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POINT of VIEW

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Our Perspective on Issues Affecting Global Financial Markets

John Maynard Keynes: Economist by Day, High Flying Portfolio Manager by Night

The most famous economist of all time was also the chief investment officer at King's College, Cambridge for 25 years. Apart from producing 16% annual returns, Keynes' work as an investor tells us that the keys to investment performance often reside outside of economics.

John Maynard Keynes: Economist by Day, High Flying Portfolio Manager by Night

John Maynard Keynes. You know him as the author of the groundbreaking 1936 *General Theory of Employment, Interest and Money*. We introduce here an altogether different Keynes: Keynes the Chief Investment Officer (CIO). From 1924 until his death in 1946, Keynes was the CIO of Cambridge's King's College.[1] While economists rarely furnish practical advice, the grandfather of modern economics transcended his own theory and produced superb investment returns.

Over his twenty-five year CIO career (he managed the endowment even before obtaining the CIO title), Keynes brought annualized returns of 16% to the King's College Discretionary portfolio. That compares to returns of 10%, 7%, and another 7% for the UK equity market, the King's College Restricted portfolio (consisting mostly of real estate), and UK government bonds over the same time period.[2] What is more, Keynes made 8% above Treasury-bill yields (what many today call "alpha") with lower average volatility than the market.

Was it the consummate economist's superior knowledge of the inner workings of macroeconomics which led to his success? Precisely the opposite. As we show below, Keynes' virtuous performance came as the result of his willingness to question prevailing opinion and act against the consensus. Keynes' convictions to diversify out of illiquid, widely-held real estate assets, to invest abroad, and to maintain a very long time horizon, drove his excellent investment returns.

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THE LANDED ENDOWMENTS

Among the investment orthodoxies in Keynes' early 20th century college endowment world was the primacy of real estate holdings. Often held as the legacy assets from founding bequeathment, land and property dominated university investment portfolios. In the case of King's College, in 1453 King Henry VI endowed thirty-six manorial estates and eight appropriated rectories (clerical landholdings). Annual income from leases, timber and crop sales replenished the coffers for the next four centuries.

To be fair, "until the late 1850s the [Cambridge] colleges were prohibited by their statutes from selling land."[3] But data from as late as 1910 show little change after the statutes modernized. In the decade before Keynes took control of King's College funds, real estate income provided 85% of the college's total income. By way of context, King's College's real estate holdings today produce only 13% of King's College annual income (see Figure 1).

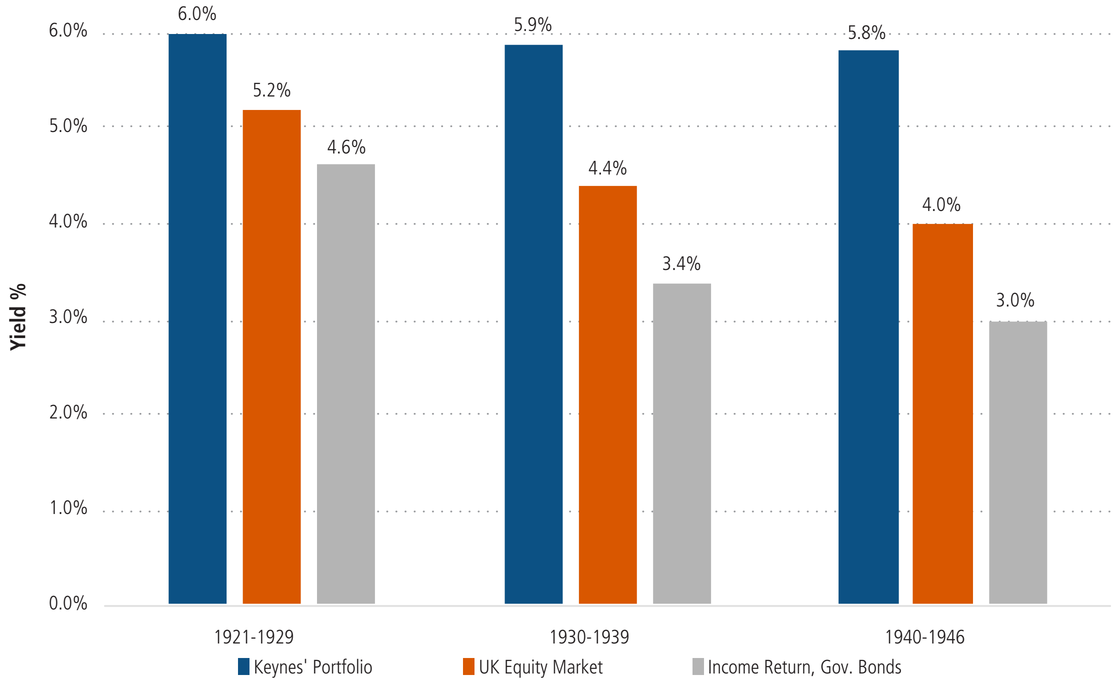
After Keynes assumed the helm, his first priority was to divest a portion of the real estate portfolio. His reasoning was twofold. First and foremost, Keynes stressed the cost of illiquidity and the danger

fig. 1 FROM PROPERTY MANAGEMENT TO INVESTMENT MANAGEMENT: KING'S COLLEGE INCOME BY DECADE

	1910	1920	1930	1940	1950	1960	1970	1980	1990	2000	2010
Total income £'000	36	52	81	93	219	313	572	2,218	5,582	7,712	13,033
	%	%	%	%	%	%	%	%	%	%	%
Property Income	85	71	50	46	41	32	29	31	30	13	13
Securities Income	7	14	12	24	34	38	36	26	35	28	22
Academic Fees	2	10	8	7	5	6	7	15	11	15	17
Residence, Catering, etc	7	5	26	23	20	22	28	27	22	33	34
Donations	0	0	4	1	0	2	0	1	1	11	14
	100	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Chambers, David, Elroy Dimson and Justin Foo (2014). "Keynes, King's and Endowment Asset Management." NBER Working Paper 20421

fig. 2 OUT-YIELDING THE COMPETITION: DIVIDEND YIELD COMPARISON FOR KEYNES' PORTFOLIO



Source: Chambers, David, Elroy Dimson and Justin Foo (2014). "Keynes, King's and Endowment Asset Management." NBER Working Paper 20421

of comfort with an investment portfolio that was never "marked-to-market." Agricultural and land holdings were rarely sold: leases turned over, farm managers changed, but by and large, institutions were not buying and selling real estate. As a result, few institutional investors assigned value to liquidity. But Keynes, who had other ideas for asset allocation, fretted over not being paid a premium for locking up capital in real estate investments.

Inaccessible capital wasn't the only hidden cost of real estate investing. Later in his career, after a particularly challenging 1938, Keynes reminded the King's College investment committee of the virtues and vices of public price quotes: "Some Bursars will buy without a tremor unquoted 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 a safe one."[4] The balance of liquidity and the dangerous illusion of prices not marked to market presented as much of an investment problem for Keynes as it does for any CIO today.

The second reason Keynes encouraged the college to diversify out of real estate was that doing so sacrificed very little income and gained the upside of industrial growth. Researchers have concluded that the dividend yield on Keynes' King's College portfolio averaged well in excess of the average dividend yield on the UK equity market and the current yield on government bonds (see Figure 2).

Most impressive about Keynes' decision to direct a large portion of the endowment to shares was the fact that few other institutions pursued the same strategy. From 1930 to 1939, the King's College average allocation to equities was 57%. By way of contrast, other endowments with more than $15 million in assets (gigantic at the time) invested only 25% of their portfolios in equities.

Then as now, following the herd offered little in the way of returns. Keynes' maverick decision to move institutional funds into the equity market and out of real estate was not popular. However, recognizing that the past need not chain present and future investment policy, Keynes' contrarian equity allocation nearly put King's on par with Trinity as the top earning college at Cambridge.

«AND INDEED, IF ANY GLOBAL MACRO FUND MANAGER WERE CAPABLE OF FORETELLING THE EVOLUTION OF THE ECONOMY (AND PROFITING FROM IT), ONE SHOULD THINK IT MIGHT BE JOHN MAYNARD KEYNES.»

fig. 3 HOME BIAS IN EQUITIES IN 2008 FOR SELECTED COUNTRIES

	Domestic Market in % of World Market Capitalization	Share of Portfolio in Domestic Equity in %
Australia	1.8	76.1
Brazil	1.6	99
China	7.8	99.2
Canada	2.7	80.2
Euro Area	13.5	57
Japan	8.9	73.5
South Africa	1.4	52
South Korea	1.4	89
Sweden	0.7	44
Switzerland	2.3	51
United Kingdom	5.1	54.5
United States	32.6	77.2

Source: Coeurdacier, Nicolas, and Hélène Rey (2013). "Home Bias in Open Economy Financial Macroeconomics." Journal of Economic Literature, Vol. 51, No.1, pp. 63-115

HOME AWAY FROM HOME: INTERNATIONAL DIVERSIFICATION

Not only did Keynes elevate the earnings power of the King's College endowment by shifting into equity securities, he also managed to avoid the plague of home bias and diversify share holdings outside of the United Kingdom.

Precisely defined, home bias is "the strong preference for domestic [securities] that investors in international markets exhibit, despite the well-documented gains from international diversification."[5] Behavioral explanations, transaction costs, and changes in the ways in which savers invest (now mediated through funds) have all been advanced as explanations for why investors prefer to remain local, even when their home country constitutes a very small fraction of the investable universe (see Figure 3).

In 1920 the United Kingdom produced 10% of total global economic output while the United States accounted for 46%. By 1950, shortly after Keynes' death, the US accounted for 52% of global activity, while the UK accounted for less than 7%.[6] To his credit, and in spite of home bias, "Keynes championed the virtues of US common stocks."[7]

He also put his money where his mouth was. From 1921 onward, Keynes insisted on diversifying away from UK common stocks. Whether in India, Africa, or the US, roughly 40% of the total equity allocation was invested outside of the UK (see Figure 4 on next page).

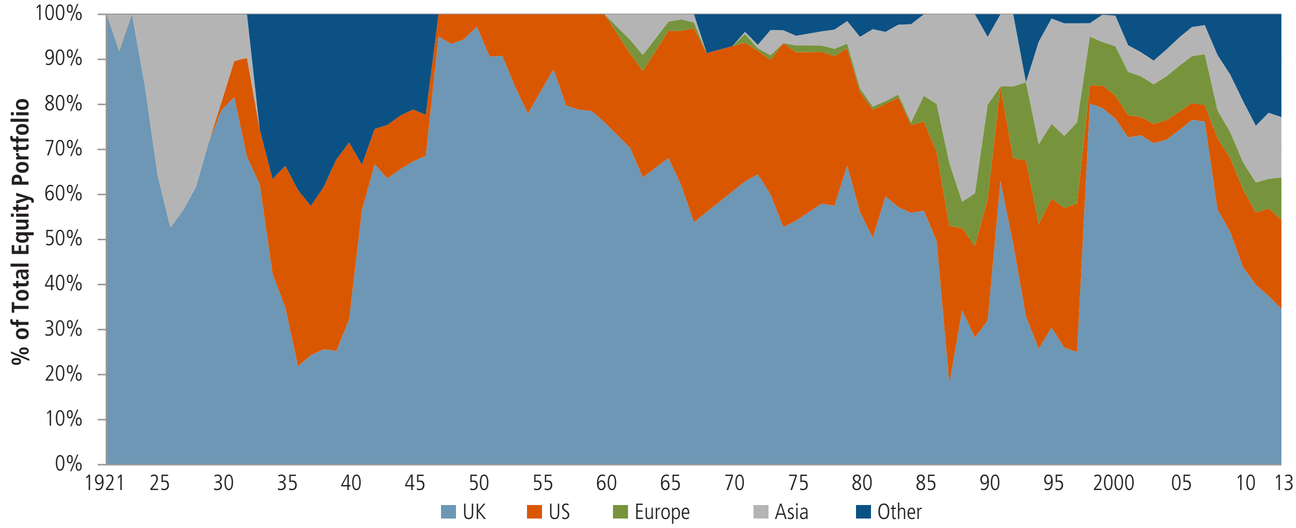
FOR THE LONG HAUL – KEYNES AND THE INSTITUTIONAL TIME HORIZON

Keynes' ability to put money in US railroad stocks during the depression, or to buy equity in speculative British/Indian ventures was as much a consequence of his position as an institutional investor who could afford to wait as it was about fundamental attractiveness. For all the virtues of global diversification, it was Keynes who famously quipped, "the market can stay irrational longer than you can stay solvent."

«THE REMARKABLE GROWTH OF PEER-TO-PEER FINANCE FOLLOWING THE FINANCIAL CRISIS SHOULD NOT COME AS SUCH A SURPRISE… INVESTORS AROUND THE WORLD ARE SEARCHING FOR YIELD.»

But it was a lesson hard won. Early in his investing career, Keynes practiced what most today know as "global macro" investing. Using his economics acumen, he invested under the assumption that "he had the ability to time moves into and out of equities, bonds and cash." The technique is now called "market-timing" and often not spoken of nicely! And indeed, if any global macro fund manager were capable of foretelling the evolution of the economy (and profiting from it), one should think it might be John Maynard Keynes.

fig. 4 STOCKING UP: KING'S ENDOWMENT ASSET ALLOCATION 1919-2013



Source: Chambers, David, Elroy Dimson and Justin Foo (2014). "Keynes, King's and Endowment Asset Management." NBER Working Paper 20421

The truth is rather different. Not even the grandfather of modern macroeconomics could predict the future. In 1938, Keynes confessed to the King's College investment committee: "We have not proved able to take much advantage of a general systematic movement out of and into ordinary shares…at different phases of the trade cycle."

Thus, in the latter part of his investing career, Keynes' eschewed speculative habits and assumed an investor's mindset: his time horizon extended, portfolio turnover fell, and the total number of securities in his portfolio declined. Sounding more like Warren Buffet than George Soros, Keynes reflected in 1934, "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 … there are seldom more than two or three enterprises at any given time in which I personally feel myself entitled to put full confidence."

Switching investment styles produced better returns for Keynes and King's College. University of Cambridge researchers have estimated that in the time from 1924 to 1932, average monthly returns were 0.2%. From 1932 to 1946, in the period after Keynes switched from frenetic speculator to longer-term investor, average monthly returns improved to 0.7%. The performance of the portfolio speaks for itself . (see Figure 5) For our cynical readers, keep in mind that both periods featured large market corrections (in 1930 and in 1938).

WHY FUND MANAGERS CAN STILL LEARN FROM KEYNES

Uniting each of the three elements highlighted in Keynes' investing career–openness to new asset classes, geographic diversification, and avoiding market-timing and macroeconomic predictions–was a profound contrarian impulse. In each case, Keynes flew in the face of accepted wisdom, preferring to find what worked, not what was popular.

To be sure, his untouchable contemporary status granted him considerable leeway with the board of directors. But by honestly surveying the investment landscape and asking questions which tested the accepted narrative of "what college endowments do," Keynes provided his institution with healthy long-term returns and a more stable endowment through time.

SOURCES

1 Keynes was technically the first Bursar, who held responsibility for endowment investment.

2 Chambers, David, Elroy Dimson and Justin Foo (2014). "Keynes, King's and Endowment Asset Management." NBER Working Paper 20421.

3 *Ibid.*

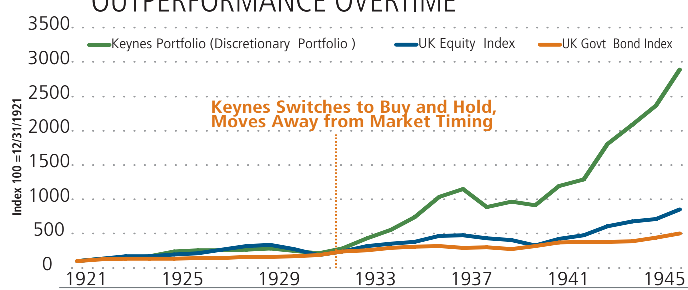
4 Capitalideasonline.com. Accessed 5 December 2014.

5 Coval, Joshua D. and Tobias Moskowitz (1999). "Home Bias at Home: Local Equity Preference in Domestic Portfolios." The Journal of Finance, Vol. 54, No. 6, pp. 2045-2073.

6 Goetzmann, William N. and Philippe Jorion (1999). "Global Stock Markets in the 20th Century." The Journal of Finance, Vol. 54, No. 3, pp. 953-980.

7 *Ibid.*

fig. 5 KEYNES THE PORTFOLIO MANAGER'S OUTPERFORMANCE OVERTIME



Source: Chambers, David, Elroy Dimson and Justin Foo (2014). "Keynes, King's and Endowment Asset Management." NBER Working Paper 20421

US DOMICILED MUTUAL FUNDS

CASH BALANCE
Payden/Kravitz Cash Balance Plan Fund

EQUITY
Equity Income Fund

GLOBAL FIXED INCOME
Emerging Markets Bond Fund
Emerging Markets Corporate Bond Fund
Emerging Markets Local Bond Fund
Global Fixed Income Fund
Global Low Duration Fund

TAX-EXEMPT FIXED INCOME
California Municipal Income Fund

US FIXED INCOME
Absolute Return Bond Fund
Corporate Bond Fund
Cash Reserves Money Market Fund
Core Bond Fund
Corporate Bond Fund
Floating Rate Fund
GNMA Fund
High Income Fund
Limited Maturity Fund
Low Duration Fund
Strategic Income Fund
US Government Fund

DUBLIN DOMICILED UCITS FUNDS

EQUITY
World Equity Fund

FIXED INCOME
Absolute Return Bond Fund
Global Emerging Markets Bond Fund
Global Emerging Markets Corporate Bond Fund
Global Emerging Markets Local Bond Fund
Global Government Bond Index Fund
Global High Yield Bond Fund
Global Inflation-Linked Bond Fund
International Bond Fund
International Short Bond Fund
Sterling Corporate Bond Fund – Investment Grade
US Core Bond Fund

LIQUIDITY FUNDS
Euro Liquidity – Enhanced Cash Fund
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US Dollar Liquidity – Enhanced Cash Fund

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