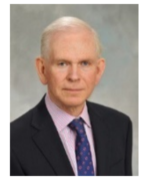


Aug 2018

The Race of Our Lives Revisited[1]

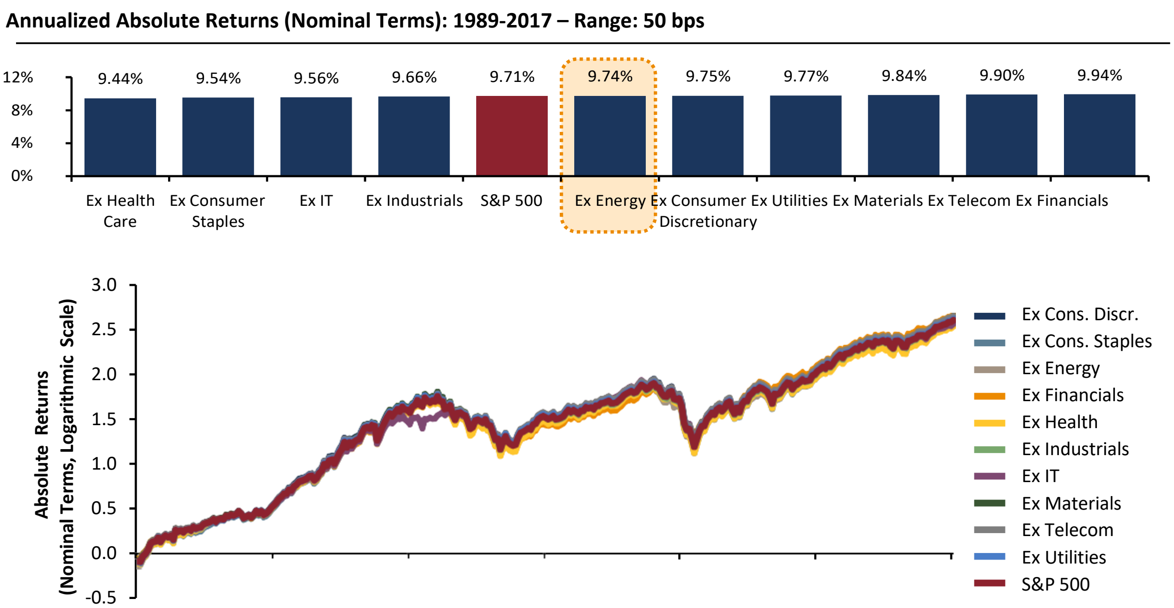
Jeremy Grantham

Part VII: The Alleged Perils of Divestment

It should be pretty clear from this discussion that if you're messing around with oil stocks, you're taking the serious risk of ending up with stranded assets, and if you're messing with chemical companies of the toxic kind, you are taking some risks also. Oil companies are being sued everywhere because they've been caught red-handed. They were writing for peer-reviewed journals in the late 1970s, proving that carbon dioxide was dangerous and that the ocean levels would rise. They took advantage of their knowledge: they took it into account to drill in the Arctic and to site their refineries. And they have misrepresented the damage they knew their products would cause. They are vulnerable and face many legal battles as we speak. Yet investment committees, the most conservative groups on the planet as we know – I have spoken to perhaps 3,000 or so of them – maintain that if they divest from oil it will ruin their performance. And that in any case, ethics, à la Friedman, should not come into it. If they accept any constraint at all, they feel, it will ruin their performance. I'm sympathetic up to a point: you don't want everyone with a bee in his bonnet to come marching in. But this issue – climate change – is the mother and father of all exceptions. It is about our survival. Exhibit 34 shows what we did to test this long-held divestment hypothesis. We took out each of the 10 major groups in the market for 30 years, leaving only 9 of the 10 groups in each portfolio, and what we found was

that it didn't make any difference. The entire range from best to worst was only 50 basis points. The return you get without Energy is highlighted – you make 3 bps more without Energy. Look at the graph. Taken together, other than IT in the 2000 bubble, they look like a single series. Even the 2000 deviation settled back as if the bubble had never occurred.

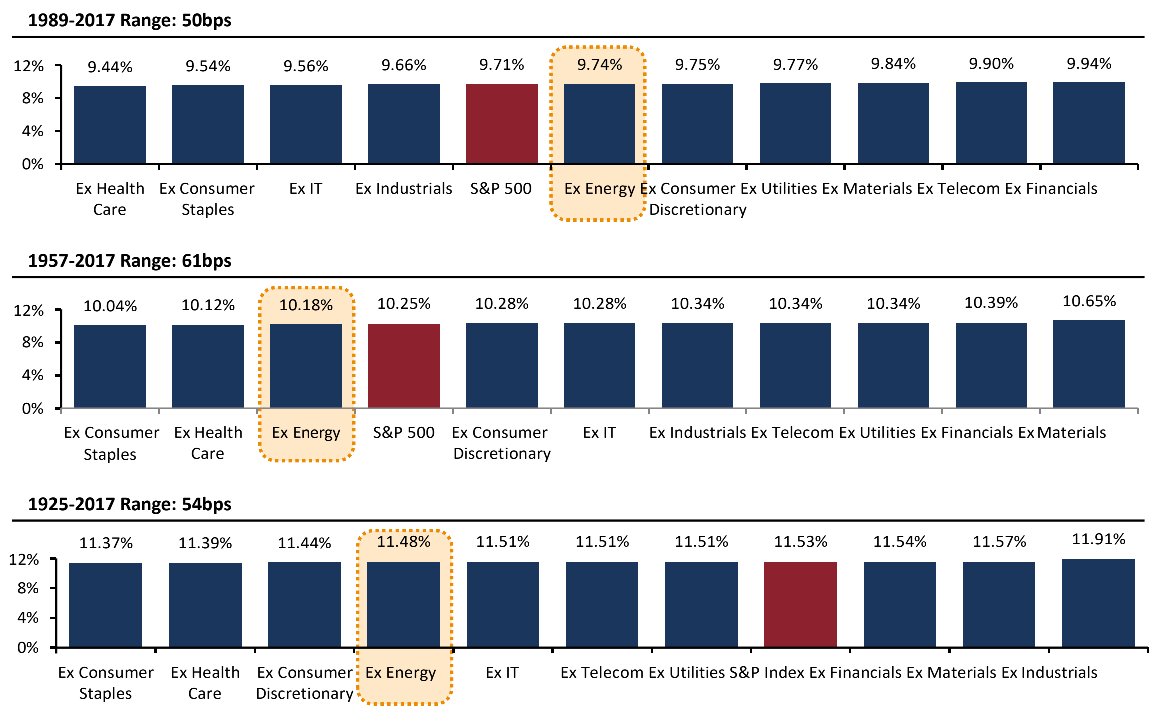
Exhibit 34: You Can Divest from Oil – or Anything Else – Without Consequence



As of 9/30/17
Source: S&P, GMO

After I first showed this exhibit I had a suspicion that we had picked a lucky time period. My conscience nagged me for a while. So, we went back in history, first to 1957, and then with some considerable effort all the way back to 1925, as shown in Exhibit 35. Look at 1925: the range between missing the best group and the worst has soared from plus or minus 50 basis points to plus or minus 56 basis points. When you divest from oil or chemicals, the starting assumption must be that it will cost you a few tiny basis points of deviation, and it's just as likely to be positive deviation as negative. These are the facts – not the hearsay of investment committees that have managed to maintain an erroneous, but perhaps convenient, consistency over decades on this issue.

Exhibit 35: Divestment Back to 1925



As of 9/30/17
Source: S&P, GMO
Prior to March 1957 the S&P 500 is represented by the S&P 90 Index.

There are two quick points to be made before we leave this exhibit. The first is on the power of compounding. In the 92 years since 1925 the S&P 500 would have turned a single dollar – not allowing for inflation and taxes – into $22,911! Not bad is it? (Without Energy you would have had 4.3% less, or $21,984.) The second point is to admire how well the market mechanism did this particular job. I have always made a lot of fuss at how incompetent the market mechanism has been in dealing with bubbles, allowing through momentum and career risk for crazy overvaluations followed by dangerous collapses. But here the market has been amazingly efficient at pegging the long-term prospects of these 10 major groups. It has taken away any possible free lunches from buying, say, appealing high-growth technology and selling dopey utilities by pricing technology higher and utilities lower to compensate. Impressive. Who knew? Not me anyway.

Now we can put a more accurate price on divestment and ethics. For example, if you were to consider it unethical to own these oil companies whose scientists wrote, as mentioned, about the serious dangers of climate change in the 1970s only to have management later ignore it all and fund deniers and obfuscators, you can believe the cost of your ethics is about +/- 20 basis points!

Jeremy Grantham. Mr. Grantham co-founded GMO in 1977 and is a member of GMO's Asset Allocation team, serving as the firm's chief investment strategist. He is a member of the GMO Board of Directors and has also served on the investment boards of several non-profit organizations. Prior to GMO's founding, Mr. Grantham was co-founder of Batterymarch Financial Management in 1969 where he recommended commercial indexing in 1971, one of several claims to being first. He began his investment career as an economist with Royal Dutch Shell. Mr. Grantham earned his undergraduate degree from the University of Sheffield (U.K.) and an M.B.A. from Harvard Business School. He is a member of the Academy of Arts and Sciences, holds a CBE from the UK and is a recipient of the Carnegie Medal for Philanthropy.