Keynes, John Maynard – The General Theory of Employment, Interest, and Money
(Chapter 12. The State of Long-Term Expectation)

Prometheus Books, 1936, [Behavioural Finance] Grade ★★★★★

This is not a review of the book that many argue is that cradle of modern macroeconomics. Instead it is a peak into the brilliant mind of J.M. Keynes the investor. One, by economists mostly forgotten, chapter of Keynes magnum opus is fully devoted to investing - and what a chapter! I will refrain from orating too much instead let the lord himself do most of the talking. The first topic is the difficult art of forecasting and the expectations of investors and how those shape the market.

"*It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even though they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty.*" […] "*The state of long-term expectations upon which our decisions are based, does not solely depend, therefore, on the most probable forecast we can make. It also depends on the confidence with which we make this forecast – on how highly we rate the likelihood of our best forecast turning out quite wrong.*" […] "*Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible.*" […] "*In fact, those who seriously attempt to make any such estimate are often so much in the minority that their behavior does not govern the market.*" […] "*In practice, we* [the market practitioners] *have tacitly agreed, as a rule, to fall back on what is, in truth, a convention* […] *assuming that the existing state of affairs will continue indefinitely, except in so far we have specific reasons to expect a change. This does not mean that we really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely.*"

Next we turn to the animal spirits of investors, the lunacy of relative investing drawn to extremes and the results that a speculative market can have on the capital allocation of a society.

"*A conventional valuation which is established as the outcome of the mass psychology of a large number of ignorant individuals is liable to change violently as the result of a sudden fluctuation of opinion due to factors which do not really make much difference to the prospective yield; since there will be no strong roots of conviction to hold it steady.*" […] "*They are concerned, not with what an investment is really worth to a man who buys it "for keeps", but with what the market will value it at, under the influence of mass psychology, three months or a year hence.*" […] "*The actual, private object of the most skilled investment to-day is to "beat the gun",* […] *to outwit the crowd, and to pass the bad, or depreciating, half-crown to the other fellow.*" […] "*We have reached the third degree where we devote our intelligences to anticipating what average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.*" […] *"When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."*

Finally, we let the value investor Keynes spread some cynicisms about how the environment treats his equals. Contrarianism surely is a lonely activity and requires its toll.

"*Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable.*" […] "*Moreover, life is not long enough; - human nature desires quick results, there is a peculiar zest in making money quickly, and remoter gains are discounted by the average man at a very high rate. The game of professional investment is intolerably boring and over-exacting to anyone who is entirely exempt from the gambling instinct; whilst he who has it must pay to this propensity the appropriate toll.*" […] "*For it is in the essence of this behavior that he* [the long term investor] *should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.*"

Eighteen pages of poetry. If you are an investor, as opposed to a speculator, you need this book.

Mats Larsson, December 12, 2012