❖ Horizon Asset Management, Inc. ❖

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Interim Market Commentary

John Maynard Keynes as an Investor
The Asset Management Industry
Observations on Securities Exchanges

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During the 4th Quarter of 2008, en route to the depths of the financial market crisis (only in retrospect did we discover that we were still "en route"), when credit markets were all but frozen, we reviewed the experience of Warren Buffett during a similarly difficult period in his investing career. A few weeks later, and even deeper into the crisis, we reviewed Benjamin Graham. Expanding on the theme of *Exploring Value Investors During Difficult Financial Markets*, we now take a historical look at John Maynard Keynes.

John Maynard Keynes as Investor

John Maynard Keynes was an extraordinary person. The best English language term that we have to describe him would be a polymath. He was not merely an economist; he was a mathematician of great ability. As a matter of fact, his book entitled *The Treatise on Probability* is still read with great interest by mathematicians. He was a patron of the arts, a critic of government policy and a writer of scintillating English prose who probably should be considered one of the greater masters of the writing style of the 20th Century. He was a corporate official, and he managed money for some insurance companies. At various times, he was not merely a critic of the government, but a government official who participated in making government policy.

Most important for the purposes of this report, Keynes was also an investor whose investment style changed greatly throughout his investment career, which was unfortunately cut short by his untimely death at the end of the Second World War. By labeling Keynes a polymath, I mean that he was a multifaceted and multitalented individual. That word, in fact, does not properly describe such a human being. It might be more appropriate to use the Italian term *uomo universale*, or universal man.

Another aspect that is very important in understanding Keynes as an investor is that his investment career was conducted almost entirely during an extraordinarily turbulent era. He was an investor during a time that spans the beginning of the First World War to the end of the Second World War. He experienced World War I and the post-war German hyperinflation, the reestablishment of the gold standard in England in 1925, which had the consequence of overvaluing sterling, and which resulted in the incredibly disruptive general strike of 1926. He lived through the Great Depression and the Second World War. During the latter part of that period, commencing in approximately 1937, he had grave health issues pertaining to his heart.

With all that, he managed to have a very interesting and fertile investment career. One of the most interesting points about Keynes is that his biographers have chosen to say very little about him as an investor, perhaps due to lack of information. In the three-volume Robert Skidelsky biography of Keynes[1] there are no more than a handful of pages on

[1] Skidelsky, Robert. *John Maynard Keynes: The Economist as Saviour, 1920-1937*. New York: Penguin Press, 1992.

Keynes as investor. Roy Harrod[2] wrote a biography of Keynes called *The Life of John Maynard Keynes*. He was a personal friend of Keynes, but that work contains even less about Keynes as an investor. The other important biography of Keynes is by the economist Donald Moggridge,[3] who is not merely an economist, but is also the editor and assembler of *The Collected Writings of John Maynard Keynes*. He also had very little to say about Keynes as an investor.

Nevertheless, there is some information about Keynes as an investor, much of which is also contained in Volume 12 of *The Collected Writings of John Maynard Keynes*. This collection is mainly comprised of various letters written to colleagues, two of whom are quoted in the Skidelsky biography (Skidelsky 525). In a letter written in 1938, Keynes stated the following:

> I was the principal inventor of credit cycle investment, and I have not seen a single case of success having been made of it.

In that quote, Keynes makes reference to the idea of trading either securities or currencies based on the ebb and flow of economic activity. Keynes was a trader early in his career. As he matured and blossomed as an investor, he began to greatly regret his early investments and even his early thinking on many different subjects. He began to change.

Another important quote is from a different 1938 letter (Skidelsky 525). It was written to one of his fellow directors of the National Mutual Insurance Company named Francis Curzon. I think that it adequately sums up Keynes's change of heart.

> I feel no shame in being found still owning a share when the bottom of the market comes. I do not think it is the business of … [a] serious investor to cut and run on a falling market … I would go much further than that. I should say that it is from time to time the duty of a serious investor to accept the depreciation of his holdings with equanimity and without reproaching himself. Any other policy is antisocial, disruptive to confidence and incompatible with the working of the economic system. An investor is aiming, or should be aiming, primarily at long period results and should be judged solely by these.

Apropos of long period results, the organization known as maynardkeynes.org undertook to document Keynes's returns from his management of the so-called Chest Fund, which was the investment portfolio of King's College, Cambridge. When the Chest Fund commenced in 1927, the index was 100 (see Table 1 on page 4). In 1945, which is the last single year that Keynes managed the fund, the index was at 480. The coefficient of expansion is 4.8x, which is compared to the U.K. stock market in the table provided by maynardkeynes.org. The site does not document how the return of the UK stock market is

[2] Harrod, Roy F. *The Life of John Maynard Keynes*. Toronto: George J. McLeod Ltd, 1951.
[3] Moggridge, Donald E. *Maynard Keynes, An Economist's Biography*. London: Routledge, 1992

calculated, but I presume it is in a similar manner as the FTSE Index. The chart simply shows that the U.K. stock market commenced in 1927 at 100, and in 1945 it was 85.2.

What's most interesting about the Keynes record is not merely that in the course of 18 years he was able to increase the value of the Chest fund by 4.8x, but that it was done during a very turbulent period that resulted in a 14.8% decline in the U.K. stock market over the comparable period of time. I don't think any other investor of a similar skill set was able to accomplish a like rate of return during an extended disruptive market. Keynes managed to do it by leaving his investments alone and allowing the best ones ultimately to become the largest part of the portfolio. In such manner, he generated that rate of return. He liked to state, though who knows if it's true, that he spent no more than one day per week thinking about his investments.

Table 1: Performance Chest Fund vs UK Stock Market

Year	Chest Index	Chest Index Change	UK Stock Market	UK Stock Market Change
1927	100.0		100.0	
1928	96.6	-3.4	107.9	7.9
1929	97.4	0.8	115.0	6.6
1930	65.8	-32.4	91.7	-20.3
1931	49.6	-24.6	68.8	-25.0
1932	71.8	44.8	64.8	-5.8
1933	97.0	35.1	78.7	21.5
1934	129.1	33.1	78.1	-0.7
1935	186.3	44.3	82.3	5.3
1936	290.6	56.0	90.7	10.2
1937	315.4	8.5	90.2	-0.5
1938	188.9	-40.1	75.7	-16.1
1939	213.2	12.9	70.2	-7.2
1940	179.9	-15.6	61.2	-12.9
1941	240.2	33.5	68.8	12.5
1942	238.0	-0.9	69.4	0.8
1943	366.2	53.9	80.2	15.6
1944	419.3	14.5	84.5	5.4
1945	480.3	14.6	85.2	0.8

Source: http://www.maynardkeynes.org/keynes-the-investor.html

As an investment thinker, Keynes is not unique. He's not the first, or even the sole, long-term investor; he's merely a great investor who has yet to be significantly studied by investment thinkers. A much deeper study than could be done here should be undertaken.

One other point that has relevance to Keynes as an investor is that his most famous quote is the phrase "In the long run we are all dead." It is usually taken as evidence that he supported the notion of short-term trading, but the origin of the quotation is not usually stated. In fact, it appears in Chapter 3 of the Keynes work entitled *A Tract on Monetary*

Reform, which was written in the year 1923. The chapter deals with what Keynes refers to as a laissez faire approach to post World War I inflationary pressures that was exhibited by the central banks of that time. The justification for that approach was that, ultimately, there would be a readjustment and the inflationary pressures would abate. Therefore, government intervention should not generally be required. Keynes took the opposite point of view. He felt that inflationary pressures would not abate unless the governments and central banks undertook actions to counter them. The expanded quote is:

> The long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again.

The quotation is meant to argue against the view that there would be a readjustment in the long run. Keynes's view was that we cannot tolerate, even for a brief period of time, the level of inflation that was experienced in the post World War I world. Taken completely out of context, that quotation has come to define the kind of investor and thinker that Keynes was, and it is completely wrongheaded to do so.

The Asset Management Industry

The asset management industry in this connection is not mentioned by way of recommendation, but to comment on its characteristics as a potential hedging vehicle. Asset management is a business characterized by remarkable operating leverage. As every asset manager knows, when the assets under management increase, the costs don't necessarily rise commensurately, and the earnings advance at an unusually high rate. Of course, when the value of the assets decline, it is accelerated by the departure of large numbers of clients, and it's very difficult to adopt any countervailing cost containment moves. A declining market is uniquely and extraordinarily painful in a profit and loss sense for an asset manager. Nevertheless, there are asset managers that are able to function rather well in this environment, and I will only make note of one and then move on to another topic.

A British manager known as Blue Bay Asset Management is probably one of the leading managers of credit in the United Kingdom. Blue Bay is a credit manager that functioned in an environment that witnessed an unprecedented collapse in the credit market. This particular asset manager has a fiscal year ending in June. At the end of the prior fiscal year on June 30, 2008, assets under management were $21 billion (USD). On December 31, 2008, when the credit collapse was nearly at its nadir, assets under management were $16.7 billion (USD). In the six months ending December 31, 2008, the manager itself experienced a cash inflow of $1.2 billion. The gross redemptions were very large but, nevertheless, 35% of those gross redemptions were invested in other Blue Bay products.

In principle, though not in practice recently, many of the Blue Bay products could generate performance fees if the circumstances were amenable to that, which is to say that in success mode Blue Bay has unique operating leverage characteristics. These comments are not to be interpreted as a recommendation of Blue Bay as an investment, but only to point out that the money manager security is probably a much more intriguing hedging vehicle than an index like the S&P 500.

Ordinarily, after selecting a number of securities for a portfolio, an investor may wish to control its volatility by selling short a certain number of shares of an index like the S&P 500. In another scenario, let's suppose that, instead of selling the index, an investor bought the index. The reason for buying the index, especially in the form of an exchange traded fund (ETF), is that the margin requirements for an ETF that is based on an index are less than the margin requirements for buying individual securities. Therefore, one could make more economical use of the capital under management in a leveraged position if one were to actuate a long strategy using index ETFs of whatever description. Given that the money managers of securities have these unique volatility characteristics and these incredible forms of operating leverage, the short exposure could be the money manager securities themselves. Since the money manager securities are so uniquely volatile, one would need to carry a lower short position to achieve the same coverage. Phrased alternatively, if one were limited to a gross exposure of X, one could make more economical use of capital by orchestrating one's investments in this manner than by engaging in the reverse.

It's not a stretch of the imagination to say that ultimately this strategy will become the preferred method of making such investments. One of the reasons is that, as stated previously, the operating leverage of the money manager is extraordinary in both a positive and negative sense. It provides a better hedge than an index, and it makes more efficient use of capital. In addition, there is much more real time information available about an asset manager than about the securities that comprise an index. For example, if one were long or short an index, it would be very difficult to know with any certainty in a given year what the earnings might be of the constituent companies. It certainly depends on the economic cycle and many other factors. However, if a money manager were active in the mutual fund arena, the performance would be available daily and information about cash flow in and out of those funds would usually be publicly available during the quarter. A short seller could focus upon a money manager that is oriented towards a certain industry, set of industries, or asset classes. It would be possible to focus one's short exposure much more narrowly than to merely take the broad approach of the index itself.

As an example, let us assume that there was a type of bubble in securities markets. Since bubbles can manifest themselves in a variety of areas, let's presume, for the purposes of this discussion, that the bubble was in the field of alternative asset managers. In that scenario, it might be reasonable to sell short the shares of an alternative manager such as Man Group in the United Kingdom, rather than to short an index like the S&P. Therefore, it seems reasonable to suppose that the day will come when long exposure will be undertaken with indexes, and short exposure will be undertaken with money managers.

Ultimately, ETFs of various orientations would be created such that money manager ETFs could be oriented toward credit, alternative investments, certain industries, and so on. They would ultimately come to be the hedging vehicles of choice.
One other observation about money managers -- if one were to examine the month-by-month rates of return in 2008 and 2009 of the money managers (please see Appendix A), it is manifest that the volatility of these underlying companies, as instruments, is far in excess of that exhibited by the index. Nevertheless, at least insofar as the cumulative performance for the US Money Manager Index is concerned, for the time period from January 1, 2008 to August 31, 2009, it has outperformed the S&P 500, even given the extraordinary volatility exhibited by the money managers as the market declined.

Observations on Securities Exchanges

In the last several weeks, the New York Stock Exchange announced two interesting transactions. The first involves the NYSE Amex Options Exchange. In this case, the NYSE invited many of the large broker-dealers to take an equity interest in the NYSE Amex Options, and they agreed, in principle, to join. One of the central presumptions of exchange analysts over the last several years was that the very large broker dealers would increasingly establish exchanges on which they would trade away from the leading exchanges. This was expected to create competition for market share and eventually erode the value of the established exchange franchises. This NYSE transaction is an example of the reverse happening. This deal returns one, in essence, to the historical exchange model in which the various members of the exchange were effectively holders of seats and, therefore, were equity holders. In that situation, they had incentive to participate in the profitability of the exchange. The difference is that, in the past, the exchanges weren't profitable, but now many of them are.

In the case of the Amex Options business, based on the NYSE announcement, the following companies are going to join NYSE Amex Options as equity investors: Bank of America Merrill Lynch, Barclays Capital, Citadel Securities, Citigroup, Goldman Sachs, TD Ameritrade and UBS. The NYSE announcement envisages that this transaction will be consummated before December 31, 2009.

Shortly before that, NYSE announced another transaction in which it is acquiring another trading platform, which is a small one that is known as NYFIX. The interesting point about this transaction is that the various equity investors in NYFIX will continue to participate as interested parties. The trend is to turn once again to the historic business model of the last several centuries, which sees the exchange platform and the participating market makers as integrated entities rather than competing entities.

notice, as are statements of financial market trends, which are based on current market conditions. The holding information presented is for illustrative purposes only. Actual account holdings and performance will vary depending on the size of an account, cash flows within an account, and restrictions on an account. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy, hold or sell any security and it should not be assumed that the securities transactions or holdings discussed were or will prove to be profitable.