Report
DYNAMO 79
3/4 2013

Keynes as an Investor[1]

Keynes is undoubtedly one of the most influential economists of all times and an enormous amount of books and articles have been written about him and his ideas since he passed away in 1946. More recently, with the crisis of 2008 and its similarities with the Great Depression of the 1930's, and the experiment of quantitative easing, the interest on his work has resurfaced strongly.

While it is easy to find what Keynes thought about the stock market and its impact on the economy (in The General Theory, for example), it is much harder to find references to what Keynes wrote about his personal experience as an investor[2]. So we were delighted to learn from a fellow investor[3] about a publication that was put together by Cambridge University Press working for the Royal Economic Society. They have combined all of Keynes' published books and articles, including his correspondence with other economists and people he dealt regularly with, in thirty thick volumes, many with close to 1,000 pages. What we found most interesting were his letters as they were written in a more informal manner, much like emails are written today. In some instances, we can even detect some of his emotions, especially when he gets upset with people who disagreed with him.

The part that includes his writings about investing is contained in the first 110 pages of Volume XII. Keynes was involved with finance and investments in three different capacities. First, he was an active individual investor who bought his first stock at age 22 and was a frequent speculator in several asset classes, especially after 1919, when he left the Treasury. Second, he was the Bursar[4] of King's College, Cambridge. Finally, he was involved with the City as a board member of a couple of insurance companies as well as some investment trusts.

1 *This is a copy of the* **Dynamo Fund Report May 2013** *written by Dynamo´s team in London.*

2 *There is a comprehensive paper on the subject, "Keynes as a stock market investor", written in September 2011 by David Chambers and Elroy Dimson.*

3 *We are grateful to Gary Channon from Phoenix Asset Management Partners Limited for pointing us in this direction.*

4 *Bursar is the person who manages the financial affairs of a university.*

Although Keynes eventually concluded that long-term value investing was the best approach (as we shall describe in more detail towards the end of this report), he was essentially what we would call today a macro hedge fund manager. He invested and speculated in equities – preference and ordinary, British and American –, global bonds, currencies, commodities (his writings on this subject take almost 400 pages of Volume XII) and real estate. He started trading on a consistent basis in 1919 and continued to be active almost until his death, even though he was less active in his final years.

Also like most hedge funds, he always operated on a leveraged basis, sometimes with quite large amounts of debt. This is certainly the reason behind one of his most famous quotes: *"Markets can remain irrational far longer than you or I can remain solvent"*. Of course, this only makes sense in the context of a leveraged investor.

Because of his trading boldness and leverage, the results he achieved in his personal dealings were dizzyingly volatile. According to Keynes's own papers, he actually had a negative net worth in 1920, the result of wrong positions in currencies, especially in marks, lire and French francs. From this reversal, he recovered quickly but it took him longer in other episodes, as can be seen in the table in the next page.

There are many remarkable points to be made about this table. Even though this 26-year period included the stock market crash of 1929, the Great Depression, one other major recession and a world war, Keynes still managed to generate a compound rate of 13.2% per annum. By comparison, the UK and US stock markets returned only 1.8% and 2.5%[5], respectively.

But it was quite a bumpy ride. He had 5 years of drawdowns in excess of 30% (out of 8 negative years). In 1929, his net assets were less than half of what he had started with 10 years before. From the peak in 1924 to the trough in 1929, he was down 88% and was only back above his high water mark in 1934.

5 *The source of this information is Table 8, page 113 of the same Volume XII.*

Keynes personal gross and net assets: 1919-1945

	Securities	Other Assets	Loans	Net Assets	Annual Results	Accumulated since 1919
1919	14.453	17.360	15.498	16.315		100
1920	19.000	-00	20.837	-1.837	-111%	-11
1922	14.288	10.050	2.720	21.618	n.m.	133
1923	26.839	8.725	1.200	34.364	59%	211
1924	56.976	8.021	1.200	63.797	86%	391
1925	26.507	18.303	1.200	43.610	-32%	267
1926	27.550	15.450	2.200	40.800	-6%	250
1927	78.500	12.400	46.900	44.000	8%	270
1928	35.480	3.370	25.790	13.060	-70%	80
1929	18.165	3.650	14.000	7.815	-40%	48
1930	20.565	56.960	65.000	12.525	60%	77
1931	19.488	7.575	11.965	15.098	21%	93
1932	23.994	17.552	19.774	21.772	44%	133
1933	78.925	55.156	78.859	55.222	154%	338
1934	299.363	11.987	165.343	146.007	164%	895
1935	377.450	31.440	188.271	220.619	51%	1.352
1936	692.059	113.950	299.347	506.662	130%	3.105
1937	346.697	58.582	190.035	215.244	-58%	1.319
1938	250.285	37.752	106.470	181.567	-16%	1.113
1939	267.605	41.026	109.136	199.495	10%	1.223
1940	188.353	43.392	60.655	171.090	-14%	1.049
1941	193.992	40.042	28.753	205.281	20%	1.258
1942	243.057	30.736	19.720	254.073	24%	1.557
1943	308.058	36.956	31.643	313.371	23%	1.921
1944	365.864	35.613	46.167	355.310	13%	2.178
1945	436.194	13.930	38.886	411.238	16%	2.521

Source: The Collected Writings of John Maynard Keynes, volume XII, edited by Donald Moggridge, published by Cambridge University Press

On the other hand, he had 8 years of returns higher than 30%, of which 3 were above 100%. Consistently exceptional gains were made during the 5-year period from 1932 to 1936 when he compounded at 102% per annum (he then lost 58% in 1937). In fact, he died without being able to take his portfolio above the high water mark of 1936.

Adjusted by inflation, Keynes' net worth of £ 411,238 in 1945 was roughly equivalent to £ 14 million today. If we use GDP per capita as the adjusting factor[6], this figure would increase to £ 48 million.

Keynes' track record as manager of King's College investments was also very good. These investments were divided into a few different buckets and the so-called The Chest is the most relevant for analysis as it was not constrained in the securities it could invest in. In the same 26-year period that we looked at Keynes' personal portfolio, the compound return of The Chest was 9.8% per annum[7], much better than stock market returns in the same period. This is a quite respectable performance considering he did the not have the same degrees of liberty as he had for his own account and probably did not use as much leverage.

Keynes suffered criticism from his fellows at King's College. He was a heavy net seller of real estate in the 1920's and early 30's and his critics did not approve of the fact that he used the proceeds to "speculate" in the stock market. In a *post mortem* analysis prepared to the Estates Committee in May of 1938, Keynes responded to such criticism:

"Some Bursars will buy without a tremor unquote and unmarketable investments in real estate which, if they had a selling quotation for immediate cash available at each Audit, would turn their hair grey. The fact that you do not know how much its ready money quotation fluctuates does not, as is commonly supposed, make an investment safer… But it is true, unfortunately, that the modern organisation of the capital markets requires for the holder of quoted equities much more nerve, patience and fortitude than from the holder of wealth in other forms. Yet it is safer to be a speculator

6 *Arguably, adjusting historic wealth figures by inflation does not reflect the increase in true buying power over time. Some economists would prefer to use GDP to make this adjustment as it would give a better measure of the economic power of such wealth.* However, if one is adjusting the price of a good, it would be better to use inflation or wage measure. If you are interested in the subject, we would suggest you spend some time at www.measuringworth.com

7 Although the return of The Chest was lower than that of his personal portfolio, it must be said that it was also much less volatile. The biggest drawdown of the fund, from 1927 to 1931 was 50%, which compares with an 82% drawdown in his personal account from 1927 to 1929.

than an investor in the sense of the definition which I once gave to the Committee that a speculator is one who runs risks of which he is aware and an investor is one who runs risks of which he is unaware."

Whereas Keynes had almost full discretion as a Bursar of King's, his experience as a board member of a handful of institutions in the City was completely different. Even with his reputation and power of persuasion, sometimes it was difficult to convince other people who did not have his degree of conviction, let alone his stamina, to deal with massive drawdowns, not to exit the markets at the wrong moments. But it was in the context of some of these discussions that he had the opportunity to expose some of his most interesting ideas.

There were many instances when Keynes had to defend his position that it was better to have a concentrated portfolio than a hugely dispersed one. In 1940, F.C. Scott, a board member of Provincial, wanted to reduce the size of the position in Electric Power and Lighting Preferred and United Gas Preferred, two companies that Keynes knew well and liked. After a bit of the history of each position, Keynes wrote: *"You won't believe me, I know. But it is out of these big units of the small number of securities one feels absolutely happy that all one's profits are made… Out of the ordinary mixed bag of investments nobody ever makes anything."*

Then in January 1942, he wrote to Scott again, in a clearly bad mood, to apologise for having bought too large a position in a specific stock: *"Sorry to have gone too large on Elder Dempster… I was also suffering from my chronic delusion that one good share is safer than ten bad ones, and I am always forgetting that hardly anyone else shares this particular delusion."*

Scott, who also wrote very well, responded in a long letter after almost two weeks: *"… So I feel inclined to challenge your assumption that on such figure information as we have on Elder Dempster papers, you are entitled to say you have picked a winner or that ten other investments picked with some reasonable care might not prove a sounder choice. You know perfectly well you villainously beg the question in the form in which you put it. At least if I had given £ 20,000 into your hands to invest, I should with reason feel easier in my mind if I knew you had spread it over four investments rather than one."*

Despite saying in the first paragraph of his reply that he would limit himself to a few points, Keynes went on to write a pretty long letter in which the points that are pertinent to the issue of concentration were the following:

"…

(1) I confess that I bought too much of this particular security and would have done better to buy less.

(2) In saying that I preferred to buy one good security to ten bad ones, of course, as you say, I was begging the question. I ought to have said that I preferred one investment about which I had sufficient information to form a judgement to ten securities about which I know little or nothing…."

In an analysis he made of the returns obtained in the 9-year period ending in December of 1937, Keynes made the argument that King's College better performance was a result of its more concentrated portfolio of 130 investments versus 325 of Provincial: *"I am convinced that the good results shown by King's are mainly due to the large proportion of its assets held in the less than 50 favourite securities. To carry one's eggs in a great number of baskets, without having the time or opportunity to discover how many have holes in the bottom, is the surest way of increasing risk and loss."*

On another occasion, in 1934, Keynes wrote to Scott to defend his holdings in yet another stock in the portfolio. His final paragraph was clear about his strong preference for a few large positions although he recognised that there was a limitation to this approach: "… *It is a mistake to think that one limits one's risk by spreading too much between enterprises about which one knows little and has no reason for special confidence. Obviously this principle ought not to be carried too far. The real limitation, however, on its application in practice is in my experience the small number of enterprises about which at any given time one feels in this way."*

Keynes clearly relished being a contrarian investor but had to contend with the reactions from more conventional thinkers. In 1944, he suggested that the Bursar of Eton, a school he also provided advice to, should buy Australian bonds. A City banker named Jasper Ridley, who also advised the Bursar, was against the idea as in fact he was against most of Keynes unorthodox suggestions. After a heated discussion on the phone, Keynes wrote to Ridley:

"Sorry to be so quarrelsome on the telephone. My central principle of investment is to go contrary to general opinion, on the ground that, if everyone agreed about its merits, the investment is inevitably too dear and therefore unattractive. Now obviously I can't have it both ways – the whole point of the investment is that most people disagree with it…"

Another noteworthy issue of debate present in Keynes' discussions with Scott from Provincial was on the investment objective of the insurance company. In the same letter he wrote about too much concentration and the Elder Dempster position, Scott argued that their first primary duty was *"… to so invest our funds, which are the security we offer our policy-holders for the fulfilment of our contracts, that the public confidence will never be impaired. Our second task is to ensure that the bulk of them are in semi-liquid form, and the third is to earn a reasonable rate of interest return."* He went on to say that capital gains should not be a concern and that they should work to reduce the volatility of their returns (*"… reduce the swing of the pendulum between high and low market valuations to the minimum."*).

In his long response, Keynes sort of dodged the main point of Scott. At that stage of his life (1942), he disregarded short-term market fluctuations so much that he could not understand how others could be so impacted by it. His main argument to Scott was that he was buying securities *"… where I am satisfied as to assets and ultimate earnings power and where the market price seems cheap in relation to these"*. If he was right about this assessment, he would achieve both measures of success in investing: "safety-first" (his interpretation of the first primary duty mentioned by Scott) and capital gains (or capital profits, as they referred to). Because markets tend to go up and down violently, an effective safety-first policy would almost always lead to capital profits.

He also made the distinction between temporary mark to market losses and permanent losses. In defending Elder Dempster, Keynes wrote: *"I have no particular expectation of this share going up at any early date. I picked it because it seemed to me exceedingly safe and, apart from short-term fluctuations, unlikely to go down in the years ahead."* Just like many value investors would say today.

The other argument Keynes kept coming back to in his letter about the objectives of the investment policy of an insurance company was the benefit of concentration. He developed it a bit further by comparing again the returns of Provincial and King's over the previous 20 years. His conclusion was that King's had done immeasurably better because it had larger positions as a percentage of their total assets and was not as diversified. He had been able to restrict King's portfolio to stocks of companies he knew more about (he certainly had more discretion at King's than at Provincial) and this had led to almost no large scale losses and many positive results: *"There had been big fluctuations in market prices. But none of the main investments had, in the end, turned out otherwise than right. Thus, against the profits that inevitably accumulate, there were comparatively few losses to offset. Virtually all our big holdings had come right. Now, that is what I call a safety-first policy as judged by results."*

From our perspective, the most interesting lesson to be learnt from Keynes was how his view on the impact of the macroeconomic environment on investing evolved along the years. In 1924, he was one of the directors of The Independent Investment Company, an investment vehicle which raised capital from the public. Here is what the prospectus of IIC said about its investment strategy:

"… aiming at obtaining a higher return on the capital employed than is open with safety to the individual investor, and also having special regard to certain principles of investing which are now well recognised but have as yet been acted on in only a limited measure. It is now known that fluctuations in the relative values of long-dated and short-dated fixed-interest securities and also of fixed-interest securities generally and of ordinary shares are all affected by a periodic credit cycle. Changes in the short-period rate of interest affect the value of long-dated securities to a greater degree than should strictly be the case, with the result that considerable profits can be made by changing from one class to another at the appropriate phases of the credit cycle… The result of accumulated experience on these matters is to make it clear that the course of events is sufficiently regular to enable those who are in close and constant touch with the financial situation in certain instances to anticipate impending changes in the course of the credit cycle."

Easier said than done. IIC was not a successful venture as, despite what was written in the prospectus, the directors did not anticipate the big fall in the market that occurred at the end of that decade. Keynes had a particularly tough time dealing with O. T. Falk, another director of IIC whom he had first met while still at the Treasury and had become friends with. His disagreements with Falk intensified during the slump of the markets and the firm was paralysed for a while as the only other director refused to take sides. Keynes distanced himself from IIC after this event and even more after his illness in 1937.

Only 14 years after the prospectus of IIC was produced, Keynes' opinion about investing had changed completely. In May 1938, he prepared the *post mortem* analysis for both Provincial and the Estates Committee of King's College that we already alluded to. In both, he made it clear that despite having been the principal inventor of credit cycle investment, he had never seen it succeed. Here is a curious and simplistic summary of his ideas on market timing contained in a cover letter that accompanied his analysis of Provincial: "*The whole thing is really summed up in something that I said in the original version of my memorandum. It is a much safer and easier way in the long run by which to make investment profits to buy £ 1 notes* *at 15s than to sell £ 1 notes at 15s in the hope of buying them at 12s 6d*[8]*."* He also makes the point that there will always be £ 1 notes for sale at 15s precisely because many believe that it will go to 12s 6d.

The *post mortem* analysis prepared for King's College was more precise in describing what he then viewed as a successful investment approach. He started section II of his analysis with a *mea culpa*: *"In fact, the chief lesson I draw from the above results is the opposite of what I set out to show when, what is now nearly 20 years ago, I first persuaded the College to invest in ordinary shares. At that time, I believed that profit could be made by what was called a credit cycle policy, namely by holding such shares in slumps and disposing of them in booms…".*

And then he goes on to explain with clarity and precision his three principles for investing:

"I believe now that successful investing depends on three principles:

1. *A careful selection of a few investments (or a few types of investment) having regard to their cheapness in relation to their probable actual and potential intrinsic value over a period of years ahead and in relation to alternative investments at the time;*

2. *A steadfast holding of these in fairly large units through thick and thin, perhaps for several years, until either they have fulfilled their promise or it is evident that they were purchased on a mistake;*

3. *A balanced investment position, i.e. a variety of risks in spite of individual holdings being large, and if possible opposed risks (e.g. a holding of gold shares amongst other equities, since they are likely to move in opposite directions when there are general fluctuations)."*

Keynes was perhaps the best economist of his time. He was also extremely well informed. He had contacts and influence with all important policy makers in the UK and, to some extent, in the US and Europe. His understanding of the intricacies of many different markets was astounding. He lived in a world where information was neither widely nor immediately available, and there was much less scrutiny into insider trading. He was the inventor of market timing, as we would call it, or credit cycle investment, as he called it. If there ever was anyone, at any point in time, who really was well positioned to succeed consistently as a macro investor, Keynes was this person.

Still, we find him talking about intrinsic value, concentration and long-term horizon (*"through thick and thin"*) in his three principles. This is what we find most remarkable.

In fact, Keynes and Buffett are not so different. Both are great fans of probability, both are involved with insurance (the quintessential probability industry) and both invest on a leveraged basis (although, to be fair to Buffett, his leverage, the float from his insurance companies, is not callable). Although Keynes knew and interacted with Ben Graham, there is no indication that he read Security Analysis, which was first published in 1934. His source of inspiration for the intrinsic value comments could well have been the book.

There is, though, one big difference between Keynes and Buffett. Apparently, Keynes only dedicated about 30 minutes per day to his investing activities on a regular basis, and he did it while still in bed after waking up. This was the time when he called brokers, read the financial pages of the newspapers and perused company reports. His investment results gain a different perspective when we realise how little time he actually spent on the subject.

We apologise for the obviously exaggerated use of quotes in this report. However, we felt it was justified because it was relevant to look at Keynes' exact words, the construction of his sentences, his emphasis, etc. Hope you enjoyed reading his writings as much as we did.

Rio de Janeiro, October 29th, 2013.

DYNAMO COUGAR x IBX x IBOVESPA Performance up to September/2013 (in R$)

Period	Dynamo Cougar	IBX	Ibovespa
60 months	159,7%	10,5%	5,7%
36 months	46,8%	-2,6%	-24,6%
24 months	44,2%	18,1%	0,0%
12 months	9,8%	1,5%	-11,5%
Year to date	3,8%	-3,2%	-14,1%

NAV/Share on September 30th = R$ 418,701958355

8 Up to 15 February 1971 (Decimal Day, or D-Day), monetary amounts in the UK were expressed by pounds (£), each of which was worth 20 shillings ("s"), each of which was worth 12 pence ("d", not a typo). As such, each pound was worth 240 pence.

DYNAMO COUGAR x FGV-100 x IBOVESPA
(Performance – Percentage Change in US$ dollars)

Period	DYNAMO COUGAR* Year	DYNAMO COUGAR* Since 01/09/93	FGV-100** Year	FGV-100** Since 01/09/93	IBOVESPA*** Year	IBOVESPA*** Since 01/09/93
1993	38,8%	38,8%	9,1%	9,1%	7,7%	7,7%
1994	245,6%	379,5%	165,3%	189,3%	62,6%	75,1%
1995	-3,6%	362,2%	-35,1%	87,9%	-14,0%	50,5%
1996	53,6%	609,8%	6,6%	100,3%	53,2%	130,6%
1997	-6,2%	565,5%	-4,1%	92,0%	34,7%	210,6%
1998	-19,1%	438,1%	-31,5%	31,5%	-38,5%	91,0%
1999	104,6%	1.001,2%	116,5%	184,7%	70,2%	224,9%
2000	3,0%	1.034,5%	-2,6%	177,2%	-18,3%	165,4%
2001	-6,4%	962,4%	-8,8%	152,7%	-25,0%	99,0%
2002	-7,9%	878,9%	-24,2%	91,7%	-45,5%	8,5%
2003	93,9%	1.798,5%	145,2%	369,9%	141,3%	161,8%
2004	64,4%	3.020,2%	45,0%	581,2%	28,2%	235,7%
2005	41,2%	4.305,5%	30,8%	790,7%	44,8%	386,1%
2006	49,8%	6.498,3%	43,2%	1.175,8%	45,5%	607,5%
2007	59,7%	10.436,6%	68,4%	2.048,7%	73,4%	1.126,8%
2008	-47,1%	5.470,1%	-50,1%	973,3%	-55,4%	446,5%
2009	143,7%	13.472,6%	151,9%	2.603,3%	145,2%	1.239,9%
2010	28,1%	17.282,0%	15,2%	3.013,2%	5,6%	1.331,8%
2011	-4,4%	16.514,5%	-20,6%	2.373,0%	-27,3%	929,1%
2012	14,0%	18.844,6%	11,8%	2.664,3%	-1,4%	914,5%

2013	DYNAMO COUGAR* Month	DYNAMO COUGAR* Year	FGV-100** Month	FGV-100** Year	IBOVESPA*** Month	IBOVESPA*** Year
JAN	1,7%	1,7%	3,3%	3,3%	0,8%	0,8%
FEB	1,7%	3,4%	-2,7%	0,5%	-3,3%	-2,5%
MAR	-0,9%	2,4%	-5,6%	-5,2%	-3,7%	-6,2%
APR	0,8%	3,3%	-1,4%	-6,5%	-0,2%	-6,4%
MAI	-4,7%	-1,6%	-11,0%	-16,8%	-10,1%	-15,9%
JUN	-8,2%	-9,7%	-9,5%	-24,7%	-14,7%	-28,2%
JUL	-0,5%	-10,1%	-0,5%	-25,0%	-1,7%	-29,4%
AUG	-2,5%	-12,4%	0,1%	-25,0%	0,1%	-29,3%
SEP	8,6%	-4,9%	9,8%	-17,6%	11,3%	-21,3%

Average Net Asset Value for Dynamo Cougar (Last 12 months): R$ 1.998.264.619

(*) The Dynamo Cougar Fund figures are audited by Price Waterhouse and Coopers and returns net of all costs and fees, except for Adjustment of Performance Fee, if due. (**) Index that includes 100 companies, but excludes banks and state-owned companies. (***) Ibovespa closing.

Please visit our website if you would like to compare the performance of Dynamo funds to other indices:

www.dynamo.com.br

DYNAMO

DYNAMO ADMINISTRAÇÃO DE RECURSOS LTDA.
Av. Ataulfo de Paiva, 1235 / 6º andar. Leblon. 22440-034. Rio. RJ. Brazil. Phone: (55 21) 2512-9394. Fax: (55 21) 2512-5720

PRINTED IN RECYCLED PAPER