I’m starting with the man in the mirror
I’m asking him to change his ways
And no message could have been any clearer
If you wanna make the world a better place
Take a look at yourself, and then make a…
Chaaaaaaaange ..... 

— Michael Jackson

Am I a great investor? No, not yet. To paraphrase Ernest Hemingway’s “Jake” in The Sun Also Rises, “wouldn’t it be pretty to think so?” But the thinking so and the reality are often miles apart. When looking in the mirror, the average human sees a six-plus or a seven reflection on a scale of one to ten. The big nose or weak chin is masked by brighter eyes or near picture perfect teeth. And when the public is consulted, the vocal compliments as opposed to the near silent/whispered critiques are taken as a supermajority vote for good looks. So it is with investing, or any career that is exposed to the public eye. The brickbats come via the blogs and ambitious competitors, but the roses dominate one’s mental and even physical scrapbook. In addition to hope, it is how we survive day-to-day. We look at the man or woman in the mirror and see an image that is as distorted from reality as the one in a circus fun zone.
Yet at first blush, there is a partial saving grace in the money management business. We have numbers. Subjective perceptions aside, we have total return and alpha histories that purport to show how much better an individual or a firm has been than the competition, or if not, what an excellent return relative to inflation, or if not, what a generous amount of wealth creation over and above cash … the comparisons are seemingly endless yet the conclusions nearly always positive, rendering the “saving grace” almost meaningless: everyone in their own mind is at least a six-plus or a seven, and if not for the most recent year, then over the last three, five, or 10 years. Investors thrive on the numbers and turn them in their favor when observing their reflections. That first blush becomes a permanently rosy complexion with Snow White cheeks.

The investing public is often similarly deceived. Consultants warn against going with the flow, selecting a firm or an individual based upon recent experience, but the reality is generally otherwise. Three straight flips of the coin to “heads” produces a buzz in the crowd for another “heads,” despite the obvious 50/50 probabilities, as do 13 straight years of outperforming the S&P 500 followed by … Well, you get my point. The Financial Times just published a study confirming that a significant majority of computer simulated monkeys beat the stock market between 1968 and 2011 – good looking monkeys that is.

In questioning initially whether I am a great investor, I open the door to question whether other similarly esteemed public icons like Bill Miller are as well. It seems, perhaps, that the longer and longer you keep at it in this business the more and more time you have to expose your Achilles heel – wherever and whatever that might be. Ex-Fidelity mutual fund manager Peter Lynch was certainly brilliant in one respect: he knew to get out when the gettin’ was good. How his “buy what you know best” philosophy would have survived the dot-coms or the Lehman/subprime bust is another question.

So time and longevity must be a critical consideration in any objective confirmation of “greatness” in this business. 10 years, 20 years, 30 years? How many coins do you have to flip before a string of heads begins to suggest that it must be a two-headed coin, loaded with some philosophical/commonsensical bias that places the long-term odds clearly in a firm’s or an individual’s favor? I must tell you, after 40 rather successful years, I still don’t know if I or PIMCO qualifies. I don’t know if anyone, including investing’s most esteemed “oracle” Warren Buffett, does, and here’s why.

Investing and the success at it are predominately viewed on a cyclical or even a secular basis, yet even that longer term time frame may be too short. Whether a tops-down or bottoms-up investor in bonds, stocks, or private equity, the standard analysis tends to judge an investor or his firm on the basis of how the bullish or bearish aspects of the cycle were managed. Go to cash at the right time? Buy growth stocks at the bottom? Extend duration when yields were peaking? Buy value stocks at the right price? Whatever. If the numbers exhibit rather consistent alpha with lower than average risk and attractive information ratios then the Investing Hall of Fame may be just around the corner. Clearly the ability of the investor to adapt to the market’s “four seasons” should be proof enough that there was something more than luck involved? And if those four seasons span a number of bull/bear cycles or even several decades, then a confirmation or coronation should take place shortly thereafter! First a market maven, then a wizard, and finally a King. Oh, to be a King.

But let me admit something. There is not a Bond King or a Stock King or an Investor Sovereign alive that can claim title to a throne. All of us, even the old guys like Buffett, Soros, Fuss, yeah – me too, have cut our teeth during perhaps a most advantageous period of time, the most attractive epoch, that an investor could experience. Since the early 1970s when the dollar was released from gold and credit began its incredible, liquefying, total return journey to the present day, an investor that took marginal risk, levered it wisely and was conveniently sheltered from periodic bouts of deleveraging or asset withdrawals could, and in some
cases, was rewarded with the crown of “greatness.”

Perhaps, however, it was the epoch that made the man as opposed to the man that made the epoch.

Authors Dimson, Marsh and Staunton would probably agree. In fact, the title of their book “Triumph of the Optimists” rather cagily describes an epochal 101 years of investment returns – one in which it paid to be an optimist and a risk taker as opposed to a more conservative Scrooge McDuck. Written in 2002, they perhaps correctly surmised however, that the next 101 years were unlikely to be as fortunate because of the unrealistic assumptions that many investors had priced into their markets. And all of this before QE and 0% interest rates! In any case, their point – and mine as well – is that different epochs produce different returns and fresh coronations as well.

I have always been a marginal or what I would call a measured risk taker; decently good at interest rate calls and perhaps decently better at promoting that image, but a risk taker at the margin. It didn’t work too well for a few months in 2011, nor in selected years over the past four decades, but because credit was almost always expanding, almost always fertilizing capitalism with its risk-taking bias, then PIMCO prospered as well. On a somewhat technical basis, my/our firm’s tendency to sell volatility and earn “carry” in a number of forms – outright through options and futures, in the mortgage market via prepayment risk, and on the curve via bullets and roll down as opposed to barbells with substandard carry – has been rewarded over long periods of time. When volatility has increased measurably (1979-1981, 1998, 2008), we have been fortunate enough to have either seen the future as it approached, or been just marginally overweighted from a “carry” standpoint so that we survived the dunking, whereas other firms did not.

My point is this: PIMCO’s epoch, Berkshire Hathaway’s epoch, Peter Lynch’s epoch, all occurred or have occurred within an epoch of credit expansion – a period where those that reached for carry, that sold volatility, that tilted towards yield and more credit risk, or that were sheltered either structurally or reputationally from withdrawals and delevering (Buffett) that clipped competitors at just the wrong time – succeeded. Yet all of these epochs were perhaps just that – epochs. What if an epoch changes? What if perpetual credit expansion and its fertilization of asset prices and returns are substantially altered? What if zero-bound interest rates define the end of a total return epoch that began in the 1970s, accelerated in 1981 and has come to a mathematical dead-end for bonds in 2012/2013 and commonsensically for other conjoined asset classes as well? What if a future epoch favors lower than index carry or continual bouts of 2008 Lehmanesque volatility, or encompasses a period of global geopolitical confrontation with a quest for scarce and scarcer resources such as oil, water, or simply food as suggested by Jeremy Grantham? What if the effects of global “climate change or perhaps aging demographics,” substantially alter the rather fertile petri dish of capitalistic expansion and endorsement? What if quantitative easing policies eventually collapse instead of elevate asset prices? What if there is a future that demands that an investor – a seemingly great investor – change course, or at least learn new tricks? Ah, now, that would be a test of greatness: the ability to adapt to a new epoch. The problem with the Buffetts, the Fusses, the Granthams, the Marks, the Dalios, the Gabellis, the Coopers, and the Grosses of the world is that they’ll likely never find out. Epochs can and likely will outlast them. But then one never knows what time has in store for each of us, or what any of us will do in the spans of time.

What I do know, is that, like Michael Jackson sang in his brilliant, but all too short lifetime, I am and will continue to look at the man in the mirror. PIMCO, Gross, El-Erian? – yes, we’re lookin’ good – in this epoch. If there’s a different one coming though, to make our and your world a better place, we might need to look in the mirror and make a Chaaaaaaaange … Depends on what we see, I suppose. We will keep you informed.
Man in the Mirror Speed Read

1) Investors should be judged on their ability to adapt to different epochs, not cycles. An epoch may be 40-50 years in time, perhaps longer.

2) Bill Miller may in fact be a great investor, but he’ll need 5 or 6 more straight “heads” in a future epoch to confirm it. Peter Lynch is a “party pooper.” Warren is the Oracle, but if an epoch changes will he and others like him be around to adapt to it?

3) No matter how self-indulgent you think this IO is, I just looked in the mirror and saw at least a 7. You must be blind!

William H. Gross
Managing Director