what difference would it make in today’s price? Remarkably, the answer is “none.” Today’s price is concerned only with the intermediate-term workings of current costs of current barrels and current demand. Yet every rational reader knows that this should not be the case: that the existence of huge reserves (or the lack thereof) should indeed influence today’s price in a world concerned about its very long-term well-being. In addition to ignoring the depleting supplies of high quality materials, no concern at all is shown for our current devastatingly erosive and resource-intensive global farming practices.

As described above, the current U.S. capitalist system appears to contain some potentially fatal flaws. Therefore, we should ask what it would take for our system to evolve in time to save our bacon. Clearly, a better balance with regulations would be a help. This requires reasonably enlightened regulations, which are unlikely to be produced until big money’s influence in Congress, and particularly in elections, decreases. This would necessitate legal changes all the way up to the Supreme Court. It’s a long haul, but a handful of other democratic countries in northern Europe have been successful, and with the stakes so high we have little alternative but to change our ways.

It would certainly help if the general public were better educated, especially in science. The same applies, unfortunately, to Congress itself. This body is desperately short of scientists and basic familiarity with things scientific. Our key problems need to be addressed by people very familiar and comfortable with science. It is said that eight of the nine senior leaders in China’s government are scientists. At that high a level, of our 535 Congressmen and the President and Vice President, less than a handful – arguably only two or three – would pass the test. (I suppose you could throw in the Supreme Court Justices if you wanted to.) It is said, on the other hand, that about 100 Congressmen do not believe in evolution. Without a respect for science in Congress and with science in the general public declining as an interest, some of the painful new issues are going to be hard to address. (The percentage of students graduating with degrees in science as a proportion of total U.S. graduates is the 60th highest by country these days!) This lack of scientific familiarity is made worse by the fact that everyone loves to hear good news, Americans more than most.

The tough news we must sooner or later grasp is made tougher by the skilled, energetic denials, well-funded by powerful industries that fear their profits would be threatened. Libertarians seem to feel that even if the bad news were true, the necessary regulations would be so distasteful that they would really prefer that the science were different, and they deem it so, putting desired political theory over science.

Meanwhile, China gets on with it and science is accepted in what used to be our normal way until the last decade or two. And I suppose they have some unfair advantages, among them leaders with scientific backgrounds and higher science scores for the general public, but they also have the luxury of a leadership that does not face election campaigns. Lucky them. The critical consequences are that they waste no time in challenging climate problems (the same is true of India) and, even more importantly perhaps, they begin to really worry, almost panic, about their long-term access to crucial resources. In contrast to our political log jam and failure to face long-term issues, they have moved rapidly to exploit new sustainable energy sources, to tie down resource deals, and to promote improved resource efficiency.

The U.S. and Canada are blessed with natural advantages that are unrivalled (at least if you include security, which, in a desperate, resource-constrained, warming world might hurt New Zealand, that otherwise would look hard to beat). Yet the relatively uncontrolled variety of capitalism that exists in the U.S. today may negate many of our advantages. Solutions to these issues – far more important than any others – need a delicate mix of capitalism and wise, democratically-controlled government regulation. That might sound like an oxymoron to far too many people. If we can't make it sound, plausible, and acceptable in the next few decades, then we are in deep trouble for the world really, really needs U.S. leadership on these critical issues.

Karl Marx went on and on about the tendency of capitalism to so fixate on growth that in time it would forget the need to put on a friendly face for society and would drive home too clearly and brutally its advantage over labor. Ironically, in some way he and Engels looked forward to globalization and the supranational company because they argued it would make capitalism even more powerful, over reaching, and eventually reckless. It would, they claimed, offer the capitalists more rope to hang themselves with or, rather, to be hung with, in the workers' revolution. The rope for the job, they suggested with black humor, would be bought from briskly competing capitalists, eager till the end for a good deal. Well, time marches on and it's going to be hard to have a workers' revolution with no workers. Organizing robotic machine tools will not be easy. However, Marx and Engels certainly got the part right about globalization and the supranational company increasing the power of capital at the expense of labor. To interfere with Marx's apocalyptic vision, we need some enlightened governmental moderation of the new globalized Juggernaut (even slightly enlightened would be encouraging) before capitalism gets so cocky that we have some serious social reaction.

But for me capitalism's complete fixation on growth at all cost that Marx concentrated on is not as important as the other issues discussed here. Capitalism, by ignoring the finite nature of resources and by neglecting the long-term well-being of the planet and its potentially crucial biodiversity, threatens our existence. Fifty and one-hundred-year horizons are important despite the "tyranny of the discount rate," and grandchildren do have value. My conclusion is that capitalism does admittedly do a thousand things better than other systems: it only currently fails in two or three. Unfortunately for us all, even a single one of these failings may bring capitalism down and us with it.

Part III: Investment Observations for the New Year

Looking Backwards and Forwards (2011 and 2012)

After a year of Sturm und Drang – powerful responses to important problems and a non-stop sense of urgency – most markets did not cover that much ground. Currencies bounded around viciously but ended strangely close to where they started. Even the euro was down only 3.5% for the year. The U.S. market was the perfect example, bouncing around but going nowhere. One day all stocks were up and the next they were all down as if the Camp Director was calling on the bullhorn “Everyone in!” “Everyone out!” “Risk on!” “Risk off!” All that excitement and no net change! Boringly, even our current investment advice is pretty much what it was last year.

It is always exciting for an asset allocator to work in a world where all assets are badly mispriced. Regrettably, this is not now the case at all. The majority of global equities are within spitting distance (a technical term) of fair value. Only the S&P 500 is materially overpriced, with an imputed return on our 7-year forecast of about 1% real, and because the high quality quarter of the S&P is priced to deliver 5.5% real (about a fair return), the 75% balance of the S&P has a slightly negative return. The rest of the world’s equities were (when I sat down to write this in January) on average slightly cheap at close to 7% real, so that non U.S. equities plus U.S. quality stocks offered a slightly higher average return than normal (a normal mix is about 6.1% real). (Today, after a dazzling rally, the forecast for the same global equity mix has dropped by 1.1%, to very slightly expensive.) This is not exactly whoopee time, but compared to the typical overpricing of the last 20 years, it’s not bad at all.

The interesting overpricing that exists in global markets is in debt markets – those that are seen to be lower risk than the rest (e.g., most developed market government bonds ex the usual suspects: Greece, Portugal, Spain, and Italy). In some markets like the U.S. and the U.K., the long bonds can be so murdered by inflation that holders should end up concerned about return of capital and forget about being paid for the risk. On the plus side, if economies collapse, the bonds with some duration may protect your money in the short term. This is a trade-off between possible short-term safety against probable long-term risk and negative return.

So in asset allocation there is one great opportunity – avoiding duration in fixed income – and one pretty good opportunity – down weighting most of the U.S. market. Not such a bad opportunity set, really.

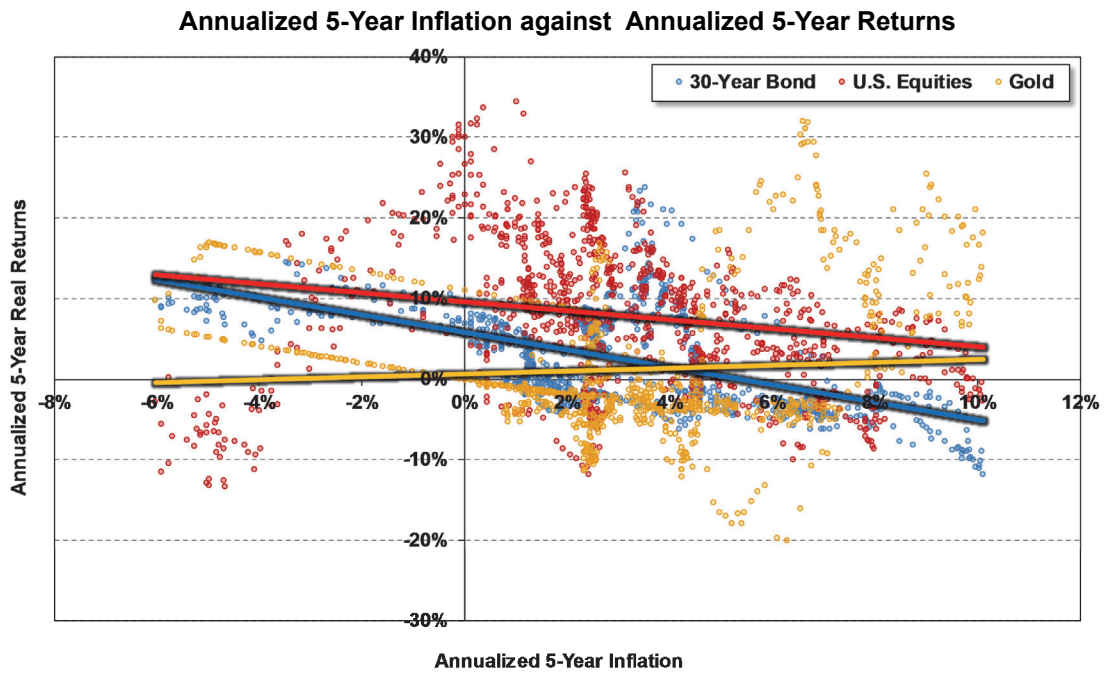
Inflation Hedges

The 800-pound gorilla (the one that prefers bond holders to bamboo) is not in the room yet, but you can hear him thumping his chest up in the hills. He will come eventually, and before he does, you should remember that stocks are underrated inflation hedges. The underlying corporations have real assets, employ real people, and sometime even make real things, although a good idea embedded in a small thing (like an iPad) or a service is just as good. Equities have been tested over and over again in different places and in different decades and they have always been found to be very effective hedges. Serious resources – oil and copper in the ground and forestry and farmland – will almost certainly also be good and very probably much better than broad stocks in the short run. Gold may be good too. Who knows? But for stocks to work dependably as inflation hedges one has to have a several-year time horizon: in the short term, rising inflation can hurt stocks badly, for as mentioned last quarter, inflation is usually a powerful negative behavioral input. Investors hate jumps in inflation because they sharply raise the levels of uncertainty. Fairly quickly, though, earnings always catch up, and after multi-year surges in inflation (as in Brazil in the ’80s) we end up with the total market value in its normal range as a percentage of GDP while regular bonds if they exist, get destroyed.

Exhibit 2 shows the co-incident 5-year relationship between the return for stocks, bonds, and gold, respectively, against the CPI since 1919 in the U.S. As inflation picks up, the real price of gold goes up, the real price of bonds declines a lot, and equities decline also, but significantly less. Exhibit 3 looks at exactly the same inflation data but adds the next 5 years of real returns for the three assets. Now, over 10 years, there is only a very slight relationship between either gold or equities with the original 5 years of change in the CPI. In the case of bonds however, there is still a strong tendency for bonds to continue to lose ground. The conclusion from that time period is that surges in inflation have been a very slight issue for holders of equities (and gold) on a 10-year basis, but a very serious one for

Exhibit 2

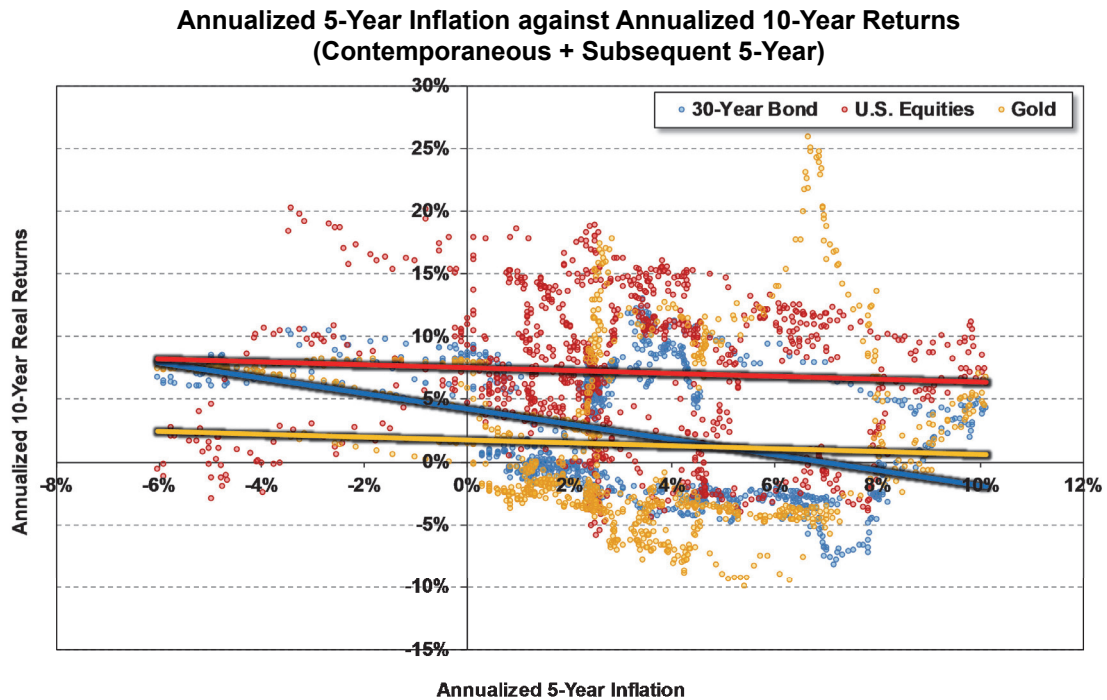
Inflation against Real Stock, Bond, and Gold Returns



Source: Global Financial Data, GMO As of 1/31/12

Exhibit 3

Inflation against Real Stock, Bond, and Gold Returns



Source: Global Financial Data, GMO As of 1/31/12

bond holders. We must also remember that previous inflationary periods in the U.S have mostly followed a pattern of rising several years to a single peak and then falling. The next one may be different. It may move up and then fall back several times, creating more of a range of hills than a single Himalayan peak like 1981. In such a bumpy ride, stocks are likely to adjust more quickly each time while long bonds will see their values steadily eroded.

The short-term correlations between stocks and inflation in the past have been quite high, but short-term correlations are for traders, not investors. I'd advise not getting too carried away with them. In general, I also much prefer to have stocks and other real assets in a longer-term approach than to have complicated hedges and options. Murphy's Law of complexity is powerful: things will go badly if they can and when you least need them to, but complex things will go bad first, and worst given half a chance, as we saw in the mortgage market a few years ago. Keep it simple when you can. And owning stocks is very simple indeed.

Resources

We now have a capability to invest in "stuff in the ground." As I argued last April, resources had gone up a lot and in a hurry. Every paradigm shift must, almost by definition, attract momentum players and a speculative component, and this was no exception. Production has responded to the higher prices very quickly for agricultural output and more slowly for infrastructure-related coal and mining. Farmers in particular, I wrote, were planting acres that had never seen corn or grain in order to capitalize on the opportunity. Given less bad weather I argued, prices could fall a lot. Since last spring, there has been some terrible weather in Thailand (the world's largest exporter of rice), in the Southern U.S., and in parts of Argentina. But, on average, the weather has indeed been less bad than the previous year and world grain output is likely to be up quite a lot. As a consequence, prices, which had weakened an average 25% plus since the early summer peak (before the recent rally), will likely come down some more. I am, though, more convinced than ever that the biggest of several substantial problems we face is that of feeding the 9 or 10 billion people that are likely to exist one day, with finite land, finite soil, and, perhaps above all, finite mined fertilizer. And, not to forget, the very, very finite long-term vision on the part of most governments and capitalism itself. GMO has long had a significant presence in timber investing and, I think it's fair to say, has built a successful forestry investing group. Recently, we have spent some considerable time expanding their capability in order to deal with global farmland. While some farmland in the U.S. has appreciated rapidly and perhaps by too much, farmland is an extremely varied and complicated market both in the U.S. and globally, and one that is inefficiently priced. With care and experience, reasonable investments can be made, although a sell-off would of course make for even more attractive opportunities. I am happy that GMO is developing a growing (ouch!) competence in this area.

At the opposite end of the resource spectrum to record-priced Iowa farmland is natural gas. Natural gas is, for most purposes like home heating and electric utility plants, a better and cleaner fuel than oil or coal, but is for technical reasons in distress: there have been several recent decades in which the BTU equivalent price for natural gas did, at least for a second, reach parity with oil. But now it is at just 14% of BTU equivalency, the lowest in almost 50 years. Everyone who has a brain should be thinking of how to make money on this in the longer term. Exhibit 4 shows the ratio.

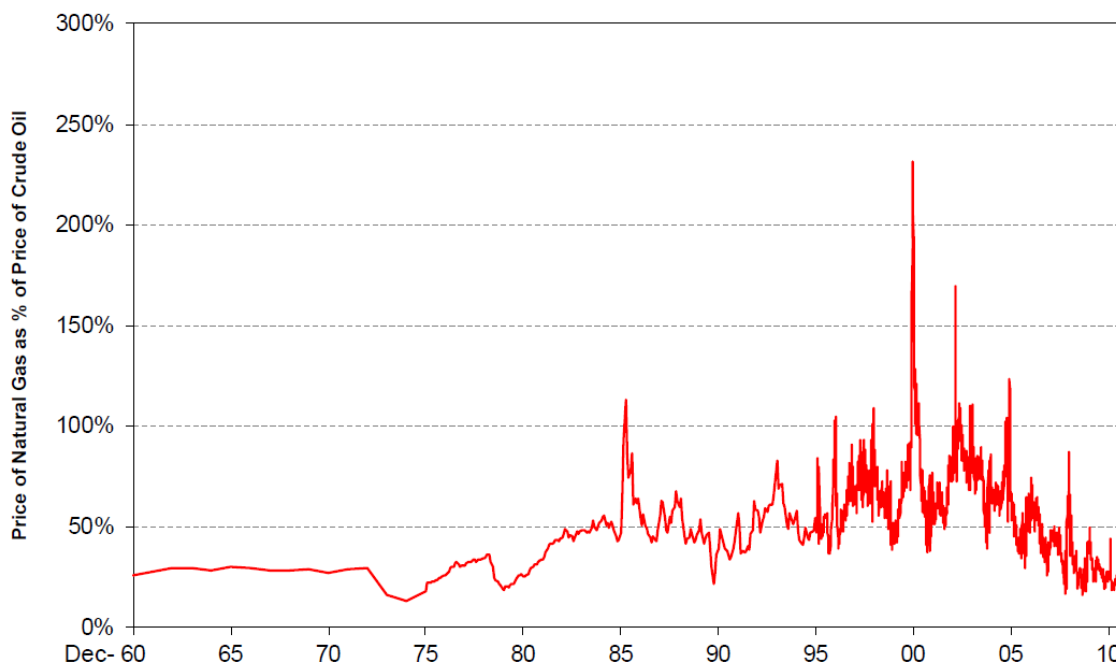
Metals producers were down almost a third from their high until the recent rapid rally. They are now (February 9) down about 20% to 25%. Some may still be vulnerable. Gold producers, though, look cheaper than the metal itself after badly underperforming the metal last year, reaching one of their weaker ratios for a while. Still, my old recommendation from April holds: these are all great long-term investments that are dangerous short term. There are two investment approaches that work. My choice is to average in. (It is what I personally have been doing.) An alternative is to know the markets short term better than the market does, which is tough; although probably a few experts can do it. The third approach, which I definitely don't recommend, is to just follow the herd up and down (although of course some small numbers do this well, too).

European Complexity

A philosophical note. Each investment group at GMO has its different strengths. In Asset Allocation, ours is in the study and understanding of asset class bubbles. That made it so much easier for us to spot the coming problems in 2000 and 2008. The 2000 problem originated from the forming and breaking of the U.S. tech and growth stock bubble.

Exhibit 4

Natural Gas / Crude Oil Energy Equivalent Price Ratio



Source: Global Financial Data, GMO As of 2/8/12

The 2008 problems were precipitated by a deflating U.S. housing bubble. In contrast, the European debt problem has no asset bubble at its heart (although housing busts have added to problems in Ireland and Spain). This problem seems to stem from original design flaws in the euro currency and the lack of necessary regulations to guarantee helpful behavior by individual countries. It has also gathered steam due to broad and persistent incompetence and delay on the part of political leaders, although given the political complexities I am a little sympathetic.

This type of sovereign debt-regulation-political-monetary mess is absolutely not our forte. When I read the 120 contradictory bits of advice in the Financial Times alone, I find myself asking the question: who is an expert? To the extent that anyone has profitably specialized in this type of problem, I suppose it is George Soros. There are also, in my opinion, one or two investment management groups that seem to talk sense (which groups will go nameless for weaselly competitive reasons). This is the problem: these probable experts are much more worried than the general market. This fact is giving rise to a new, tentative but definitely uncomfortable theory: perhaps the default assumption when dealing with ignorance or lack of confidence and skill is to assume everything will muddle through okay. Certainly we were amazed by this attitude generally displayed by the world (and most competitors) in the build-up to the 2000 and 2008 bubbles. Now we at GMO are calmly sitting around playing equities by the numbers, which are not too bad, and the market in general seems quite relaxed, while those few who look like experts on this crisis are pulling out their hair in fright. As I said, this is just a theory. But it is scary.

GMO Performance in 2011 Was Quite Good

In Asset Allocation, being overweight in emerging hurt us, as did lack of duration and underweighting the U.S. But a massive overweight in global quality stocks, 80% of which are in the U.S., was huge. They outperformed the U.S. market by about 10% (and the non-quality component by almost 14%), for in the end it was indeed a risk-off year. During the year, it was steadily three steps forward, two and a half steps back for these quality stocks relative to the rest. We also got a lot of little things right so in the end, despite a cluster of things where we could have been smarter or luckier, we did decently enough. In asset allocation (dragged along mostly, I admit, by quality) most of our allocation

strategies won against their benchmarks, with our flagship Global Balanced Asset Allocation Strategy adding 3.9% relative, net of fees. Far more of our equity strategies outperformed their benchmarks than underperformed. As usual, we tend to do better in tougher years, which is the way we like it. This was especially noticeable in the sharp summer decline. It was in all an interesting year. I look forward to this one.

Summary of Recommendations (with apologies for the lack of changes)

- Heavily underweight U.S. equities, but not the high quality quartile, which is almost fair price. Non-quality equities, in contrast, have a negative imputed 7-year return after their handsome rally in the last 3 months through to mid-February.
- Slightly overweight other global equities, which are almost fair price, down from a little cheap at year end.
- In total, be about neutral in global equities. Yes, there is more than our normal fair share of potential negatives lurking around, but on our data: a) most of the negatives are reflected in stock prices; and b) all fixed income duration is dangerously overpriced. This last situation is, of course, engineered by the Fed, which hopes to drive us all into taking more risk, notably by buying more equities. I hate to oblige, but at current equity prices it just makes sense to do what they want. As mentioned earlier, equities are also good long-term hedges against inflation.
- Underweight as much as you dare long-term bonds, especially higher-grade sovereign bonds.
- In the long term, resources in the ground, forestry, and agricultural land are attractive, but come with the usual caveats of the risk of short-term over pricing, so average in.

“When You’ve Got it, Flaunt it.” GMO’s 10-year Forecast to December 31, 2011

The GMO 10-year forecast ending on December 31 last year is shown on page 3. As Zero Mostel says in “The Producers” as he looks down at a yellow Rolls Royce outside his window, “That’s the way baby. When you’ve got it, flaunt it!” As you can see, the rank correlation number for the last 10-year forecast was, well, ridiculously high. Now if we could only get the T-Bill right. Ten years ago, minus 2% real for 10 years would have seemed crazy. But the Greenspan-Bernanke team had this plot to ruin our forecasts. Unfortunately, the negative 2% – which stirred up the first U.S. housing bubble in history – ruined a few other things along the way.

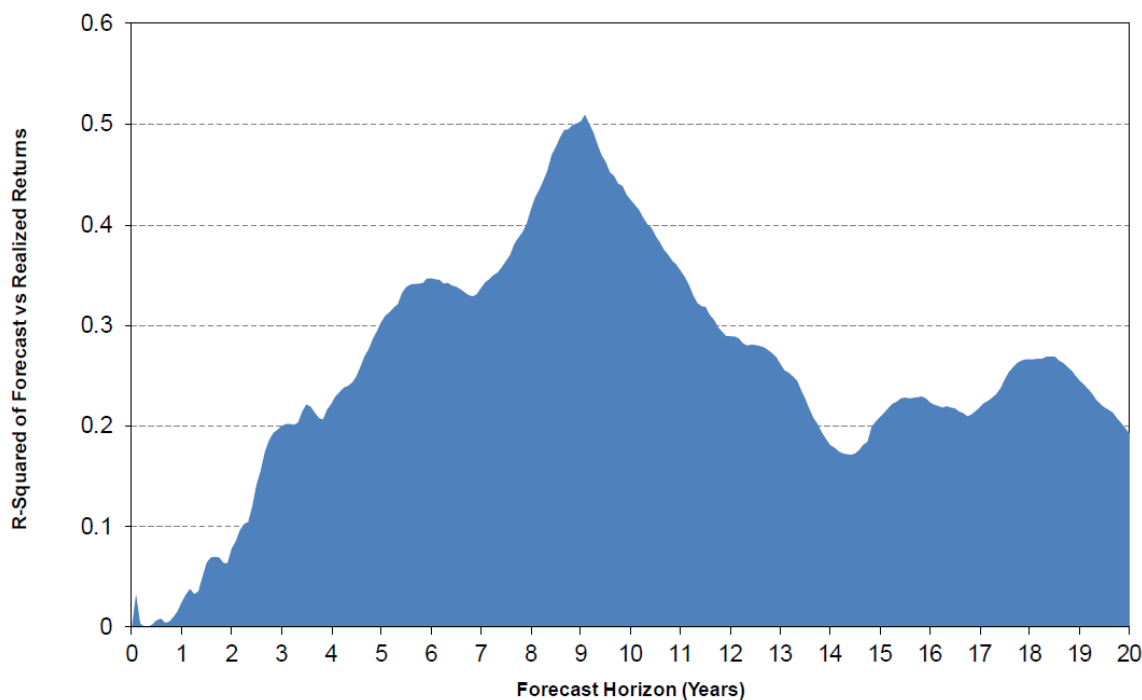
We had by far the lowest estimates back then for the S&P 500, perhaps no surprise. But we also had the highest estimate for emerging market equities. The forecast gap between these two was 10.4% a year, which would turn \$100 in the S&P into \$270 in Emerging. The actual result was \$280! These two asset classes had short-term correlation that started out high, at .5, and rose to the even higher level of .6. This correlation did not, however, prevent a huge gap in performance. This is an indicator of the limited usefulness of short-term correlations. Yet, all we were saying was that the abnormally high P/E on the S&P (about 30 times) would decline to a normal 15 times, and the depressed emerging markets at 13 times would rise.

Our recent 10-year forecast is also ammunition to use against the “notorious bear” label that a journalist gave me recently. Dude, give me a break! The U.S. market was terrible for the last 10 years, gaining a pathetic 0.5% per year overall, after inflation adjustments and even including dividends. Without dividends, the index itself has not gone up a penny in real terms from mid-1997 to end-2011, or 14½ years. This is getting to be a long time! Are we expected to be bullish out of patriotism? You might think so given the flood of optimistic views for the last 10 years (or is it 100?). The industry so much prefers bullishness. It is much, much better for business. So, in general, does the press, and I do sympathize – optimism really does make for more compelling reading. I’ll tell you what. Try taking it out on the army of well-known bulls who blew the trumpets in 1999 and 2007 and waved everyone into the rather bloody breach. (Did you know that trumpeters were killed out of hand in the Middle Ages because of their pernicious role? How about that for a precedent when we get to the next burst bubble?) Also, we were, as you can see, very bullish indeed on emerging market equities and have been for 15 years, occasionally quite painfully. This optimism on emerging, though, has generally carried little weight in counter balancing our firm’s reputation (mine in particular) as bears because emerging equities are considered to be a very minor affair relative to the main event – the U.S. equity market – at least in this country.

By the way, I used our original 10-year forecast rather than our 7-year forecast for a very complicated mathematical reason: it did better. (Although the 7-year forecast had a perfectly respectable rank correlation of .42.) In fact, 10-year forecasts, on a reasonably long test seem to work a little better than 7 years. This is partly because longer time periods give mean reversion longer to work. By way of illustrating this point, our 1-year results tend to look like a random number generator, and our 1-day would, of course, look the same. Value is a very mild but very determined influence. It gets you there in the end but can break you and your clients' hearts along the way. Exhibit 5 shows some new research we have done that suggests that 9 years would, data mined, have been the best in the last few decades, at least for one (obviously very important) asset class, the S&P 500.

Exhibit 5

S&P 500 Forecast Accuracy by Time Horizon



Source: GMO As of 1/31/12

P.S. Defending Last Quarter's Letter

Due to the shortage of time, I clutched at material from our conference in November and managed, by breaking up the thesis into bullet points, to confuse my point and many readers: some thought I was a crazy bear, some bullish, and some in between. Ironically, the point in a nutshell was precisely that: stock market opinions must be read with a careful understanding of the time period being used. Apparently contradictory opinions are often wholly or partially the result of using different times periods. As an extreme example I gave three very different views of the market, all of which I find useful, that draw their differences from their time horizons. Here are the three:

- 1) Financial historians interested in the very long term would notice that all of the great bull markets before Greenspan ended by going below their trend line for several years. In the Greenspan-Bernanke era, declines were aggressively curtailed as policy. We should all be aware that the possibility exists of an old fashioned bear market overcorrection. Few have experienced a 1970's type bear market and therefore it would be found particularly difficult to deal with. The usual expectations of long rallies would be serially disappointed.
- 2) In the very short term, the Inker-Grantham "comfort" model for explaining P/E points out that the "normal" response (over response would be better) both to current high profit margins and to current low inflation would call for a substantially higher market than existed three months ago (the gap has been half closed in the intervening

months). To me this suggests that just like last year, the U.S. market will fight bad news and try to go up and that it is unlikely to go down much until either the current, extremely high profit margins decline or some very big wheels fall off: Europe, China, or the U.S. That is to say, in the near term, periodic moderate bad news of any kind, except about profit margins and inflation, is unlikely to keep the market down.

- 3) In the intermediate term – seven years – the GMO forecast suggests that global equity prices on December 31 were, boringly, about normal, if you avoid lower quality companies in the U.S. (today they are modestly overpriced). Our GMO forecasts do not allow for overruns (point 1) or behavioral inputs (point 2) but have had a good record. So, you see, we had something for everyone: bullish, bearish, or fair value. You just had to pick your time frame.

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 performance information for the Global Balanced Asset Allocation Strategy is supplemental to the GIPS compliant presentation that was made available on GMO's website in April of 2011.

Disclaimer: The views expressed are the views of Jeremy Grantham through the period ending February 24, 2012, and are subject to change at any time based on market and other conditions. This is not an offer or solicitation for the purchase or sale of any security and should not be construed as such. References to specific securities and issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities.

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Appendix

Hamlet, Act 1, Scene III

Polonius: Yet here, Laertes? Aboard, aboard, for shame!

The wind sits in the shoulder of your sail,
And you are stay'd for. There, my blessing with thee.
And these few precepts in thy memory
See thou character. Give thy thoughts no tongue,
Nor any unproportion'd thought his act.
Be thou familiar, but by no means vulgar.
Those friends thou hast, and their adoption tried,
Grapple them to thy soul with hoops of steel;
But do not dull thy palm with entertainment
Of each new-hatch'd, unfledged comrade. Beware
Of entrance to a quarrel; but being in,
Bear't that the opposed may beware of thee.
Give every man thy ear, but few thy voice;
Take each man's censure, but reserve thy judgment.
Costly thy habit as thy purse can buy,
But not express'd in fancy; rich, not gaudy;
For the apparel oft proclaims the man,
And they in France of the best rank and station
Are of a most select and generous, chief in that.
Neither a borrower nor a lender be;
For loan oft loses both itself and friend,
And borrowing dulls the edge of husbandry.
This above all: to thine own self be true,
And it must follow, as the night the day,
Thou canst not then be false to any man.
Farewell. My blessing season this in thee!