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Grantham's Torch

Jeremy Grantham is a highly respected chief investment strategist with the $117 billion money management firm GMO. ($25 million minimum) His Quarterly commentaries are read far and wide in the securities industry for his wit, wisdom and insights.

"...in 1998 and 1999 I got about 1100 full-time equity professionals to vote on two questions. Each and every one agreed that if the P/E on the S&P were to go back to 17 times earnings from its level then of 28 to 35 times, it would guarantee a major bear market. Much more remarkably, only 7 voted that it would not go back! Thus, more than 99.0% of the analysts and portfolio managers of the great, and the not so great, investment houses believed that there would indeed be "a major bear market" even as their spokespeople, with a handful of honorable exceptions, reassured clients that there was no need to worry." – *Jeremy Grantham, My Sister's Pension Assets And Agency Problems (The Tension Between Protecting Your Job Or Your Clients' Money), July 2012*

The study Grantham did back in 1999, illustrated exactly what I saw happening all around me - and what I saw was the reason I started Cornerstone. In 1999, Investment managers recognized that the market was overvalued but would not do anything about it. Few made any asset allocation adjustments to protect their clients or take the time to warn their clients of the risks. When I questioned why there was no defensive strategy in place, I was told the worst that could happen was that all the investors would be in the same boat; everybody would have lost money. *"Your clients could not blame the market on you,"* was the prevailing attitude. When I told people in the business that I was planning to warn investors about the risks in the markets, they told me I was crazy.

"It is not good for business to be bearish... You can't deliver the hard truth and prosper..." - *Jeremy Grantham's Warnings to Investors – Advisor Perspectives, 06/02/2009*

Again Grantham was right. Investors do not want to hear that there are risks. They just want to be reassured that everything will be okay, the sun will come up tomorrow, and all their stocks will go straight up.

But unfortunately that is not reality: From 2000 through 2002 the market had its worst bear market in decades. Then it happened again from 2007 through 2009, this time the worst bear market since the Great Depression.

Whether investors like it or not, the markets had risks that they needed to be aware of, so that they could invest accordingly. Informing clients of what the research shows and then implementing defensive strategies, until the market becomes a good value again, has been our mission from the beginning.

The portfolio managers in Grantham's study were unwilling to put their own careers at risk for the sake of protecting their clients. They put reducing their own "career risk" ahead of their "client's risk." Cornerstone was established because this way of thinking does a disservice to the investor.

"The central truth of the investment business is that investment behavior is driven by career risk. In the professional investment business we are all agents, managing other peoples' money. The prime directive, as Keynes knew so well, is first and last to keep your job. To do this, he explained that you must never, ever be wrong on your own. To prevent this calamity, professional investors pay ruthless attention to what other investors in general are doing. The great majority 'go with the flow,' either completely or partially. This creates herding, or momentum, which drives prices far above or far below fair price.

Missing a big move, however unjustified it may be by fundamentals, is to take a very high risk of being fired." - *Jeremy Grantham, My Sister's Pension Assets And Agency Problems (The Tension Between Protecting Your Job Or Your Clients' Money), July 2012*

Career Risk for a money manager is keeping your job, or more specifically, keeping your clients. To put what Mr.

Grantham is saying more bluntly: the choice money managers have to make is between putting their careers at risk, or putting their client's money at risk.

Putting your client's money at risk means keeping them fully invested or almost fully invested at all times and doing what everybody else is doing. "Going with the flow," as Grantham says, is failing to do your own analysis of the risks in the market.

By choosing the "client risk" option, you (the money manager) cannot be blamed for what a market does. If a bear market comes along, everybody else is down too, so you are in good company. How can an investor complain when everybody is down? So while your client loses some money, at least you still have a job.

"Career risk" for a money manager occurs when you try to protect your client's assets by taking them out of the market and then the market continues higher. It does not matter how fundamentally sound your research is - *missing a bull move gets money managers fired.* As Grantham said at a Morningstar conference:

"The biggest career risk is getting out of a bull market [while it's still ongoing]..." - *Grantham on Avoiding the Pitfalls of Career Risk 06-22-2012 – Morningstar Conference*

Was 2009 like 1982?

Is 2015 more like the end of a bull market than the beginning?

	1982	2009	2015
P/E Multiple	8.6	83.6	18.76
Shiller CAPE P/E	7.35	16.92	26.46
Div Yld	5.71%	2.73%	1.94%
S&P 500/Book Value	1.1	1.9	2.7
Int Rates	Near all time Highs	Near all-time lows	Near all-time lows
Fed Funds Rate	14%	0%	0%
30 yr Treas Rate	12.76%	4.08%	3.19%
Profit Margins (CP/GDP)	4.90%	8.30%	9.70% (2014)
Empl Comp/GDP	47.40%	43.30%	43.10% (2014)
Fed Debt	$1.1 Trillion	$11.7 Trillion	$18.2 Trillion
5 yr ave GDP Gr	10%	3.30%	3.80%
Debt/GDP	35%	84%	103%
Deficit/GDP Ratio	-3.83%	-9.80%	-2.79 (2014)
Pers Savings Rate	11.50%	6.10%	4.80 (2014)

Sources: Shiller, Federal Reserve, S&P; Format: CIS

For Better or Worse – Putting It Into Action

The declines from 2000 - 2002 and 2007 - 2009 happened almost right on que, confirming our strategy of putting client risk first. The market since 2009 has been much less cooperative.

Since 2009, our research has indicated that the main push on the market has been the Fed's money pump. This artificially inflated market is not based on economic growth or value. It is based on money flowing into risky assets, making them riskier.

But many on Wall Street argued that 2009 was like 1982, the start of a new long term bull market. But did the data support that claim?

The table compares 1982, 2009 and today. 2009 does not look anything like 1982, and the numbers have only gotten worse, which means the risks have continued higher.

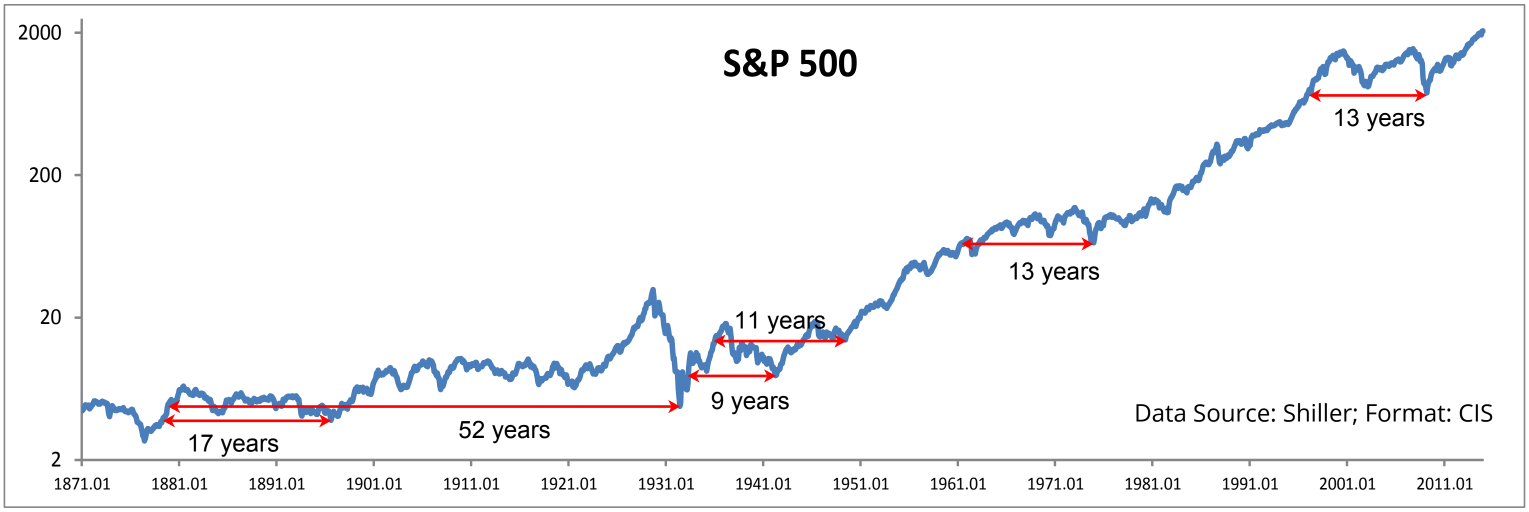
1982 was the beginning of a multi-decade bull market. It began the way many bull markets begin, low P/E Ratio, High Dividend Yield, and High interest rates. Meaning - stocks were historically cheap, the high dividends paid the investor well and high interest rates attracted lenders to lend to corporations, thereby giving the economy a jump start.

2009? The Shiller CAPE P/E Ratio was more than double that of 1982. Meaning - stocks were not only NOT cheap, they were up in the area where stock markets usually have peaked in the past. The 2009 Dividend Yield was almost half the rate in 1982, confirming the overvaluation shown by the Shiller CAPE P/E Ratio. (Dividend yields and P/E Ratios have a negative correlation. High dividend yields and low P/E Ratios indicate cheap markets; high P/E's and low Dividend Yields indicate expensive markets.) The Price to Book value in 2009 was almost double the 1982 level of almost 1:1, another confirmation that the market in 2009 was overvalued.

Interest rates were much higher in 1982 and the economy got the benefit of DECLINING rates. Today dropping rates to zero has obviously not worked. With rates already at zero, the next major move for rates is higher, and that is not good for companies or the economy.

Fiscally, the Government was in much better shape in 1982. Because of the low Debt/GDP ratio, it could expand its debt in a way that would have a positive impact on the economy. The Debt/GDP Ratio in 2009 showed

Bear Markets that have given back years of gains



that government debt levels had little room left to expand; meaning its impact on the economy would be minimal. 2015's debt level is over the dangerous 100% mark, which studies have shown tends to put economies in a precarious situation. The government has no room left at all to stimulate the economy and may even start to be a drag on it with such a high debt load.

Profit margins have skyrocketed though. Since 1982, as measured by the Corporate Profits/GDP, profit margins have almost doubled. This is not as good as you would think. Profit margin expansion and contraction are part of the bull/bear cycle. So a bull market can start with low profit margins and expand as the bull and economy grow. If the profit margins have already expanded, as they are now, having set a record high in the past year, "mean regression" dictates that the next major move for margins is down, not up. Contracting margins are not good for stock prices.

Fundamental data point after data point in 2009 told us that this was not the beginning of a new bull market. Those data points have only gotten worse in the past 5 years.

It is our opinion, and that of many other qualified commentators, that the Fed's money printing is largely responsible for the rise in the stock market. With that in mind, how does one measure risk? How do you know when the markets will stop having faith in the Fed's ability to blow bubbles?

Here is the risk - many times, when a market corrects, it gives back everything it gained over a long time period. So staying out of an artificial market, as protection, is the wise, if not brave move. It takes incredible intestinal fortitude to recognize that a market is elevating on nothing more than air. It takes an in depth understanding of the markets to patiently wait for mean reversion.

But I've missed the move!

The chart of the S&P 500 from 1871 to 2015 shows just how much damage a bear market can do. The low in 2009 gave back 13 years of gains. That means if you had gotten out of the market in 1996, you could have gotten back in, in 2009 and not missed a thing; except the bear market from 2000 - 2002 and the crash in 2008.

The 2009 bear was not unique. The bottom of the 1975 market gave back 13 years of gains as well. One could have gotten out in 1962 and gotten back in, in 1975 and not missed a thing.

The gran-daddy of them all was the 1929 bear market. It gave back 52 years worth of gains. That's right, you could have gotten out of the market around 1880 and waited until 1932 to get back in at the same price. All you would have missed was a bear market that lasted over 15 years in the late 1800's, the 20 year flat market from 1901 to 1921 and the crash in 1929.

Today's market does not have the same characteristics of previous bull markets starting points. It has much more in common with how they end. The 2009 bottom never made it to historically normal lows. Maybe the next bear market will.

I'd rather ride it out in an Index fund, at least I'll be in the market when it goes up.

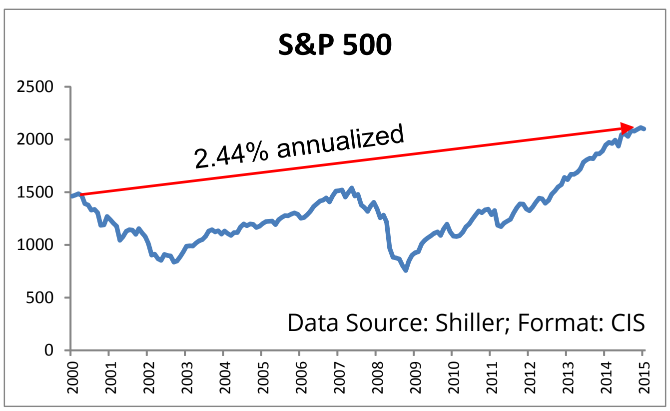
You can fool yourself into believing anything, and believing Index funds are the right answer for the average investor is one of the most dangerous. Yes, you will be in the market when it goes up, and yes, the Index did very well over the past 5 years.

But if I recall, there are 2 basic principles most investors believe in - Long term investing and buy n hold (in other words - not actively trading). So let's put that Index idea to the test. Let's say the market goes down to its historic lows P/E Ratio of around 8 x earnings. (Remember, 2009's P/E only went down to the high teens.) That would put the S&P 500 well below its 2009 low. In other words, it could give back everything it has made over the past 5 years.

Don't believe that is possible? Since 2009, the S&P has more than doubled - up over 100%. But, if the investor holds to his principles and stays a long term investor, then he would have to look further back, to see how the S&P has done over 10 or 15 years.

The average annual return for the S&P 500 over the past 15 years is only 2.44%. That's right, a total gain of only about 43% since 15 years ago, in 2000. (and that is before the internal fees of the Index fund.)

Long Term Investors have to live through the ups and the DOWNS in an Index fund.



But you would be smarter than everybody else. You wouldn't stay in the Index the whole time. You would get out before things got bad, right?

What would be your trigger, your signal to get out?

On what would you base your decision to sell the Index fund?

Would it be when it starts to decline? How much of a decline? 5%? 10%? 20%?

How many 10% declines were there from 2009 through 2015? You might have sold out several times along the way, and then when would you get back in? When it recovered the 10%? Then you are getting back in where you got out, so what was the point? There has to be a better way.

Fundamentals might tell you. Things like P/E and Dividend Yield and Book Value can tell an investor if the market is over or under valued.

So what P/E would be the trigger to get out? Looking at historical tops would be a good starting point. 18x? 19x? 20x? Maybe a dividend yield of under 3%?

Those are the valuations of the market back in 2009 - valuations that would normally be seen at the top of a market. This is why we have avoided the markets for so long. High valuations tend to exaggerate problems. A market trading at only 10x earnings is in a much better position to withstand a negative economic surprise or panic sell-off than an overvalued market at 20x earnings.

The other side of the cycle is coming, the only variable is "when." It could start next week, next year or 3 years ago. Bears have always followed bulls. The problem many investors do not comprehend is that this rally started from a place much higher than previous bulls and was based on much less. The potential for a much deeper and longer bear than the last should be expected.

Jeremy Grantham's words have not gone unheeded. before we had ever read the first word from Mr. Grantham's study, these principles have been the core investment philosophy at Cornerstone. We simply will not put reducing our career risk ahead of client risk. He may not know it, but Mr. Grantham has passed the torch of responsible investing on.

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