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Keynes' General Greatness from Chapter 12

If you understand chapters 8 and 20 of The Intelligent Investor (Benjamin Graham, 1949) and chapter 12 of the General Theory (John Maynard Keynes, 1936), you don't need to read anything else and you can turn off your TV."
- Warren Buffett

Dear fellow investors,

In 1936, John Maynard Keynes penned his work *The General Theory of Employment*, Interest and Money. Most of the work was trying to strike against the consensus of economics. Many in the intellectual communities of the west believed in the classical theory of economics. We will describe it briefly by saying that these economists believed that humans function much like an algebraic response to prices or stimuli. Keynes struck out against this notion in his work, allowing thoughts of entrepreneurship, experience and some of the unexplainable human responses to rebut this linear view of human behaviors in economics. Keynes' ill-repute of the establishment was put on display when he wrote:

> *The classical theorists resemble Euclidean geometers in a non-Euclidean world who, discovering that in experience straight lines apparently parallel often meet, rebuke the lines for not keeping straight—as the only remedy for the unfortunate collisions which are occurring. Yet, in truth, there is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry.*

Keynes used what had been witnessed in mathematics to explain that academics often witnessed events contrary to their beliefs. They intended to not rethink their beliefs, but instead doubt reality. As we wrote in our letter titled, "The Heart of the Matter," this has also been practiced in medicine and other fields many times over.

This brings us to chapter twelve of Keynes' book. Keynes wrote the chapter on long-term expectations and the individuals, markets and psychology surrounding it. He starts out by helping us understand that the future is unknowable. "It would be foolish, in forming our expectations, to attach a great weight to matters which are very uncertain." He tells us instead "to be guided by the facts which we feel somewhat confident, even though they may be less decisively relevant to the issue other than the facts about which our knowledge is vague and scanty."

Because of an unknown future, humans lean on bias. He put it best when he wrote, "Our usual practice being to take the existing situation and to project it into the future." The closest reference to this logic today was Jim Grant in Barron's magazine in June who said, "Humans eat, sleep, and extrapolate. What we think we can foresee is often nothing more than what we have recently seen. 'More of the same' is the sensible default prediction in politics, baseball, and interest rates alike. In rates, it actually tends to work."

The next very important thing that we must remind ourselves is that being optimistic and seeking truth is a long-term reward. As Keynes put it, "If human nature felt no temptation to take a chance, no satisfaction (profit apart) in constructing a factory, a railway, a mine or a farm, there might not be much investment merely as a result of cold calculation." In Malcolm Gladwell's latest book, Talking with Strangers, he talked about Harry Markopolos, who figured out Bernie Madoff's scheme long before it was uncovered. He referred to Harry as a 'Holy Fool' for his critical thinking against what others trusted. While this is beneficial, Gladwell goes on to say, "If everyone behaved like Harry Markopolos, there would be no fraud on Wall Street – but the air would be so thick with suspicion and paranoia that there would also be no Wall Street."

A strong distrust of Wall Street and the ability to allocate capital (stock pick) has caused a 180-degree turn. This is Keynes' "cold calculation." Instead of figuring out where the growth of the society will be and allocating capital appropriately, investors today are looking at the capital markets to tell us what society should do. Alliance Bernstein in their 2016 blog stated this:

> *Of course, passive management offers benefits. In particular, it lowers costs for clients, as Fraser-Jenkins acknowledged in the report. Yet the rise of passive as a powerful market force also has dangerous side effects. That's because active management actually serves a social function in global markets by allocating capital to industries and companies that play a role in developing an economy. The problem with passive is that: 'Rather than looking at the real economy and seeking to understand its future development, passive allocation self referentially looks to the financial economy to inform its asset allocation choices.'*

We believe this gives us a distinct advantage, based on the truth of the purpose of capital markets. "Mr. Market is there to serve you, not to guide you," as Warren Buffett has stated numerous times.

Much like the classic theorists that Keynes repudiated during his time for their lack of understanding of what actually goes on in life, we believe investors are making grave mistakes around where value is added and where economic growth comes from. The long-term expectations are a constant. The outcomes ascribed to the future are always unknowable and being repriced by the mass psychology at play in capital markets. We believe there is a short-sightedness to the logic of our day as it pertains to the price of money and, thus, the prices that are ascribed to many assets in the markets.

We choose, as stock pickers stewarding capital for clients, to do exactly what Keynes felt was important for himself. "...There is no remedy except to throw over the axiom of parallels and to work out a non-Euclidean geometry." We don't agree with what is going on and believe we will be rewarded for seeking truth and being optimistic. The long-term expectations remain the same.

Warm regards,

Cole Smead, CFA

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