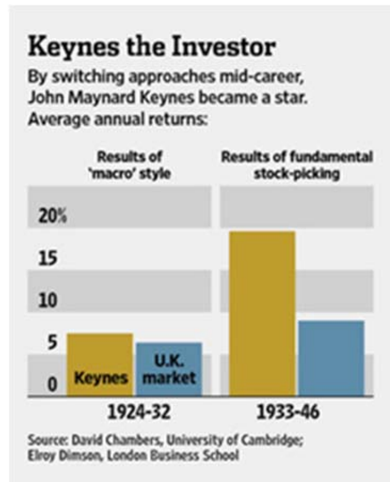
John Maynard Keynes: 'Stellar' Investment Manager

John Maynard Keynes is known as an economist, but he also was one of the first active portfolio managers – and his returns were stunning for his time. He managed part of the endowment of King's College in Cambridge. Over Keynes twenty-two year investment career (1924-1946) his Chest Fund accounts returned 15.21% compared to the U.K. market's return of 8.08% - an annual outperformance of 7.13%. Over time this excess return generated incredible gains for his investors compared to the indexes.



To determine the strategy Keynes utilized to generate these excess returns David Chambers, a professor at Cambridge Business School, and Elroy Dimson, a professor at the London Business School, examined more than two decades of trading data.

The professors found that Keynes actually utilized two market strategies over his investment career. In the first eight years he tried to time the market to generate excess returns. In the second period he actively selected individual stocks he found attractive. In the first period he barely beat the market – but in the second period he substantially outperformed the major stock indexes over an extended time period. (Chart courtesy Wall Street Journal)

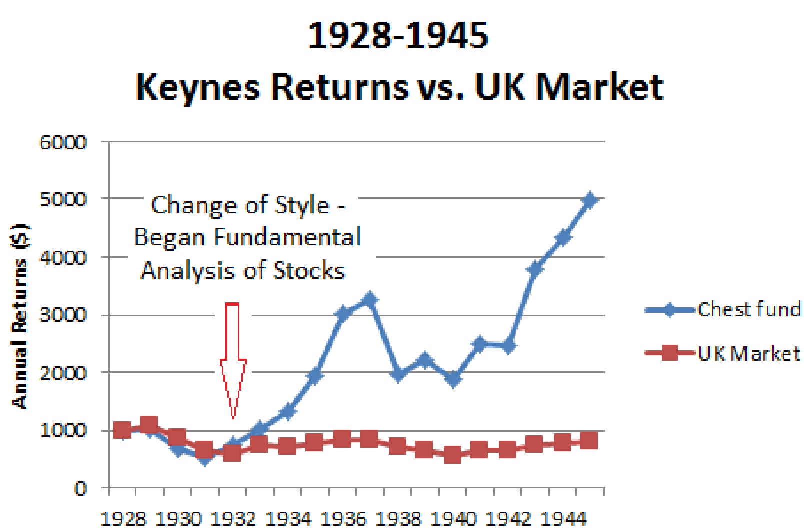
The study concluded Keynes excess returns in the second (later) period were a result of the following strategies – many which were later adopted by super-investors Warren Buffett and Charlie Munger:

1. Keynes ran a highly concentrated portfolio. During certain periods he would concentrate 50% or more of his portfolio in his favorite five holdings.

2. Keynes focused on small companies that were relatively illiquid and ignored by investors

3. Keynes invested in firms that were undervalued and mispriced by the market

4. Keynes invested for the longer-term, holding many of those companies for five years or more during which time investors discovered the underlying value of the enterprise



5. Keynes only invested in sectors that he deemed attractive, and avoided those he did not

6. Keynes was not bound by the concept that he had to diversify his portfolio to limit risk. He only invested in companies and sectors where he felt the risk/reward relationship was tilted heavily in his favor.

7. Keynes was not afraid to invest in an asset class that was not highly favored by knowledgeable investors of his time

The coefficient of determination (‘r squared’) between Keynes’ Chest Fund and the UK market was essentially zero – meaning that the movements in the UK market did not statistically explain the movements of the Chest Fund (a fact that supports Keynes active management style and stock picking ability – the excess returns were due to his skill and not market trends).

Note that the Chest Fund was 2.4 times as volatile as the UK market over the 1928-45 time frame. If volatility is a measure of risk as some academics argue, Chest Fund investors were rewarded for those higher risks by the excess returns they earned. While Keynes excess returns were substantial, they fall short of the excess returns generated a few decades later by Warren Buffett and Charlie Munger.

What is striking about the study is that both Munger and Buffett adopted many of the strategies used by Keynes – investing in a concentrated portfolio of undervalued small companies and holding for long term appreciation. Like Keynes, Buffett and Munger only invested in sectors they found attractive and did not diversify to limit risk. All three mangers generated substantial excess returns over time. The LSGI Fund has also adopted many of the strategies that Keynes utilized to deliver excess returns.