February 1, 2010

Almost Nostradamus Revisited

A year ago we published and article entitled “Almost Nostradamus”, sighting Jeremy Grantham’s, Chief Investment Officer of the GMO funds precient ability to predict the future returns of the different asset classes and the sub-components that comprise them. As a reminder, we quoted a study that concluded there was only a 1 in 500,000 chance of him guessing and being as acurate as he had proven to be.

Historical Valuations

Jeremy’s work is based on historical valuations versus current market valuations; with that he updates his seven year forecast quarterly. This is a similar methodology that we use with our stock selections that has also proven sucessful.

He Proved Correct

A year ago the U.S. markets traded at only 10 times earnings versus a long-term average of 15 times. With that Jeremy suggested outsized stock returns going forward. He proved correct; the S&P 500 stock index closed 2009 with a mid 20’s percent gain, though markets became even cheaper before bottoming in early March.

Fixed Income

So where are we today? I’d like to start with the asset class that scares Jeremy and us the most, bonds. In exhibit 1, displayed right of center in red is his forecasted real (above inflation) returns for the different sub-catagories of the fixed income markets. It’s not hard to see that if we and Jeremy prove right once again, fixed income investors have a very lean 7 years ahead. This also fits well with our thesis of not following the crowd (see Exhibit 2, for the Dalbar average investor), as more that 10 times more money flowed into bonds in 2009 than did stocks.

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Exhibit 1:

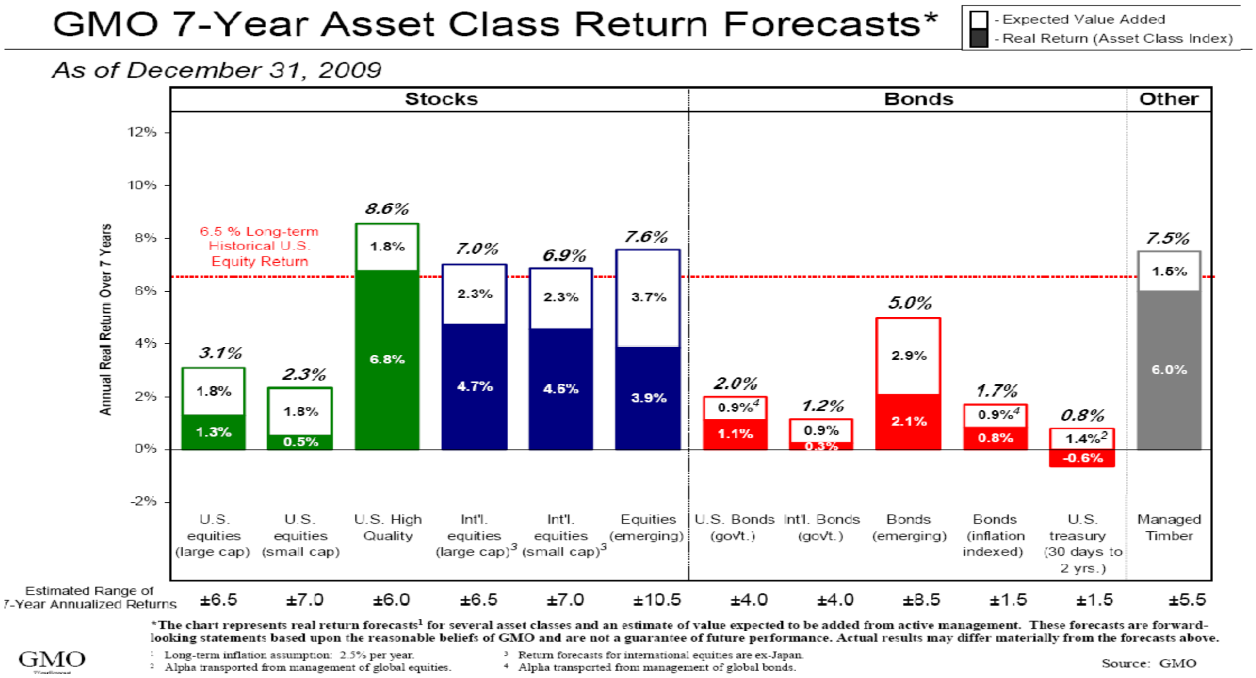
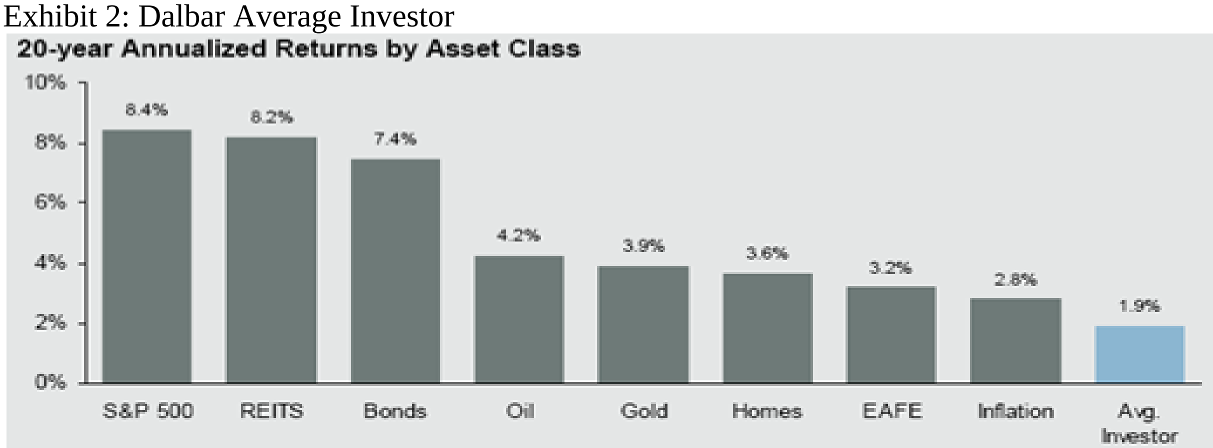


Exhibit 2: Dalbar Average Investor



U.S. High Quality

On the left of center side of exhibit 1, Jeremy outlines his estimated annual real return for stocks. Historically, stocks have returned a full 6.5% annually over inflation, but his current work suggest lower returns except for the category of "U.S. High Quality", which should meet or slightly exceed historical returns.

"Safety" Aspect

What Jeremy is referring to as U.S. High Quality are companies with pristine balance sheets, including low debt to equity and consistent business's. This fits well with our outlook of an extended period of consumer and corporate debt reduction, tighter lending standards and more debt supply from the U.S. Government. You can create easy screens to search for such names with most research tools by focusing on the tools "safety" aspect. For example, Value Line rates companies for financial strength with their highest rating of A++ and a safety rating with the top grade of 1. That would make a great place to start your search.

Warren Buffet

Though 2009 looked like a great year for stocks, not all stock categories participated to the extent of the mid 20's jump of the S&P 500. U.S. High Quality was left far behind in general; for example Warren Buffet's Berkshire Hathaway only returned 0.60% for all of 2009. With these High Quality bargains now being presented, look for gradual change to your portfolio to take full advantage.

"For the longer term, the out-performance of high quality U.S. blue chips compared with the rest of U.S. stocks is nearly (90%) certain." Jeremy Grantham 1-27-2010

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