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Back to the future

John Maynard Keynes' investment philosophy and its implications for today's portfolio management

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John Maynard Keynes (1883-1946) is still one of the best-known economists of all times. His analysis of the worldwide economic crisis in the 1930s laid the foundations of modern macroeconomic theory and influenced a whole generation of economists. Policy recommendations derived from his theory influenced the monetary and fiscal policies of the economically most significant nations for decades. In addition, he developed basic insights into how economic decisions can sometimes become irrational. The concept of "animal spirits", which has become popular in recent years, is due to him. In addition, he developed basic ideas about how uncertainty and non-knowledge affect economic behaviour.

Indeed, his views on the business cycle and how to control it were and are still seen as very controversial. The fact that his theory mainly concentrated on the effects of demand and neglected incentives on the supply side caused a radical turning away from Keynes, particularly in the 1980s. However, in the meantime, there has been a renaissance of his thoughts, in particular due to the 2008 financial crisis and its consequences. His considerations about uncertainty play a particularly big role in many recent research projects.

Speed Read:

- John Maynard Keynes is not only a famous economist, but also one of the most successful fund managers of all times.
- Before becoming so successful, however, he applied different investment approaches with mixed success. Having started as a hazardous trader, he evolved to a careful long-term investor, who achieved an outstanding performance.
- A well-considered preselection of market segments with high growth potential, thorough fundamental analysis of companies and broad diversification of risks were the key to his achievements.
- His approach, which involved concentrating only on segments of the stock market that enjoyed structural advantages, seems superior to the management approaches of many modern-day portfolios, which try not to deviate too much from representative market indices. Buying the market means not only buying the winners, but also the losers. This would have seemed rather odd during the instable times Keynes lived in.

His role as fund manager and his significance for the investment world are less known, but relatively undisputed. His importance is based not only on the fact that he was one of the pioneers in the 1920s and 1930s who introduced shares as an acceptable investment form for institutional investors. Furthermore, he also developed an investment style which decisively influenced very different investors such as Warren Buffet, George Soros or David Swensen in later years. Above all, however, the outstanding performance of his investments was responsible for his fame. During difficult years of depression and war he was able to achieve positive returns with share investments and considerably outperform the whole equity market.

There are varied statements about the magnitude of his outperformance. The most common is that Keynes succeeded in beating the British stock market by approximately 11% p.a.. However, more recent calculations indicate that this number is based on comparisons with unrepresentative indexes, which do not include dividends. It is more realistic to assume an above-average performance of approximately 5.4% annually. But even this number is so outstanding that Keynes can rightfully be considered one of the greatest investors of all times.

His achievement is even more note-worthy, because fund manager was only his second job while his main activity was economics professor. Indeed, it was not easy for Keynes to become an outstanding investor. Before his winning streak started, he experienced some failures; nevertheless he learnt from these, drawing the right consequences.

1. Keynes in the 1920s: the change from hazardous trader to investor

John Maynard Keynes was born as a son of an economics professor in Cambridge in 1883. His mother, one of the first female college graduates in Great Britain, was involved in different social initiatives and also politically active. In 1932, she was appointed mayoress of Cambridge, the second woman to occupy this position. Although hindered by long phases of illness, Keynes was a very successful schoolboy and student. In 1906 he entered the civil service. Appalled by its inefficiency and incompetence, he left after two years and began his academic career in Cambridge. He became economic adviser to the British government, but withdrew from his position as political consultant in 1919 because he rejected the hard action against the war loser Germany. On account of his experiences with politicians, he retained a deep aversion to this profession, which is reflected in some of his famous statements, such as: "You have not, I suppose, ever mixed with politicians at close quarters. They are awful... their stupidity is inhuman...." or “… a Government I despise for ends I think criminal“.

After his break with politics he turned to journalistic activities as well as to the financial markets. In August 1919, at the age of 36, he opened a deposit account with a broker for the first time, starting his career as a speculator. First he traded currencies based on the analysis of economic trends and disequilibria and was very successful. However, in May 1920, he lost everything and registered a net loss of £13,125 (today's value approximately £570,000 or US$884,000) on all of his tradings. Only a short-term loan of £6,500 (today's value approximately £282,400 or US$440,000) and the advance sales of book rights enabled him to escape bankruptcy. One of his most famous quotations describes this experience: "The market can stay irrational longer than you can stay solvent." His experience was one which is also familiar to many people nowadays when they speculate against fundamentally unjustified market developments. Until one gets right, a long and very costly time can pass. Especially if leverage is used, the inter-temporal losses can increase in such a way that the capital can be lost before the markets move in the right direction again.

During the next five years, however, Keynes was able to increase his assets again to approximately £57,000 (today's value £2.92 million or US$4.53 million) with a considerably more risk-controlled trading strategy. He achieved this not only by betting on currency movements, but was also increasingly involved in futures markets for commodities.

During this time, Keynes came to the conclusion that shares had big advantages as long-term investments for institutional investors compared with government bonds and real estate, which were more popular at the time. From 1919, Keynes advised the Nationwide Mutual Life Assurance Society on its investments and from 1923 he advised the Provincial Insurance Company. In 1924 he founded the Independent Investment Company, an investment trust in which he implemented his ideas on how to invest. In the same year he became the sole fund manager for the endowment trust of Kings College Cambridge. Before this, in 1921, he had already taken over responsibility for the investments and had insisted that the assets were split into two different funds. The first fund was a so-called “restricted” fund, which was bound to regulations on the investment of endowment money and invested mainly in fixed-income securities. The second fund was a so-called “discretionary” fund, for which Keynes was able to select the investments according to his own views. To finance the share investments, some real estate was sold. This "discretionary“ fund also became known as the "chest" fund and is responsible for Keynes’ fame as an investor, because this fund achieved an average return of 16% p.a. in spite of crisis periods. From 1925, he also structured his private investments similarly to the "chest" fund. However, in his first years as a fund manager, Keynes did not succeed in beating the British equity market. In the second half of the 1920s his investment results were even much worse. First he acted too cautiously, missing some of the stock market rally in the late 1920s. Later, he also failed to anticipate the stock market crash in 1929 and sustained heavy losses. Apparently his macroeconomic approach to investing was resulting in pro-cyclic behaviour. It was only when he fundamentally changed his investment strategy at the beginning of the 1930s that his fortunes improved.

2. Keynes in the 1930s and 1940s: the long-term investor

Keynes never explicitly explained his investment philosophy. However, he regularly commented on his investment decisions in management reports and public statements. It is therefore possible to draw conclusions on his investment style. A significant change in his attitude towards investing was perceptible at the beginning of the 1930s. In previous years, Keynes had tried to invest on the basis of his expertise in economic trends. From 1932 onwards he completely neglected macroeconomic issues. Instead, he shifted his methodology to identifying fundamentally attractive enterprises and analysing their valuation.

Careful research was a key factor for his investment success. He put a lot of emphasis on the thorough study of business reports and company news. Furthermore, as a leading economic researcher and as a member of the British establishment, he had a wide network of economic experts and managers who continuously provided him with the most recent information about developments of sectors and companies. Personal contacts with top managers were very important for him. Like Warren Buffet nowadays, Keynes considered a trustworthy management to be central for the long-term success of a company. As far as this can be reconstructed today, insider's knowledge in today's sense - the exploitation of confidential information - however, played no role in his investment success.

Keynes was one of the first investors to place emphasis on a thorough valuation analysis. He tried to calculate the "intrinsic value" of corporations and compared this to the stock market valuation. Furthermore he

determined valuation ratios and used them for comparisons with competitors. Although this may seem obvious to us today, it was not common 80 years ago. However, to call him a "value investor" would be too simplistic.

Keynes paid no attention to approximately 50% of the stock market and did not invest, e.g., in financial companies or oil shares. It is unclear whether he had basic doubts about certain sectors or whether he simply avoided sectors that he did not know so well. He concentrated on the mining sector and the capital goods industry. It is interesting that these were exactly the sectors that largely benefited from the mega trends of the past in first half of the 20th Century. In this respect Keynes' investment style is very similar to the GARP (growth at a reasonable price) approach of today's investors; he was focused on the growth sectors of his time and in these sectors he preferred relatively low-valued shares.

In this respect he differs from other fundamental investors, for example from Warren Buffet. While Buffet invests in important enterprises from different sectors, Keynes clearly puts the focus primarily on the sector and then, in a second step, on the enterprises. This was also reflected in an increasing trend towards rather low weightings of most of his positions in the portfolio. Thus Keynes never had less than 44 positions after 1932. At the beginning of his career he had relatively few positions and a high concentration on top holding companies. Then, however, this concentration was gradually reduced. However, he still kept high weightings in especially successful shares. For this reason, the frequent appraisal of Keynes as a focus investor is too simplistic. A clear focus can only be identified at the beginning of his career as an institutional money manager. However, when applying sector selection, Keynes only occasionally maintained the focus on single enterprises.

> "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about and in the management of which one thoroughly believes."
>
> John Maynard Keynes

Another important difference to other long-term investors like Warren Buffet is that Keynes was not a classical "buy-and-hold" investor who generally stuck to a position and avoided transactions. At the beginning of his career Keynes changed his holdings relatively often (he reshuffled the complete portfolio approximately once a year) and also traded actively. In the course of time, this changed and the turnover factor clearly decreased. Thus he accumulated significant long-term positions in his favourite enterprises such as Union Corporation, Hector Whaling and Austin Motors. Indeed, Keynes also did not renounce trading even during his last years and opportunistically tried to exploit market inefficiencies. However, his activities were very different to the trading of most of today's investors who try to jump on short-term market trends. With his trading Keynes essentially acted anti-cyclically - against the trend. When he saw excessive stock price movements, he took positions to offset them; after normalisation the trading position was dissolved again.

Beside sector specialisation, two other characteristic features of Keynes' portfolios are noteworthy: on the one hand, avoidance of blue chips - the shares with the biggest stock market capitalisations – and, on the other hand, a clear preference for enterprises with foreign activities.

Nowadays, the segment of small- and middle-size enterprises is also the segment comprising the companies with the biggest growth potential. There are also bigger information deficits than for the well analysed blue chips, so that market inefficiencies can be exploited better.

Keynes had a preference for enterprises earning their money outside Great Britain. This applied to British enterprises with considerable foreign activities as well as foreign enterprises. This approach was very unusual at the time, because globalisation was much less important than today and the stock exchange reflected the much stronger domestic economy. It is unclear whether this preference was based on a deliberate decision or whether this orientation arose implicitly from individual investment decisions. Indeed, this approach is confirmed by today's experience; the enterprises that prove successful on international markets are generally more efficient and more innovative than domestically focused companies.

All together four phases can be distinguished in Keynes' life as an investor:

1) Keynes as a hazardous trader (1919-1920):

In his first phase on the capital markets, Keynes had the same experience as many intelligent people today. With their theoretical knowledge they believe they can outsmart the capital markets. They try to exploit market trends with risky leveraged products. This may often work out well for a certain time, but it causes these people to overestimate themselves and their abilities. They increase their risk more and more as they are attracted by growing profits. However, at a certain point in time, the markets change. An approach that worked as a recipe for easy money before suddenly fails, resulting in terrible losses.

2) Keynes as a successful speculator (1920-1924):

Keynes learned from his painful experiences and earned back what he had lost before and was even able to increase his wealth even further. Indeed, he seemed to be substantially more mature, controlling his risks and not getting carried away with reckless speculations. After he had once again accumulated assets of a substantial size, he stopped short-term trading and turned to long-term investments.

> "Investing is an activity of forecasting the yield over the life of the asset; speculation is the activity of forecasting the psychology of the market."
>
> John Maynard Keynes

3) Keynes as a global macro-manager (1924-1932):

Privately and in his activity as a fund manager, Keynes now focussed on investments in shares and fixed-interest bonds. However, during this period, he still tried to benefit by applying an investment strategy that involved analysing economic trends. Sometimes he was right and sometimes he was wrong. At the beginning of this period of considerable uncertainties, he was able to achieve comparable yields to the British stock market. In this period he was similar to many current fund managers who try to chase market trends with their funds. Sometimes they hit the trends, sometimes they get it quite wrong. However, all in all, they mainly generate transaction costs and therefore underperform the market over a longer time frame.

4) Keynes as a company oriented investor (1932-1946):

At the beginning of the 1930s Keynes changed his investment strategy. He, as economist, stopped taking into account economic trends when making investment decisions and focused instead on identifying fundamentally attractive shares. Indeed, he adopted a similar approach to a growing number of value investors emerging in the USA of the 1930s. However, it does not appear that he was influenced by them. It seems that both Keynes and the value investors (the best-known value investor was Graham Dodd with his book "Security Analysis" of 1934) came to similar conclusions at the same time.

It is remarkable for today's times, obsessed with performance measurement and controlling, that Keynes was indeed very unsuccessful twice with his activities on the capital markets. The first time was when he was on the brink of bankruptcy in 1920 and the second time was at end of 1920s when he failed with his approach based on macroeconomic views. It is also noteworthy that his (anonymous) financiers of 1920 as well as the Kings College management tolerated the mistakes and continued to trust him.

It was making mistakes that enabled Keynes to gather the experience that allowed him to become an outstanding investor later. The basic knowledge that one can learn best of all from one's own mistakes does not seem acceptable any more in times of modern risk management. Recently many fund managers who missed some short-term trends in the volatile times of financial crises and the Euro crisis were forced out of their positions or obliged to change their investment policies. Fund managers who miss their performance targets are eliminated fast nowadays. However, only those that have the courage to make mistakes can gather experience and achieve an outstanding performance.

Not only tolerance concerning mistakes would give today's risk managers a heart attack. They are also dominated by benchmark thinking, in contrast to Keynes' investment philosophy. He never used representative market indices as a guideline for structuring portfolios. However, Keynes cared very much about the independence of risk factors. With his preference for uncorrelated risk he anticipated one of the undisputed results of modern portfolio theory.

Keynes' aim was not to replicate the stock market performance. This would have also been relatively dissatisfactory in the crisis periods and wartimes in which he lived. The benchmark thinking of present days, which uses a market index as a guideline for performance and risk measurement, would have seemed odd to him and his contemporaries. He wanted to achieve absolute returns and increase his college's assets. His risk management did not involve naively diversifying investments or performing complicated analytics of correlation coefficients and volatility, but involved avoiding potentially problematic sectors, carefully judging the valuations as well as diversifying single holdings while taking into consideration their specific risk interdependencies.

In this respect it is very doubtful as to whether Keynes would have viewed strong divergences from the market index as a higher risk than would be the case nowadays, where the dominant investment philosophy favours investments close to an index. Keynes was not aware of modern portfolio theory and its conclusions and could not comment on them. However, Warren Buffet, whose investment philosophy is very close to Keynes's philosophy, has done this by rejecting the risk philosophy that has arisen from modern portfolio theory: "The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability – the reasoned probability – of that investment causing its owner a loss of purchasing-power over his contemplated holding period." On another occasion Buffet wrote: "Risk comes from not knowing what you´re doing." At least in his successful period, Keynes always knew precisely what he was investing in.

As a conclusion, the investment principles of Keynes' successful years can be summarised as follows:

- Concentration on attractive segments of the stock market that benefit from structural trends.
- Strong risk diversification between single holdings that are dependent on very different risk factors.
- High weightings were only allowed for a few, very intensely analysed core investments.
- Thorough fundamental analytical research is the basis for investment decisions.
- A huge number of valuation criteria were used to find out the extent to which the share price reflected the value of the enterprise.
- Enterprises with a strong market position and trustworthy management were preferred.
- Additional yields were achieved by medium-term oriented, anti-cyclical trading.

Nowadays these criteria have become anything but outdated. On the contrary, after the experiences of the financial crisis they appear more relevant than ever. Buying a portfolio similar to a market index exposes investors quite significantly to absolute risk. By increasing relative risk in comparison to the market, by leaving some unappealing segments aside, absolute risk may be reduced.

Therefore, in particular Keynes' successful concentration on areas of the stock market that appeared attractive in the long term should give people something to think about if they propose only buying the market. If someone buys the market, he buys the winners and the losers. However, as an investor, he profits only from the winners. Of course it is difficult to identify them. If, however, the stock market is decomposed into different segments and stocks are only selected from the promising segments, a lot can be gained. Keynes recognised this. We should consider following him.

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Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlshochschule International University in Karlsruhe.

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The calculation of today's money values were conducted using this website: http://www.thisismoney.co.uk/money/bills/article-1633409/Historic-inflation-calculator-value-money-changed-1900.html

Warren Buffet is quoted according to:

"The riskiness of an investment is not measured by beta (a Wall Street term encompassing volatility and often used in measuring risk) but rather by the probability – the reasoned probability – of that investment causing its owner a loss of purchasing-power over his contemplated holding period." (Letter to the shareholders of Berkshire Hathaway for 2011) (http://www.berkshirehathaway.com/letters/2011ltr.pdf).

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