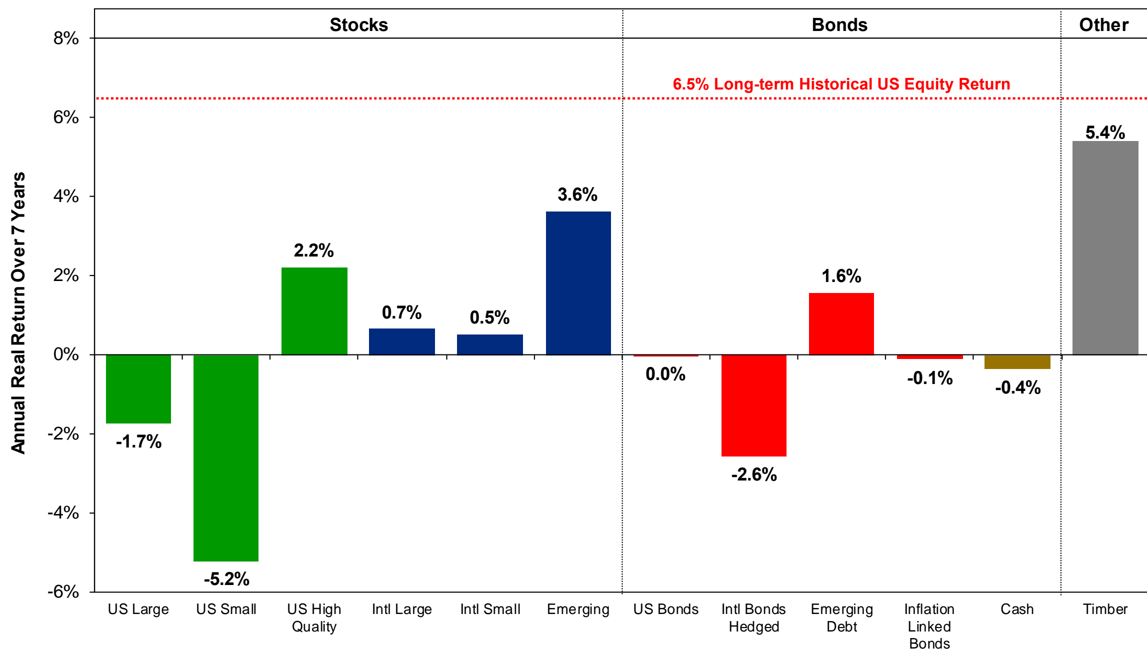
The Starboard Side Report

The week ending October 3, 2014

Graph of the Week

GMO 7-Year Asset Class Real Return Forecasts*

As of June 30, 2014



*The chart represents real return forecasts for several asset classes and not for any GMO fund or strategy. These forecasts are forward-looking statements based upon the reasonable beliefs of GMO and are not a guarantee of future performance. Forward-looking statements speak only as of the date they are made, and GMO assumes no duty to and does not undertake to update forward-looking statements. Forward-looking statements are subject to numerous assumptions, risks, and uncertainties, which change over time. Actual results may differ materially from those anticipated in forward-looking statements. US inflation is assumed to mean revert to long-term inflation of 2.2% over 15 years.

GMO

GMO standard book template

Source: GMO 0

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This GMO LLC graph* was mentioned in the August 22nd Weekly Report. Understanding and concentrating on the information that it contains is the essence of successful long-term investing. Investing in stocks is all about answering the question: how much reward do I receive for the risk that I'm taking? Unfortunately, most investors cannot think long term and get caught up in the greed of the moment. This is especially true in this country where *action in the moment* is all consuming. The major value of charts and graphs is that they allow us to look at the historic supply and demand picture versus the present market action, which quite often can be a false impression.

TECHNICAL COMMENTS

The red dotted line at the top of this graph is very important. It depicts the actual average return for US Equities, which is 6.50% and dates back to 1929. The various colored bars represent GMO's estimate of various asset classes and how they will perform historically over the next 7 years. All asset classes are lower than the average long-term return, with US Small Caps being minus 5.2% expectation. If we average the time period at 3.5 years, that would mean at least a 40% downside for small cap stocks to get back to their mean of 6.5%. **That is why we own the Russell 2000 Inverse ETF**. If we apply the same math to US Large Cap Equities, they would need a 28.7% downside to get to their mean. Keep in mind that is only getting them to their past average. According to another similar study on the US market, the return got to over 14%. That could create a downside of 55%. These numbers represent your historic long-term risk in today's market and those who ignore this danger do so at their own liability.

FUNDAMENTAL COMMENTS

Quantitative Easing (QE) should be the catalyst for the decline in the market and it ends this month. We anticipated that the market would discount the inevitable end of QE; however, stock prices have climbed higher based on the illusion of economic momentum created by the FED. This week's graph is based on 80 years of asset, earnings and market data, not an economic experiment by the Central Bank that is likely to end badly.

ASIDE

The main take away from this week is that if you don't have ample return, then all you have left is risk. As stated in these missives many times, when it comes to risk, we subscribe to Benjamin Graham's philosophy:

"***The essence of investment management is the management of RISK, not the management of returns. Well managed portfolios start with this precept".***

*The graph above was taken from the internet and is not to be distributed and is used for educational purpose only.

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