Investing for Generations

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Investing Is a New Profession

• Distinguish investing from banking

• Every banker is an investor—every loan a banker ever makes is an investment

  • And banking may well be the oldest profession of all
  • Before credit and money, you don’t have “professions”—you have jacks-of-many-trades doing favors for their friends and family
  • Only with banking do you get: “you owe me, and I owe him, so why don’t you help him build a fence and we’ll be square—in fact, make fence-building your profession: you’re good at it…”

• Relatively new, however, is non-banker investing as a profession…

  • …or as an avocation, or as a vice…
History of Investing I

- Before 1700, you keep your wealth at hand, in your business
  - Whether your business is commerce, war and government, farming, or manufacture
- Seventeenth century: Dutch and British:
  - Dutch: investments in national debt
  - Dutch: shares in the Dutch East India Company
  - British: passive land investments managed by estate agents
- Eighteenth century: Dutch, British, and French:
  - Investments in national debt
  - In East India and Hudson’s Bay companies
  - In canals
  - And, of course, the South Sea and Mississippi Bubbles
    - Isaac Newton: “I can calculate the motions of heavenly bodies, but not the madness of crowds…”
History of Investing II

- Nineteenth century:
  - Canals
  - Land speculation
  - Imperial public works—formal empire and informal empire
  - Railroads
    - The Stanford endowment: Crocker, Huntington, Hopkins, and Stanford
  - Mines
    - The crime of Amalgamated
- Charles Dickens on investing:
- Only with the 1880s and the growth of Drexel-Morgan and then Morgan and company does investing as we have known it come into being
  - Railroad reorganizations
  - Industrial corporation flotations
  - Morgan and Kuhn, Loeb want to run a business…

- Asset classes:
  - Emerging markets—public and private
  - Equities
  - Technology
  - Debt—public and private
  - (Passive) real estate
  - Derivatives: leverage, gearing, options, synthetics…

- Risks:
  - Inflation
  - War and revolution
  - Depression
  - Creative destruction
  - Jumping the gun
  - Illiquidity
Investing Landmarks
1880-2007

- Equity Landmarks
  - The equity return premium
  - Once-in-a-generation equity market collapses
- Land Landmarks:
  - Farmland
  - Urban land

- Debt Landmarks:
  - Inflation:
    - Wartime and postwar
    - Fiscal collapse
    - The puzzling 1970s
  - Term premiums
  - Risk premiums
  - Market Landmarks: fees
Equity Landmarks, 1880-2007

- The equity return premium
- Over ten years, expect to earn the current earnings yield
- Unless P/E ratios at world-record heights
  - What goes up, comes down
- Once-in-a-generation equity market collapses
  - But what goes down, comes up
  - If you can wait twenty years, risks appear much lower
Debt Landmarks, 1880-2007

- Inflation:
  - Wartime and postwar
  - Fiscal collapse
  - The puzzling 1970s
    - Slow market reaction to it
    - Then slow market dereaction to it
- Term premiums
- Risk premiums
Land Landmarks, 1880-2007

- Farmland
  - Agricultural technology runs ahead of world population growth
  - You are not going to get rich owning farmland
  - (You may get rich running agribusiness)

- Urban land
  - Auto-based transportation—until 1990 or so—runs ahead of urbanization
  - You are not going to get rich owning urban land
  - (This starts to change around 1990)
Market Landmarks
1880-1980

- Fees—about 1% of assets per year
- Finance—about 2.5% of GDP
- Assets—about 2.5 years’ of GDP
- Mean reversion: what goes up comes down, what comes down comes up
- Crashes: once a generation
Since 2007...

• Big changes:
  • Equity crashes no longer once a generation…
  • Real return on safe debt essentially gone…
  • Houses no longer safe forced-savings vehicles…
  • The remarkable growth in financial-sector fees…
  • Wealth accumulation and distribution in the post-Social Democratic era
  • How many of these will become the new normal?
Equity Crashes No Longer Once a Generation

- 1901-1908, 1929-1933, 1970-1975
- The Minsky-Kindleberger hypothesis:
  - The interns during the last crash have to retire before the next one
  - No longer true
  - Equity risk outsized for those without long horizons
Real Return on Safe Debt Essentially Gone

- A global savings glut?
- An era of secular stagnation?
- Simply a hangover from the unwillingness of investors to trust ratings agencies?
- On the one hand, have to take risk to gain return
- On the other hand, risk premiums are high
The Remarkable Growth in Financial Sector Fees

• For most of 1880-1990, fees = 1% of assets/year
  • House of Morgan/Kuhn Loeb would take more—but they were worth it

• Starting in 1990, fees and profits for finance rise:
  • From 1%/year to 2%/year
  • Assets rise from 2.5 years’ GDP to 4 years’ GDP
  • Finance rises from 2.5% of economy to 8% of economy
  • That has continued…

Notes: All wages are in 2000 U.S. dollars and are weighted using sampling weights. Data: March CPS.
Wealth Accumulation and Distribution in the Post-Social Democratic Era

- Very difficult to hold onto wealth from 1914-1980
  - Wars, revolutions, high progressive taxes to finance defense
  - Persistence of high progressive taxes after WWII
  - Thomas Piketty: that era has come to an end
- Prediction: it will be much easier to hold onto wealth 1980-2100
  - Which means there will be a lot more of it
  - Will this be good for non-wealthholders?
    - cheap capital for workers, or NIMBYland?
  - Will this be good for wealthholders?
    - Plutocracy or “euthanasia of the rentier”

**FIGURE 1.2.** The capital/income ratio in Europe, 1870–2010

Aggregate private wealth was worth about six to seven years of national income in Europe in 1910, between two and three years in 1950, and between four and six years in 2010.

Sources and series: see piketty.pse.ens.fr/capital21c.