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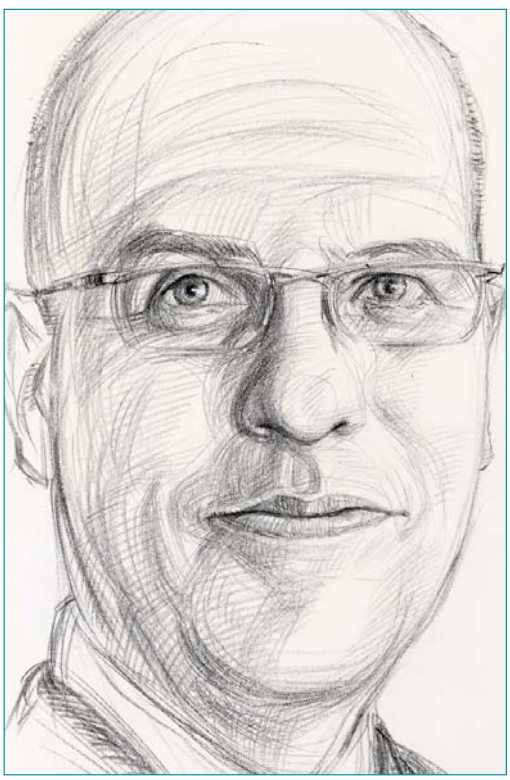
INSIDE

listeningin

Rich Bernstein

Asset Allocation Champ Defensive, Looks For Biggest Gains At Home



***Richard Bernstein** is not jockeying multi-billion-dollar portfolios — at least, not yet — at his very own Manhattan-based firm, named (surprise) **Richard Bernstein Advisors**. More like half a bil., which is not bad at all, for an outfit that traces its roots all the way back to 2009. To be sure, it's not exactly as if the long-time **Merrill Lynch** über analyst, whose gimlet-eyed strategy calls kept him at the top of the heap in* Institutional Investor*'s rankings over a 25-plus-year career with the thundering herd, is an unknown quantity among investment pros. But these days, Rich and his quantitatively oriented team aren't only making strikingly non-consensus strategy calls, they're using their research to pull the trigger on top-down portfolios that they're running for Eaton Vance and First Trust, while traveling a whole lot less — and enjoying life more.*

Europe hadn't "solved" all its problems yet, when I chatted with Rich on Monday morning, but everyone else's focus wasn't Rich's, anyway. He sees more upside potential here at home — and less, much less than the crowd expects — coming from the emerging markets. Listen in.
KMW

Another week, another set of on-again, off-again financial crisis talks.
It is crazy, but it is where we are.

So let's start out by talking about something relatively fresh and new: Richard Bernstein Advisors. How strange is it to go from mega-analyst to mega-PM?
Since you brought that up, I don't know if you're aware, but we found out about a week ago that I have been named to the *Institutional Investor* All-America Research Team Hall of Fame, which is pretty cool. I can't remember the exact number of analysts that they've named to their hall of fame, but there are over 10,000 analysts they've ranked and only something like 49 are in the hall of fame. There aren't many awards that I actually take seriously, but this is one that's actually pretty cool.

I'm sure you knew you had quite an

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impact, but it's always nice to get that sort of validation – especially, I imagine, as you're trying to extend your reach –
Oh, yes. We just came out with our second mutual fund with **Eaton Vance**. The first one, the **Eaton Vance Richard Bernstein Equity Strategy Fund** (ERBAX) came out about a year ago, and obviously focuses on equity strategy. The new one that just came out, the **Eaton Vance Richard Bernstein All Asset Strategy Fund** (EARAX) is a global all-asset macro strategy fund. We also have had a couple of unit investment trusts come out, through **First Trust**. They are quality income portfolios, and the first was quite successful, even in a bad market period. Unit investment trusts have three-month selling periods, as I'm sure you know, and we raised about $90 million in the first series, which was pretty good, given that people did not really want to invest in the equity market at that point. The Series 2 has just come out. So our relationship with First Trust is going well. We've also continued to have a great relationship with **UBS Wealth Management Americas**, through which we offer several asset allocation ETF-driven models on their mutual fund discretionary wrap platform. And we're talking to a lot of other people. Obviously we want to do a lot with my former firm, **Merrill Lynch**, and they're fantastic partners for us. We have a couple of things in the hopper to do with them, and we have a couple of other companies that are interested in having us manage various insurance products and such.

"What's interesting, from our perspective as asset allocators, is that we remain quite amazed at how unwilling people are to hold treasuries."

You are keeping plenty busy, in other words.
Yes, Yes – though I'm not traveling around the world the way I did for Merrill, which is not very good for frequent flier miles, but is very good for your health.

Not to mention your sanity. "Super-duper platinum elite status" is only good in airports, anyway!
Exactly. So I'm flying in the back of the bus now. You're not in the elite on anything when you have your own company. So, if you're on a flight and you look towards the back and see a guy wearing a tie sitting right near the restrooms at the back of the plane, it's probably me. I buy the cheapest seats possible. But that's okay. I mean that's part of owning your own business.

Especially if you're not living on planes anymore.
Right. It's not horrible at all.

So tell me about your transition. It evidently hasn't been a huge stretch for you to convince people to go from taking your advice on how to structure portfolios to letting you do it yourself.
Well, certainly there's always an aura of skepticism and probably rightly so. People want to do their proper due diligence and they always like a track record. But, "past performance is not indicative of future results." We all know that. So you take risks with people with track records and you take risks with people without track records. Having one makes you feel a little better, but a lot of people who knew my group's work at Merrill have been very willing to invest and, fortunately, we're putting up a very respectable track record as well.

I just looked up your Eaton Vance equity fund and saw that you beat your bogey, the MSCI AC World, over the last year.
Right. We got pretty defensive during the summer and that's helped us quite a bit.

What made you do that? So many investors got blind-sided.

Well, in the summer we began to notice, first of all, that yield curves around the world began to flatten. And yield curves are very good predictors of future economic growth and future profit growth. If you go back six or seven months, people were talking about how robust the global economy was. We just sat there and said, "Well, if everything is supposed to be so robust, why are yield curves flattening?" Then the yield curves of some of the BRIC nations, like India and Brazil, actually became inverted – and an inverted yield curve is pretty much the kiss of death for equity investors – so we took notice of that. We also looked at some of the leading indicators – things like jobless claims, which were starting to deteriorate or at least stop improving, and we saw, as the summer progressed, that no major government anywhere in the world was trying to really stimulate the economy. You had monetary and fiscal policy on hold pretty much around the world and then you also had a corporate sector around the world that was very risk-averse. I think that during the summer Americans got too introspective. We began to think that what was going on here was the most important thing in terms of the politics and the budget and everything that was going on in Washington. We really ignored what was going on around the world, the fact that the rest of the world was in the same boat. So we just said, "Look, you have no private sector that wants to get involved. You have no public sector that wants to get involved. How do you construct a bullish story out of that?" We decided you couldn't, so we just kept getting more and more defensive.

Which paid off, clearly.

It did. I think what's interesting, from our perspective as asset allocators, is that we remain quite amazed at how unwilling people are to hold treasuries.

You're getting paid so little; they're "certificates of confiscation," etc.

Well, I have my fears about treasuries, too, like everybody else. But the numbers don't lie, and treasuries these days are the only asset class that provides diversification. We saw that yet

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again during the summer when gold didn't provide the diversification that was promised. Despite the fact that the numbers show that gold does not provide diversification, everybody was convinced that it does. But holding gold didn't help. Non-U.S. stocks didn't. Hedge funds did not help. All of these "diversifying" asset classes, to us, didn't look like they were diversifying portfolios anymore. So it was very confusing to us that people didn't want to hold treasuries to diversify their portfolios – and so we incorporated treasuries.

What you're saying is that treasuries were the only asset class that wasn't correlated?
Uncorrelated, right.

And diversifying into other asset classes hasn't helped investors escape pain in declines in which everything but treasuries have been correlated –
Yes, right. What I've been trying to say is that treasuries alone have been negatively correlated to equities of late. What happens is that the correlations between stocks and bonds change through time.

Sure. What's been unusual lately is that only one asset class, treasuries, has been providing *any* negative correlation. Everything else has been moving in lockstep.
Absolutely. Everybody who thought they had diversified by holding gold over the summer was sadly mistaken. I think gold is a pretty good hedge against inflation – but as the economy slows, the probability of inflation going up *decreases*.

Really? Is that how it works?
It is. There were a growing number of people who just fervently believed during the summer that gold would act as a hedge against everything – and that's usually not a good sign.

When so many people are snapping up gold as a hedge against Armageddon, it's generally not good news for the human race.
Right, exactly. Except that the fact that people are so scared of Armageddon, to use your word, actually shows that the long-term prospects for stocks are quite good.

So you remain the good contrarian, as a portfolio manager, that you long were as a strategist?
That's me, all right.

Well, clearly expectations for equities got pretty dismal last summer, though I wouldn't say valuations have ever gotten pound-the-table cheap – except maybe for a nanosecond or two, when the market suffered some of its steep reversals.
No, I would agree with you. I don't think that U.S. stocks are pound-the-table cheap, but I do believe they're undervalued. And if you look at U.S. stocks versus, say, emerging market stocks, then U.S. stocks are quite attractive. So it may be the nicest house on a bad block in terms of valuation, but I still think there's something to be said for that.

Even though the emerging markets have corrected quite a lot this year?
They certainly have. Most of the major ones are down over 20% or close to it. But what's interesting is that peoples' *expectations* about the emerging markets, and so about the expected returns on emerging markets, have not really decreased. What I find most interesting is that when the U.S. stock market goes down 15% or 20% from its peak or whatever it was, depending on which index you use, all of a sudden people think it's the end of the free world as we know it. Meanwhile, the emerging markets go down by 20% or 25%, or they go down by even more – they underperform. Yet everybody says, "What a great opportunity." So I actually think the *unanticipated* risks are in the emerging markets. They're *not* in the United States. And to a lesser extent, I really don't think they're in Europe, either.

Really? It seems every other headline is about the crisis in the eurozone.
Well, people know about the risks, right? That's where I think the issue is: People *believe* the emerging markets aren't fallible. That they are *the answer*.

I agree. But that asset allocation train has built up a lot of momentum. Practically every institution has decided it *has to diversify* into emerging markets and alternatives. And once that flow starts, it's awfully hard to reverse.
It is. Part of what I've argued over the past decade has been that a lot of our monetary policy – particularly the lowering of interest rates – has really done more to spur the emerging markets than it has to spur the United States.

Do tell –

Well, if you think about it, over the past decade when we did have a weak dollar, monetary and fiscal policies were geared in such a way that they lowered risks and returned money to people. But when you have a weak currency, what that does is invite capital flight. So a lot of that capital freed up by our easy money and tax cuts took flight and went into the emerging markets. When I was at Merrill in 2003, I wrote about that. I mean, the Fed had lowered the fed funds rate to 1%, which was unheard of at the time. Now we've got 0%, but at the time a 1% fed funds rate was unheard of. So at Merrill, we wrote something that said, "Look, we don't know if they're going to reflate the U.S. economy, but they're certainly going to give free money to China." And I think that's what happened. Because the vanishingly low hurdle rate encouraged people to take more risks. It was a naïve assumption on the part of the Federal Reserve that the incremental risk taking would occur in the domestic economy. Instead, it occurred *outside* the domestic economy. I mean, that's not to say that *nothing* happened here. Of course, it did. But the multiplier effect of monetary policy on the domestic economy clearly has gone down.

No argument. But what now? Monetary policy can't get much easier than it is, stuck at zero.

Well, monetary policy, I think, is going to remain pretty impotent. So the question will be how fiscal policies change in the next 12 to 18 months.

What a great way to cue your recent commentary piece in the *Financial Times*.

Well, that's exactly right. The point that I tried to make in that article ["Turn America into a giant 'enterprise zone" http://www.ft.com/ intl/cms/s/0/41b2fa68-f346-11e0-8383-00144feab49a.html#axzz1c146Nggb] was really pretty straightforward: The Democrats are just trying to reflate the bubble. They're going back and trying to stimulate consumption in housing and, unfortunately, the other credit-sensitive parts of the economy. But that's where the bubble was and history says that you can't reflate the bubble. Meanwhile, the Republicans just want to give out open-ended tax cuts to get the economy moving again. But the problem with open-ended tax cuts, in an open economy, is sort of like the monetary policy problem that I mentioned before. There's no guarantee that the *domestic* economy actually benefits if open-ended tax cuts are handed out. So *neither side* is promoting a workable solution. What I was trying to do is suggest a combination of the two approaches and say, "Well, okay, if we're going to stimulate, we can do that on the fiscal side but we can't – we have to skip over the credit-sensitive sectors. So let's go to the next area, in a normal cycle. And the next area in a normal cycle would be capital investment. You normally start out with a consumption cycle and then it's supposed to mature into an investment cycle.

But these aren't normal times –

So my idea was, "Okay, let's just forget stimulating the credit-sensitive sectors. Let's focus on stimulating the *investment cycle* instead of the *consumption cycle*." But then the question was, "Well, how do you do something on the tax side?" Well, if you just combine the two, fiscal stimulus and tax cuts, you can come up with *targeted* tax cuts aimed at *capital investment put in place in the domestic United States*. That's basically what my idea – essentially turning the whole country into a big "enterprise zone" – is all about. You only reward companies when they actually put plant and equipment in the United States. There are no favored industries. There's no cronyism. There's nothing of that sort going on here. It's a very, very straightforward idea. I would argue that it's a very old-fashioned centrist idea – and there's a giant black void in that space right now, as far as I can tell.

You can say that again.

Well, I'll tell you, on a personal note, that before it was published, I sent that article to 15 or 20 very well-known policy people – on both the left and the right – asking very sincerely for comments. What do you think? Is this idea good or bad? And the interesting thing was I got absolutely no response.

Oh, that's depressing.

It is. Not even one note back saying, "Thanks for sending. I'll take a look." It was just completely ignored, and I find that perplexing, as well as depressing, I mean, I could use any number of different adjectives here because what it says it that most policy makers' minds are completely closed, and I find that very upsetting in the current environment – to think that neither people on the left or on the right are looking for novel approaches to help solve the current economic malaise.

It really speaks very unfortunate volumes about the state of public discourse in this country. At least I saw one enthusiastic response to it on FT.com.
Oh, really? I didn't even see that. I'll have to take a look. Good.

I think it came from one of your thousands of former colleagues at Merrill –
Oh, well then, it doesn't count! If it was somebody from Merrill – we all still bleed little bulls –

Even after everything that's happened?
Yes. There was a great camaraderie at Merrill Lynch. Even people who left Merrill still feel some of that. It's a great firm.

It always *was* legendary. And your enterprise zone idea makes a lot more sense than giving corporations tax holidays on cash they're holding overseas – which would most likely flow right back there, after collecting a tax break.
Right. Again, if – and this is a big if – *if* the issue is jobs, just giving out an open-ended tax cut – or anything that is open-ended on the tax side – does not guarantee that jobs will be created *in this economy*. They might be. But given the state of the economy, do you want to risk something on a "might?" That, to me, is the issue here more than anything else. If you don't accept the premise that jobs are the No. 1 factor missing from the equation, then you can go do other things. But if jobs are the key missing link, then you have to make sure that jobs get created. You can't leave it to chance.

Not to mention that history says that tax cuts' and temporary tax holidays' records, in terms of job creation, are pretty dismal.
Sketchy, at the very least.

And that merely adding zeros to the end of our budget deficit total isn't a solution, either.
No, agreed.

So does the deafening silence that has greeted your creative economic thinking change your top/down outlook at all?
No, not really. I mean, we still have a pretty conservative stance. We're looking for excuses to get more bullish. But the current rally has to be taken a little bit with a grain of salt because, just technically, the market was down for five straight months. So the probability of having six straight down months was not high – I don't think it's ever happened before, or at least not more than once or twice. It's very, very rare that you have six straight months in a row of a down market. So we were bound to get a snap back rally here. And we'll be happy to take part if our leading indicators begin to get better. But it will be even better if the leading indicators get better because of other things in the economy, besides the stock market. It *could* be that some economic policies might start to work. Who knows? I don't really care *why* they get better. It's just a question of if and when they get better – and then we'll chime in. We're happy to take part. I'm not stuck in the mud on any particular viewpoint.

Can you look at the horizon and see any of your other leading indicators that might be getting better?
I don't. Some have stopped getting worse, though.

Well, that's a start.
That's about as good as I can see here, I would say. For instance, just look at the one I mentioned before, jobless claims. Jobless claims were getting worse. Then they got a little better. But they're really going sideways right now. And it's that sideways movement that is difficult to assess. Now, if it continues to improve, well fine, we'll change our strategy; get less defensive. Like I said, we have no axe to grind. But the jobless claims number is a good example of a leading indicator that's really doing nothing right now.

I did see that China's PMI came out better this morning. But I don't really believe most numbers coming out of China –
Exactly. The big issue in China now is the fight between growth and inflation. Are they going to really worry about inflation or are they going to try to promote jobs? They're very much in a place like the 1960s and '70s were here in the United States. In other words, I think they're stuck in between that rock and a hard place. As are Brazil and India, as well. Because the credit bubbles there have been so extreme. I find it interesting that people here rail against **Fannie Mae** and **Freddie Mac** – and I'm no big fan of Fannie Mae or Freddie Mac, either – but then they tell me how great China is. Yet China is essentially one massive Fannie Mae and Freddie Mac. The government is funding growth everywhere throughout that economy. That is not

really a private-sector economy.

Not by a long shot. Red capitalism means the government is involved on every level.
Exactly. So I'm confused as to why investors are so bullish about a credit bubble that just hasn't deflated yet.

People have become conditioned at this point to thinking that the pre-popping stage of bubbles is the only happy place for investors.
Well, of course, that's been true throughout history. Bubbles attract investors like flames do moths.

You said earlier that you suspect that if there's a surprise coming for the markets, it's going to come from the emerging markets – so you're expecting trouble in Asia?
Yes, history shows pretty well that cycles begin in the United States, they travel to other developed markets and then they end up in the emerging markets. There have been many economic cycles throughout modern history that have followed this normal pattern and I think that's what's happening. The United States' credit bubble deflated first. Now we're seeing it happen in Europe. And I think the next round of credit bubble deflation will take place in the major emerging markets. That's the one I don't think that people are aware of – or prepared for.

Haven't you heard, "this time is different" and all those old cycles are mere history in this new Asian century?
Well, those sorts of changes in leadership – the way people like to talk about it – do happen. But they happen secularly and they happen slowly. I don't think that in one cycle, all of a sudden, the laws of economics don't apply. What I mean is that there's a credit bubble going on in China. And their credit bubble is even more pervasive than ours was. So, to some extent, one should expect their growth to be stronger than ours. If you lever up your economy, you're going to get stronger growth and that's what has gone on for the last two or three years. That was not always the China story. I'm not trying to make it out that the China story was like this forever. But in the last two, three, four years, that has been the China story: A huge amount of leverage. I mean, you can take a company and lever it up and get huge earnings growth, right? You can get a huge return on equity. But that company would normally be considered riskier, *not safer*. Well, that is essentially what's going on in the Chinese economy. They're leveraging their economy more and more. Yet as they do that, for some reason it is considered to be safer, not riskier. That's the issue. Look, I'll tell you, in the United States, right now, there are free cash flow yields between 7.5% and 12%, depending on how you want to define cash flow, while in China right now, they're negative.

Negative?
Yes! So, by the way, this is the exact opposite of where we were 10 or 11 or 12 years ago, right? In 1998, 1999, 2000, you would have found that the United States, although it didn't have a negative free cash flow yield, had about a 2% or 3% free cash flow yield. Now it's close to 8%, using the exact same measure, apples to apples, while in the emerging markets it is about 2% or 3%. And the emerging markets in general probably had free cash flow yields of about 8% 10 or 11 years ago.

That's a definite reversal.
It is. And this is real apples to apples type stuff. No fudging the calculations.

You're saying that the emerging markets have juiced up on so much leverage since the 2008 financial crisis that their free cash flow yields have cratered – yet even before Lehman et al, there was an orgy of capital misallocation going on in China.
Absolutely correct. And China has other issues going on. Its demographics are not particularly good. The working age population is starting to fall. Labor costs are going up. Productivity is falling. They're losing market share. There was a study in the *New York Times*, I think, very recently that showed that wage rates in China – which eight years or so ago were just a fraction of wage rates in Mexico – are now actually even with wages in Mexico.

At the same time, ethnic and political tensions are rising in China.
Yes, though we should acknowledge that Mexico is not the most stable place, either.

Granted. *Muy loco*. And then there are its warring drug cartels.
Yes, but those issues make the United States reasonably attractive in that – though one might laugh at my comment here – we are a

politically stable nation. The risk of nationalization is virtually zero – unless you *want* to be nationalized, like the auto companies. That may not be true in other countries, especially if political stability goes down.

Sometimes it's hard to see, when you're scanning the headlines, that politics could get any worse here.
That may be a fair point. But I still think in the major emerging markets those are issues people have not even considered yet.

Okay, what's your take on the seemingly endless euro mess?
The European situation is interesting, simply because it's clear that the European politicians didn't learn anything from the United States' experience. Rather, they're trying to copy it – like didn't we learn from TARP that it wasn't a good solution? Yes, it stabilized the economy but it didn't produce the end result that was really desired. The money that was lent in TARP wasn't lent back into the United States and didn't reinvigorate the economy. That outcome just didn't materialize.

Even worse, we've been left with a rotten core of the banking system that's more too big to fail than ever.
Well, we now have fewer, and even larger big banks, that's right. And, the thing is that the banking system is still lobbying quite aggressively against any regulations that have anything to do with constraining what caused the credit bubble to begin with. I find that quite unfortunate because one of the reasons the United States economy has not prospered in the last 10 or 12 years has been that our financial sector became an enormous and quite influential part of the economy itself – as opposed to remaining a tool used by the economy for capital formation. I just think that the road to a stable recovery of the U.S. economy – getting back to some level of growth and of employment we'd all agree is acceptable – has to include (fortunately or unfortunately) revamping the financial sector. We have to get it to once again be a tool of capital formation, not a tool whose first or only purpose is to make more money for itself, in and of itself.

I couldn't agree more. The casino has to come out of finance so that it can be refocused on serving the economy – and not the reverse.
I think that's right. We have to remember what the role of the financial sector is *supposed* to be. Look, I'm not one of these people who says that Wall Street makes too much money. I don't really care one way or the other. If people are successful, good for them. But what we've forgotten here is that the old school bankers weren't exactly paupers – yet their activities benefited the overall economy to a great extent. And I think that's what we've lost. Through the last decade, the growth in bank lending was to other banks. It wasn't to the real economy.

No. It was to other banks and to the myriad "innovations" of the shadow banking system.
Let's say to the financial sector itself. The majority of the growth in bank lending was to the financial sector itself, not to the real economy.

Where the leverage was endless and profits were seemingly conjured from thin air.
Sure, you just lever and trade among yourselves. That's the ultimate service economy. You scratch my back, I scratch yours. Then you add a little leverage and all of a sudden we've got something. But that's not a productive use of capital. My point is that I think regulation – financial regulation – is extraordinarily necessary, and I actually think that it won't necessarily hurt Wall Street one bit.

You *are* a heretic!
Yes, the business will change, but Wall Street has always been a place for entrepreneurs and capitalists. I think it always will still be. I just don't see what the big deal is about playing by rules. And I think it's in our national interest to get capital back into the real economy as opposed to continuing to just recirculate capital in the financial economy.

Of course. But I can't help being deeply skeptical about regulators' ability to do anything that doesn't cause worse unintended consequences down the road –
Well, to some extent that's valid, although remember what things were like in the 1920s and '30s – and we now all live under the **Securities Acts of '33 and '34**, and under the **Investment Company Act of 1940**. I mean, there's nothing inherently wrong with the legislative process.

Our grandfathers were evidently much smarter and wiser – we repealed Glass-

Steagall.
True. And the irony of the Glass-Steagall repeal is that it was done *after* **Long-Term Capital Management** collapsed, so the early warning radar had been bleeping like crazy. There were blips all over the screen and Washington chose to ignore them. But there it was right there. It was literally right before they got rid of Glass-Steagall that LTCM collapsed and caused all sorts of problems with the New York banks and everything else. So the radar was plainly warning this is the wrong thing to do.

What were some radar blips against the persuasiveness of Citi's Sandy Weill – and the entire bank lobby – arguing that Glass-Steagall had to go to strengthen the U.S. banking system?
Well, they said "the banking system" and what they really meant was the financial system. That's a subtle, but a very important difference.

Yet at this juncture, serious discussion of these issues is as rare in policy circles as is attention to your national enterprise zone idea –
Well, part of the problem is – and we all know this – is that to a certain extent there *may* be a need for campaign finance reform before that can occur.

There's no "*may*" about it. It's requirement No. 1.
I'm trying to be a little bit political myself in saying that – I think that's a big problem.

Let's get back to business. Despite its evident problems, you said the domestic landscape is relatively attractive?
It's not so much that it's in better shape in an absolute sense. It's in a better shape relative to expectations, versus expectations for other economies. That, I would argue quite vehemently. We're not going to grow faster than China's economy. It would be amazing if we did. But the question is, what do people *think* is going to happen? And further, what's the possibility of that rosy outcome in China? Versus what's the probability of a dire outcome here in the United States? Well, both of those outcomes are probably pretty well discounted. So that makes us believe that the United States is more attractive. In our funds right now across the board, we are very overweight, the United States, on the equity side. I think in the MSCI All Country World Index, the United States is about 55%, 50%. But in our equity portfolios; we're weighted probably up around 70%-75% in the United States.

That's a serious bet.
We try very hard not to be index huggers. If we have bets to make, we're going to make them. So we're pretty overweight in the United States. We also are overweight large caps for the near term. Not so much multinationals, but domestic large caps as much as we can. Longer term, I think U.S. small caps are the great story. If I could buy a time capsule and put money in it for 10 years – and not disturb it for those 10 years – I personally would put that money in U.S. small-cap companies. I think U.S. small-cap companies are where the emerging markets were in 1998, where commodities were in 2000. There's a very good long-term opportunity here in U.S. small caps. However, that being said, one has to remember that – my favorite line is, "All you have to do is whisper the word 'volatility' and small caps get crushed." They don't just under perform, they get crushed. With that realization and our conservative stance right now, we've backed off on our small-cap game for the near term. For us, that just means equal weighting small caps. It doesn't mean under weighting them. But we're looking for opportunities to get back again into that long-term game.

One thing you can be confident in with small caps is that you're probably going to get another chance to pick them up cheap.
Absolutely. Nonetheless, I really think that the scarcity of capital that the small companies are facing in the United States presents an extraordinary investment opportunity for people who are willing to provide capital to small companies. I'm not talking about sexy technology – wind turbines, solar, cloud computing – all of that. I'm talking about basic, small, real economy-type companies.

The stuff nobody wants to touch now, least of all the banks.
Correct. Production-oriented companies. Maybe some service companies, but they've got to be small. To us, that's where we see a macro opportunity in this environment. What's interesting is there aren't many people investing in this space. Even on the private equity and venture capital side, and you'd think that those guys would be running into that space, because they could play loan shark to small companies.

But there are very, very few. Which shows you that this scene is really in its infancy.

Those guys are still opening new offices in places like Hong Kong.
Exactly. Like they're the first guy there. I say that sarcastically, obviously! But how many of them are setting up offices in Iowa or Texas or upstate New York? The places where there's got to be business going on and yet nobody's there funding those small, growing businesses.

That requires long-term capital. Have you seen much of that lately?
That's an interesting question. There is long-term capital out there. But it comes, as an investor, with a lockup. So there is *forced* long-term investing. It's quite unfortunate that the only way that one can get a longer term oriented fund together these days is to be involved with a lockup. That's quite unfortunate.

Let's dig a little deeper into what you're overweight, among U.S. large caps –
It's large caps across the board. Right now because of our defensive posture, we're overweight the defensive sectors – staples, healthcare, utilities. But the one thing that I do want to make clear is that we're not overweight large-cap multinationals. We actually do own multinationals, of course, but that's not where we really try to put our defensive bets. If we're worried about the emerging markets – as we are – and most of the growth in multinationals is coming from the emerging markets, why would we want to step into that? I'm not trying to say we have none. Of course we have some multinationals. But our defensive overweight in large caps is not in multinationals. That's splitting hairs, some people might say, but as a macro-oriented investor, I think that's very important. And, as I said, our defensive posture also has us in treasuries, and we've been pretty far out on yield curve because that's where your big diversification benefits come from. The negative correlation that I mentioned before between stocks and treasuries gets more negative as you go out on the curve. That's where the total return potential lies. Positive or negative, I should point out.

Again, you are making a bet that will be costly if rates go against you.
That's right. But what nobody points out is that if you are well-diversified and you have treasury positions and they do under perform, everything else in your portfolio is going to do *very* well. Your stocks are going to do well. Your lower quality bonds are going to do well. Your hedge funds are going to do well. Your private equity is going to do well. That's what diversification is all about. Some assets go up and some assets go down and you want the volatility to be the fulcrum of that seesaw.

Okay, is your underweight in the emerging markets also a big bet?
Yes, we only have about 2% or 3% of our funds in the emerging markets right now. Very little. And, in Europe, we've obviously stayed away from the European financials. In fact, we're very underweight financials, period. But we're quite underweight European financials across the board in our various funds. But let me put it this way: Defensive Europe has not performed so badly. I think people have been caught up in this notion that European financials are all of Europe. But that's not true. I mean, the major decision that portfolio managers had to make in 2011 was simply did you want to be in financials or not. And if you made that call correctly, the odds are you at least did reasonably well.

While, by contrast, anyone who tried to be a hero by snapping up "cheap" financials has been bloodied.
Exactly. For many people, it's been a value trap. They just get cheaper and cheaper and cheaper. But my point is that defensive Europe maintained its normal defensive qualities. So we do have exposure in Europe but it's been non-financial and primarily defensive.

Given your positions, I guess you think the dollar is also going to continue to surprise people with its resilience?
I may be the biggest dollar bull in the world. I'm not sure. I don't want to wear a crown or anything. But I may be up there with the bigger dollar bulls. And the reason is that I think people have underestimated a lot of the risks around the world. One of the major arguments against the dollar is that there's going to be huge inflation in the United States. Well, we don't have huge inflation here for many reasons. But where there is actually high inflation is in the BRICs. The BRICs have some of the highest inflation rates in the world because they have some of the fastest money growth in the world. Again, everybody is supposed to be a global investor yet everybody becomes very myopic on the United States and tells you how

horrible everything is in United States. They don't look to see what is going on elsewhere. But when we do that, we find the situation is actually worse in a lot of other countries than it is here. Again, maybe it's just another situation where we have the nicest house on a bad block. I don't know. But the dollar – or the DXY index, – actually troughed in April of 2008. Now, some people don't like using the DXY for various reasons. I understand that, for instance, it's pretty bad at representing the trade-weighted value of the dollar. But if you *do* use the DXY, it topped in 2008 and it has been *very* volatile, but it has actually been gradually *appreciating* since then. Yet when I tell people that the DXY troughed three and a half years ago they think I'm insane. So I find myself saying, "Look, guys, I'm not making up the numbers." You can argue this is a good index or a bad index but everybody used to love the DXY. Then, it basically stopped showing what they wanted it to show, so they moved onto other dollar indexes. Well, that's *certainly* the way to manage money: If the index that you've been using through time all of a sudden tells you something different, you can just decide the index is now no good to you.

If you can get away with it –

Right. The other thing that I try to point out to people – which, again, nobody believes – is the S&P 500 has outperformed the BRIC equities markets for coming up on four years now. *Four years.* That's just extraordinary. If you looked at the funds flows into domestic equity mutual funds versus the funds flows into emerging market equities funds, you'd say that their relative performance was just the opposite. So what I am saying is that I don't think people appreciate the risks in the BRICs. And I think the market, as usual, is way in front of the investing herd.

It's a flashback to the '70s, when all the institutions remained frozen up to their eyeballs in the Nifty Fifty, when they could have been making good money in small stocks, despite the secular bear market.

Absolutely. Those small caps did very well in the '70s. You made positive absolute returns in small caps if you didn't stick with the herd.

What about next year? How much will the U.S. election muddy the waters?

Well, I actually think that, just talking about the domestic economy, if we can get some clarity in terms of economic programs, 2012 could be a pretty reasonable year. But if we continue to be stuck in malaise or if we go into 2012 with each side carving out their territory purely to win the election, it could be a nasty year. I'm hoping that Washington may actually get its act together. Of course, as many people have said, hope is not a good investment strategy. I agree. And as I've said many times, if you take **President Obama** and the House Speaker, **John Boehner**, and you take **Mitch McConnell** and you take **Nancy Pelosi** and **Harry Reid** – those five people, are never going to be confused with **Winston Churchill**. The lack of leadership – as opposed to political bickering – is astounding. Absolutely astounding. And we've all entered into an echo-chamber society, where we like to hear what we like to hear – and we think everybody else is crazy. Unfortunately the leadership of the country has succumbed to that. And I don't think there's ever been a successful leader who has been subservient to popular emotion.

True enough. But didn't Churchill say something to the effect that Americans can always be counted on to make the right decision – but only after trying all the alternatives first?

Something like that, as I recall. That is what I feel is probably going to happen in 2012. But it probably won't be pretty. I think politics are going to drive an awful lot in the next 12 months, which is quite unfortunate. So as I said, we are defensive today. If our indicators change tomorrow, we will change. All our funds could go anywhere. I'm not a dedicated small-cap manager. I'm not a dedicated U.S. manager. I'm not a dedicated emerging market manager. I'm not dedicated to anything. So if the indicators change, we change.

And your newest fund gives you the ability to invest in all sorts of assets, in addition to equities.

That's right. But even our equity fund is not constrained. Among equities markets, we can travel wherever we want to go. We have maximum flexibility. Can even go into cash.

A rare and beautiful thing in the equity space.

I agree. What we are doing is like the way that money used to be managed a long time ago. I mean, we do use a top-down approach. But if you think about very old-fashioned managers, they would go anywhere where they thought there was value or they thought there was

growth. And if they couldn't find anything, they'd raise cash.

So you're back to the future?
Yes, even though we don't start from stock picking, we are top-down asset allocators – but we are also very attuned to the benefits of income to our portfolios. My favorite line is that since NASDAQ's inception in 1971, utilities stocks have outperformed NASDAQ. Which is a graphic illustration of the power of the compounding of dividends. I think that's just marvelous, because everybody says that if you're a long-term investor you have to invest for growth.

That's conventional wisdom, all right.
I have nothing against growth – don't misunderstand my point. But what the record of the utilities versus the NASDAQ says is that for long-term investors there is a role for income, as well. Yet people tend to talk about income producing securities as if they are only for retirees and near retirees. Personally, I think that is absolutely wrong. Everybody should have some income in their portfolio. The only question is what do you do with the income. If you're a retiree, you spend it. If you're younger, you reinvest it.

Sure, that's how you get compound returns.
Yes, and it's such an easy way to build wealth.

But it's not sexy –
No, it's not. Everybody runs to the next **Google** or the next **Apple** or the next gold – but none of these things pay any income. I just can't understand why you would pass up such an easy way to build long-term wealth.

Words to profit by. Thanks, Rich.