John Maynard Keynes-What investment advice would he give us today

By Wes McComb

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John Maynard Keynes was the world's greatest economist of the last 100 years. There may be arguments made that Hayek or Friedman are in the running but as far as influence on government policy and shaping the world we live in, Keynes is the most significant. He was involved in Bretton Woods towards the end of WW2 where today's international banking framework was created, including the World Bank and the International Monetary Fund. His insights into macro economics have held up well in practice. He postulated that during times of financial stress governments must intervene and during good times they must save enough to have a balance sheet available for the inevitable downturns. The issue with this in reality is that politicians like to always spend like it is a downturn. But his insights into supply and demand during the depression of the 1930s helped Ben Bernanke navigate the Great Recession of 2008-09.

He was also an investor and managed other people's money. So, watching his development from a speculator to a money manager is as inevitable as it is informative. He was not a humble man. He excelled in all his intellectual pursuits, educated at Eton and Cambridge and was a member of the famed Bloomsbury group. This, along with a genealogy traced back to William the Conqueror instilled a noted amount of hubris. This arrogance is often found in newly minted money managers, though usually for much less reason than Keynes had. Especially if they experience easy initial success.

He believed in active management of the assets he was the custodian of. And he believed that equities were an asset class that would provide investors with long term time horizons outsized returns. This was actually a novel concept prior to WW2 when most institutional money was in secure bonds and real estate. His investment track record was significantly better than the market and that is why examining his methodology is important. Why reinvent the wheel when we have a first-class mind who left massive amounts of writing showing his evolution from a top down to bottom up manager? So, let us take a look at what he can teach us.

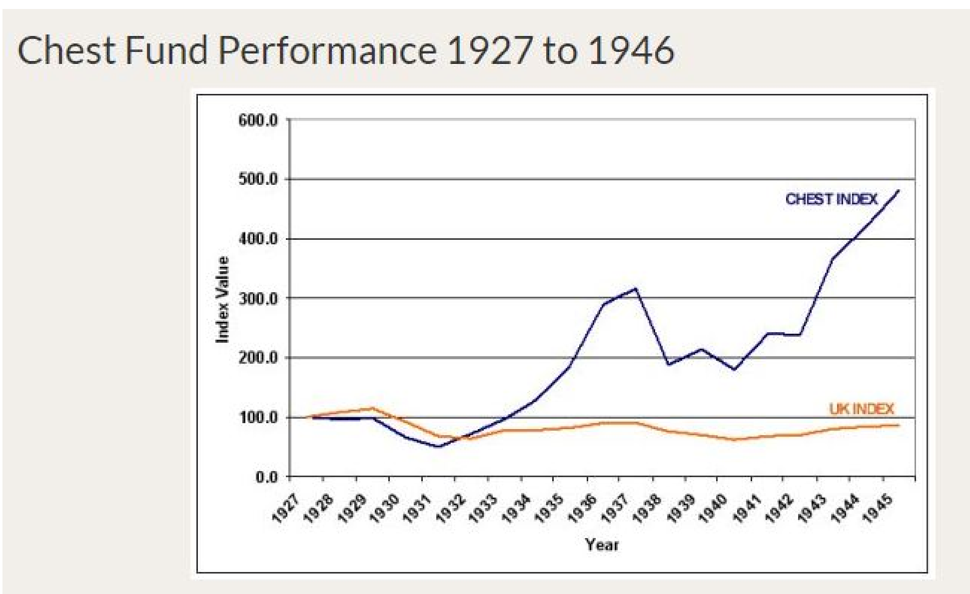
Keynes did not believe in efficient markets. In a speech from 1938 he says:

"[Markets] are governed by doubt rather than conviction, by fear more than forecast, by memories of last time and not by foreknowledge of next time. The level of stock prices does not mean that investors know, it means they do not know. Faced with the perplexities and uncertainties of the modern world, market values will fluctuate more widely than will seem reasonable in the light of after-events"

When he began actively managing money in 1921, he felt that he could time markets. That he could move from equities, to bonds, to cash in anticipation of market moves. He called this his Credit Cycle Theory. He slowly became disillusioned with this top down approach and by 1928 was coming to the realization that the theory was not empirically sound. The crash of 1929 was the coup de grace of his Credit Cycle Theory. During this time, he was developing and testing alternative ideas for managing money.

This is the interesting part. He developed the theory of what we would call value investing today. He did this independently of Graham and Dodd, the two American investors whose 1934 book Security Analysis laid the groundwork for valuing companies. Keynes even used the term 'intrinsic value', which is the foundation of value investing. The money managers job is to figure out the intrinsic value of a company and be patient until they are able to buy that company below its intrinsic value. Keynes also came to understand that holding good companies for the long term helped his performance.

Once he committed to value investing, he began to significantly outperform the UK equity index. The chart below shows the performance of his primary investment vehicle, Cambridge University's Chest Fund from 1927 to 1946, when he died. As this illustrates, once bottom up analysis became his focus in the early 1930s, he did much better than his benchmark of the United Kingdoms stock market.



I think there are two primary points to take away from Keynes' development as an investor. His initial arrogance in believing he could time markets took six years to dissipate. We see a similar strain of conceit in markets today. Many young or new-to it investors are enjoying the recent bull market in technology stocks and have developed a certain smugness. By heeding Keynes maybe some of them can avoid the inevitable painful lesson that he discovered at great cost.

Secondly, we once again are led to the fact that by using patience, value investing and a long-term time horizon, investors can do phenomenally well. Keynes was brilliant and his well documented use of bottom up stock selection is another convincing argument that there is blueprint we can follow to investment success. We don't have to reinvent the wheel.