

The General Theory of Employment, Interest and Money

Chapter 12: The State of Long-Term Expectation

John Maynard Keynes

– a synopsis by Rob Weigand

The considerations upon which expectations of future returns are based are partly existing facts which we can assume to be known more or less for certain, and partly future events which can only be forecasted with more or less confidence.

It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. For this reason, the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations. Our usual practice is to take the existing situation and project it into the future, and modify it only to the extent that we have a more or less definite reason for expecting a change.

Long-term expectations do not solely depend upon the most probable forecast we can make — they also depend on the confidence with which we can make this forecast. The state of confidence is a matter to which practical men always pay the closest and most anxious attention. Our conclusions in these matters should mainly depend upon the actual observation of markets and business psychology.

The most important fact to remember is the extreme precariousness of the basis of knowledge on which our estimates of future returns must be made.

In former times, when enterprises were mainly owned by those who undertook them, investment depended on a sufficient supply of individuals with optimistic temperaments and constructive impulses who embarked on business as a way of life. These individuals paid little attention to precise calculations of expected profits. Their business undertakings were partly a lottery, with the ultimate result largely dependent upon whether the abilities and character of the managers were above or below average. And, even long after the enterprise was launched, the entrepreneurs of old usually did not care whether their returns had exceeded or fallen short of the prevailing rate of interest. Except in the case of businesses that exploit natural resources or earn monopoly profits, it is probable that the actual average returns of the old-time entrepreneurs were disappointing relative to the hopes that prompted them — even during periods of progress and prosperity. Businessmen play a mixed game of chance and skill, and the true after-the-fact return is often not known, even to the players who have a hand in the game.

If human nature felt no temptation to take a chance, or derived no satisfaction (apart from profit) in constructing a factory, a railway, a farm or a mine, there might not be much investment merely as a result of cold calculation.

With the separation of ownership and management that prevails today, and with the development of organized investment markets, a new factor of great importance has entered in, which sometimes facilitates investment but can also add greatly to the instability of the system. This factor concerns the way the stock exchange revalues investments every day, with these revaluations providing individuals with many opportunities to revise their commitment to their investments. It is important to see that these daily revaluations of the stock market inevitably exert a decisive influence on capital formation and flow. When you think about it, enterprises that in former times would have been started up from scratch may now be bought in their entirety — after all, there is no sense in building up a new enterprise at a cost greater than that for which a similar enterprise can be purchased. Perhaps of even greater

consequence, there is an inducement to spend extravagant sums on all sorts of new projects that would have never been undertaken in older times, because now shares of the project can be sold off in the stock market at an immediate profit.

The key point is that now there are many new classes of investments that are governed by the average expectation of those who deal on the stock exchange and focus almost exclusively on the price of shares, rather than by the more genuine expectations of professional entrepreneurs.

How then, are these highly significant daily and hourly revaluations carried out in practice? We have tacitly agreed upon a convention, the essence of which lies in assuming that the existing state of affairs will continue indefinitely — except when we have specific reasons to expect a change. We are assuming, in effect, that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge, and that it will only change in proportion to changes in this knowledge.

Correctly speaking, however, the existing market valuation cannot be uniquely correct, because our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation. All sorts of considerations enter into the market valuation that are in no way relevant to assets' expected future returns.

Nevertheless, the above conventional method of calculation provides a measure of continuity and stability in our affairs, so long as we can rely on maintenance of the convention. With organized investment markets and a reliance on maintenance of the convention, an investor can comfort himself with the idea that the only risk he runs is that of a genuine change in the news over the near future. Thus investment becomes reasonably safe for the individual investor over short periods. But it is not surprising that such an arbitrary convention should have its weak points.

Due to the gradual increase in the proportion of equity owned by persons who neither manage nor have special knowledge of the enterprise, the element of real knowledge in the valuation of investments has declined. Day-to-day fluctuations in the profits of existing investments, which are obviously of an ephemeral nature, have an excessive — even absurd — influence on the market.

A conventional valuation that 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 that do not really make much difference to future returns, since there will be no strong roots to hold it steady.

In abnormal times in particular, when the hypothesis of an indefinite continuance of the existing state of affairs is less plausible than usual, the market will be subject to waves of optimistic and pessimistic sentiment that is unreasoning, yet, in a sense, legitimate — because no solid basis exists for reasonable calculation.

But there is one feature in particular that deserves our attention. We might suppose that competition among expert professionals, possessed of knowledge beyond that of the average private investor, would correct the vagaries of the ignorant individual. The energies and skill of the professional investor are not concerned with making long-term forecasts of the probable return of an investment, however, but with foreseeing changes in the conventional basis of valuation a short time ahead of the general public.

Professional investors are not concerned with what an investment is worth to a man who buys it "for keeps," but rather with what the market will value it at, under the influence of mass psychology, three

months or a year hence. Moreover, this behavior is not the outcome of a wrong-headed propensity. It is an inevitable result of an investment market whose organization encourages these behaviors. For it is not sensible to pay twenty-five for an investment that you believe has an intrinsic value of thirty, if you also believe the market will value it at twenty three months from now.

The professional investor is therefore forced to concern himself with the anticipation of impending changes — in the news or in the atmosphere — that experience shows most influence the mass psychology of the market. This is an inevitable result of investment markets organized with the goal of so-called "liquidity." Of the maxims of orthodox finance, none is more anti-social than the fetish of liquidity: the doctrine that it is a positive virtue on the part of investment institutions to concentrate their resources upon holding "liquid" securities. This doctrine forgets that there is no such thing as liquidity of investment for the community as a whole.

The social object of skilled investment should be to defeat the dark forces of time and ignorance which envelop our future. However, the actual, private object of most skilled investment today is to "beat the gun," as the Americans so well express it — to outwit the crowd, and to pass the bad, ever-depreciating half-crown to the other fellow.

Further note that the battle of wits to anticipate short-term changes in valuation a few months from now, rather than the expected return of an investment over many years, does not require participation by uninformed individual investors — it can be played by professional investors among themselves. Nor is it necessary that any of the players should believe in the long-term validity of the value of any investment. Because the way investment management is conducted is similar to games like Old Maid or Musical Chairs — a pastime in which the winner passes the Old Maid to his neighbor before the game is over, or secures a chair for himself before the music stops.

Or, to change the metaphor slightly, professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole. Notice that in this game, the winner will not pick those faces which he himself finds the prettiest, but those which he thinks likeliest to catch the fancy of the other competitors — all of whom are looking at the problem from the same point of view, of course.

It is not a case of choosing those faces which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth, and even higher degrees of this game.

If the reader is motivated to interject that there must surely be large profits to be gained in the long run by a skilled individual who remains undistracted by the prevailing pastime and continues to purchase investments on the best genuine long-term expectations he can frame, he must be answered, first of all, that there are such serious-minded individuals, and that it makes a vast difference to an investment market whether or not they predominate in their influence over the game-players. But we must also add that there are several factors that jeopardize the predominance of such individuals in modern investment markets. Investment based on genuine long-term expectation is so difficult today that it is basically impractical. He who attempts it must surely lead more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes.

There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable.

It requires more intelligence to defeat the forces of time and our ignorance of the future than to play "beat the gun." Moreover, life is not long enough. Human nature desires quick results; people find a peculiar zest in making money quickly, while far-off 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; of course, he who has this instinct must pay the proper toll for possessing this propensity.

Notice that it is the long-term investor — he who most promotes the public interest — who will in practice come under the greatest criticism whenever investment funds are managed by committees or boards or banks. For it is the essence of his behavior that he should appear eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm his rashness; and if in the short run he is unsuccessful, which is very likely, he not receive much mercy. Worldly wisdom teaches that it is better for one's reputation to fail conventionally than to succeed unconventionally.

It is rare, one is told, for an American to invest, as many Englishmen still do, "for income"; he will not readily purchase an investment except in the hope of capital appreciation. Thus, when he purchases an investment, the American is not attaching his hopes to the investment's long-term expected return, but rather to a favorable change in its short-term valuation; i.e., he is a speculator. Now, speculators may do little or no harm when they are only bubbles on a steady stream of long-term investors; but they can be seriously harmful when long-term investors become the bubble on a whirlpool of speculators. 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.

A large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation. Our decisions to do something positive are usually taken as a result of *animal spirits* — a spontaneous urge to action rather than inaction — and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself that the statements in its own prospectus, however candid and sincere, accurately describe its true motivations. If the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die.