



**CFA Society of Nevada**

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Thank you for the honor and privilege of speaking with you tonight. Let's also thank Lee Hernandez for leading the charge to kick-start the first formal meeting of the CFA Society here in Reno.

Before starting, we should recognize those in the audience who are CFAs. Please stand up.

Now those who have passed their level 3 Exam or are awaiting certification, please stand up.

Finally, let's recognize those who are on the pathway to a CFA by having passed their Level 1 exam. Please stand up.

Much has changed since I was awarded my CFA back in 1980. My charter number is 6443. It has been amazing how large this program has become since then.

Good luck to all of you who are going through this program and may it may help you in your career aspirations.

For tonight, given that we have so many young professionals here, I thought I would begin with some observations, insights and challenges that I have experienced during my 43 year career and hopefully, they may provide you with one or two thoughts that could be helpful to you in your budding careers. I will then provide an economic and financial market overview. Finally, in my typically controversial and unvarnished way, I will attempt to provide my view of the future. As with all forecasts, listen and then come to your own conclusion.

I've been known for making outlandish forecasts before. They may have seemed extreme at the time but in retrospect, many were generally spot-on. When I spoke before the CFA Society of Chicago in June 2007, not many were thinking about the impending financial calamity that lay shortly ahead. I tried to forewarn what might take place in my speech, "Absence of Fear," which laid out the financial crisis to come. As the Morningstar keynote speaker in 2009, I again tried to warn of the dangers that lay ahead. In both cases, few listened.

What I have learned in my career is that few will listen to you when you have a viewpoint that diverges materially from the general consensus. I didn't realize this when I first entered the investment field in 1971. At that time, I viewed senior investment and business professionals with awe. They were more knowledgeable and wiser than I, or so I thought.

I was fortunate to learn early on that my inexperienced view was way off base. I did not realize that most investors, business professionals, regulators and government officials are genetically programmed incorrectly so that herd mentality decision making is the typical outcome.

Before I could develop a more independent thought process, I first had to experience some painful lessons. Crucial events that took place in 1971 and 1973 would not only "Future Shock" me but also the broader investment industry as well. By future shock I mean the process by which information overwhelms the recipient unexpectedly, particularly in new areas without precedent, so that one is unable to process it effectively. In August 1971, the Bretton Woods world of fixed exchange rates came crashing to an end when the dollar was removed from the gold standard suddenly and without warning; thus, the era

of floating exchange ensued. Most were caught by surprise and did not understand the repercussions or the unintended consequences of such a change. In 1973 the world experienced its first oil-embargo and again most underestimated its significance. For example, the Dow Jones Industrial Average continued to rise in price a week after the event. In another year, the largest market decline since the Depression would be taking place.

These events transformed me as an investor. I did not understand how such significant events could occur and yet, the crowd misread what they meant. What really shocked me was how my formal education had not prepared me for the unexpected. The investment concept of having a “margin of safety” was yet to be discovered by me. During the summer of 1974, I spent most of my free time after work at the USC library studying old business and financial books from the 1920’s to see whether any might provide me with some insight about what was unfolding within the economy and the financial markets. In my quest, I “discovered” the 1934 edition of “Security Analysis” by Graham and Dodd, which forever changed my investment philosophy.

I was also lucky to have an “old guy” of about 50 speak to my fall 1974 USC graduate investment class. He too had a major impact upon investment thought process. After all the students had left the room, I asked our speaker, Charlie Munger, this one question, “Mr. Munger, I am early in my investment career. If I could do one thing that would help me make myself a better investment professional, what would you recommend?” He answered, “Read History! Read History! Read History!” I already had a deep interest and love of history but his comments made it seem all that more important. Since then, I’ve become a pretty good historian in many areas. This bit of advice has served me well over the years.

The 1974 market collapse also taught me that most people are undisciplined and guided by emotions. One of the basic tenants of Value Investing is to be extremely unemotional in the evaluation of prospective investments and the management of them after they have been made. My associates and partners know that I can be somewhat emotional and a bit of a character at times, except when it comes to investing. I tend to have ice water in my veins. I’m also an odd duck in that when asset prices are rising, I get depressed, while when they are falling or collapsing, I become ecstatic. We value style managers tend to be a weird group. We disdain crowds and like our solitude. We view herd style decision making as an opportunity to be taken advantage of.

I can distill what I do down to a simple formula. Call it my suggested formula for investment success. It requires five inputs. Leaving one of them out disrupts the whole equation. Are you ready?  $D+P+C+P+D$ =investment success. D stands for Discipline. The discipline that is required in evaluating a prospective investment. P is for Patience. One must have the patience to wait for an investment to enter a potentially high-return/low-risk zone. I’ve waited as long as seven years for an equity investment opportunity to finally emerge. C is critical. It stands for Courage. One thing I’ve learned over my career is talk is cheap, actions speak. There are many well educated investment professionals who can speak well and convincingly but when it comes to the execution part, they fall flat on their face, particularly during times of distress. P again stands for Patience. It represents the ability to allow an investment to unfold over time. In my opinion, the professional money management industry of today exhibits elements of a casino type mentality, as reflected by hyperactive portfolio turnover ratios. This is particularly true since the onset of the Fed’s QE policy, whereby we have a new “Risk-On, Risk-Off” investment strategy. Finally, Discipline again. One must have the discipline to sell when expectations have been met or more importantly, the discipline to recognize that the original analysis was incorrect. In other words, you blew it.

After the collapse of 1974 and the ensuing inflation of the 1970's, I concluded there appeared to have been a systemic failure in professional investment management as it was then practiced. To outperform the market and my competition, I had to implement a portfolio strategy and methodology that was fundamentally different from that of the general consensus. Although many believe they do not follow the crowd, in retrospect, they generally do. My strategy became one of owning fewer stocks and industry sectors, when compared to a typical institutional portfolio. I would not fall into the trap of emulating an index or differentiating by modestly adjusting component composition. It has been one of investing in the land of tall trees whereby I targeted a few selected sectors while ignoring the others. The highest conviction securities received a disproportionate capital allocation. Over a thirty year period, I typically had exposure to no more than three or four sectors, with 40% to 60% of assets deployed into the top 10 holdings, and no more than 35 to 40 holdings.

This was not the accepted way of managing money. When I stepped down from day to day active money management at the end of 2009, my equity fund, FPA Capital fund, had outperformed various measures of stock market performance by approximately 400 to 600 basis points compounded annually since June 30, 1984, while finishing as the #1 diversified equity fund for that period\*. This same type of philosophy was implemented in my high-quality fixed income fund, FPA New Income, with the result that it outperformed various measures of bond market performance, while being the only bond fund to never experience a calendar year of negative performance, for the same timeframe\*.

***\*Past performance is no guarantee of future results.***

What I have learned in my career is that there is far more to becoming a successful investor than just being superb at accounting, financial modeling and smart. If I were to go back and begin again, I would spend more time studying human psychology. Very few people know themselves and are self-critical. I recommend that you ask yourself the following questions:

- How do you deal with stress and uncertainty?
- Are you more comfortable working alone while making independent decisions or do you like to know what others are thinking and doing?
- Have you dealt with adversity in your life and how did you handle it?
- Have you ever wondered why so many smart people get it wrong in investing and why?
- Do you have common sense and if so, how do you prove it?

I ask you to think about these questions since two of the biggest stock market collapses in human history, 2000-2001, and, 2007-2009, occurred while the investment industry had the largest number college graduates employed with the timeliest access to information ever. The investment outcomes were not much different from those that occurred in earlier eras.

If you have any doubts about this statement, I quote from Theodore Burton's 1902 volume, *Financial Crises and Periods of Industrial and Commercial Depressions*, "by higher standards of education and consequently greater wisdom, .....depressions may be avoided." More than 100 years later, are we any better? I leave that to you to judge.

To add to this view, Walter Bagehot in 1856 observed, "much has been written on panics and manias, ....but one thing is certain, that at particular times a great many stupid people have a great deal of stupid money." When I read this quote, I immediately thought of the tech bubble of 2000. In 2000, I was quoted



many times and said that net company valuations were not only discounting the future but also the hereafter.

To be a successful investor over the long-term, I'll quote from someone you may never have heard of, Warren Buffett. In his 2006 chairman's letter about qualities a successor to him should have, he says, "A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered. Additionally, temperament....., independent thinking, emotional stability, and a keen understanding of both human and institutional behavior (are) vital to long-term investment success."

I hope these observations will be of some assistance to you young professionals.

Now for my longer term economic and financial market outlook.

I wish I could be optimistic but I just can't bring myself to it. Too much has unfolded during the past decade that dictates a far more cautious outlook, in my opinion. For the record, I've maintained this view since 2011, so some of you may think that I am unwilling to throw in the towel. You may be right but I don't think so.

Before commenting about the economy and financial markets, let me say this unequivocally, the fiscal and monetary policies implemented over the past fifteen years have been, in a word, terrible. They have led to a leveraging up of the financial system and have also incentivized excessive risk taking. Should these policies continue, I believe many will experience an exceedingly painful outcome that will cause severe damage to both their ego and their pocket book.

#### On Economic Growth and the Financial Markets

Since mid-2009, I've forecasted that real GDP growth would likely average approximately 2% and it would be accompanied by elevated levels of unemployment that would be structural in nature. Each year the Fed began with a very optimistic growth outlook for the following year and then subsequently it had to be revised lower by a substantial margin. This year is no exception. Last month it revised lower its December 2013 central tendency forecast for 2014 to 2.1% from a range of 3% to 3.5% growth. Again, it continues with an optimistic bias for 2015 where the forecast is for more than 3% growth. I believe will have to be lowered again, as has been the case for nearly five years.

I've been highly critical of the Fed's monetary policies for years and particularly the various add on QE programs since they first began. I believe this policy will lead to one of the present day future shocks. Many an unintended negative consequence will be the result of this unwise and unsound policy. Like the lead up to the 2007-09 crises, at FPA, we see many credit market sectors that exhibit the presence of unsound underwriting standards that are quite similar to that which took place prior to the Great Financial Crisis. This is particularly true in subprime auto loans and high-yield credit. I believe QE and ZIRP (zero interest rate policy) will eventually be viewed as false elixirs of growth. As such, these policies will achieve the same level of contempt as was the case for snake oil salesman in the nineteenth century.

Other nations are proceeding down this unsound monetary pathway. Both Japan and Europe are in the process of expanding their respective QE programs. QE has not and will not achieve the intended goal of sustained economic growth escape velocity. Europe is on the verge of falling into its third recession since the Great Financial Crisis ended. Japan has not achieved a growth level that is anywhere close to what

was anticipated, even after conducting the most aggressive QE policy of any nation that, at times, was as large as 15% of GDP.

What is more troubling is that there has been no real deleveraging in debt levels both here and abroad. Geneva Reports, in their recently released September study, noted that debt-to-GDP ratios worldwide are now at higher levels than what preceded the last financial crisis. Additionally, their data confirms that higher debt level ratios, particularly those above the 90% to 100% range, are resulting in lower economic growth outcomes. This is what some of us were forecasting back in 2009 and what was argued by Reinhart and Rogoff in their 2010 book on 800 years of financial folly.

Economic systems are floundering and there seems to be no real answer to the slow or no economic growth issue other than for a more aggressive monetary policy. None of the developed nations are willing to attack the excesses in fiscal policy that are driving this massive debt growth cycle for fear of worsening the growth dynamics in the short-term. Additionally, even greater levels of regulation are being implemented. Four years ago, former Fed Chairman Bernanke argued that fiscal reform should be delayed and that enhanced regulation could help prevent a reoccurrence of another financial crisis. This from a person who said that there was no housing bubble in 2005 and 2006 and that there would be no contagion from subprime credit excesses in 2007. Nothing of any real significance has been done since then to change this nation's non-sustainable path of fiscal policy excess. Despite nearly \$13 trillion in deficits and QE since September 2008, the US still faces substandard economic growth.

I've consistently argued that QE would be ineffective because it is ill-suited to fight the structural elements of unemployment. The heartland of the workforce, those workers between the ages of 25 and 54, has not recovered to its December 2007 peak level. This group is still down by 3.9 million workers from 104.8 million, while the total workforce has increased by 1.9 million to 155.9 million. Additionally, the group between 16 and 19 has declined by 1.4 million to 5.6 million. What is obvious is there is an educational and skills deficit that is reflected by over 2.2 million fewer workers working that have only a high-school diploma or less, when compared to December 2007. No amount of easy money will cure an educational deficit. Two groups that have improved their relative positions are those over 55, up by 6.9 million on a base of 27 million, and college graduates, bachelor and master degrees, up by 3.2 million and 1.5 million, respectively, on a combined total of 39.2 million. The older workers most likely continue working because of their diminished financial circumstances that is partially a function the Fed's QE/ZIRP policies.

The real beneficiaries of QE have been in the stock and bond markets. Chairman Bernanke's strategy of inflating asset values, as a means of stimulating the underlying economy, has generally failed. Additionally, the Fed's goal of a 2% inflation rate has also not been met. However, it has been successful in creating asset price inflation on Wall Street. Its zero rate policy has encouraged enhanced risk taking since the general consensus is that one cannot keep money invested at a near zero rate. This is a mistaken belief since the opportunity cost of holding liquidity is among the lowest ever, when compared to dividend yields averaging just over 2%.

The stock market has been a fabulous place to be, particularly the past two years. However, approximately 60% of the market's total return for this period has been a function of PE expansion. Profit margins have only improved slightly while top line revenue growth for the S&P500 has averaged between 2.5% and 3%. In contrast, earnings' per share growth, benefitting from aggressive corporate share buybacks, has been above 5%. I warn you that share buy backs should be viewed skeptically since corporations have a long history of implementing them at stock market peaks while they are then terminated at troughs. Are these the components of a sustainable stock market rise? I think not, when it

is driven by monetary policy manipulation of financial markets in conjunction with corporate financial balance sheet engineering. However, this game goes on since the consensus believes there is no alternative to the risk-on trade because cash earns nothing.

As a dedicated contrarian, I anticipate that prospective stock market returns should average less than 5% and more likely closer to 3% for the foreseeable future. Again, the penalties for holding liquidity are not that substantial when compared to the risk and likelihood of principal loss. This brings to mind the observation that Ben Graham made of the 1929 stock market. Had one sold stocks in 1925, one would have missed the other half of the market's rise; however, between 1929 and 1932, the decline was so severe that one would have to wait nearly 20 years to regain the index's point loss. For those who stayed in to the market peak, it would take nearly 25 years to recoup the loss in Dow points. On a more current basis, the NASDAQ has not yet recovered to its 2000 peak of 5,043.

As a side note, my value stock screen is within one of its all-time low with 27 qualifiers. For comparison; in June 2007 35 passed, while in March 1998 and January 2004 47 qualified. This is screen I use for the small/mid-cap sector so it signifies this is a very rich market segment. Though large cap stocks appear cheaper, my previous comments about financial engineering should be kept in mind. Furthermore, lower interest and labor costs have been key elements in corporate profit margin improvement. Are these sustainable trends? With interest rates near record lows and labor compensation at the lowest level of national income since 1948, I think not. Caution would appear to be warranted.

The bond market presents another difficult choice. With the ten-year Treasury bond yield at 2.3%, there is little margin for error, unless we remain in a low inflationary environment. For the next two or three years, I believe this will be the case. However, with each passing year after that, I believe the risks of principal loss rises at an exponential rate.

These are dangerous times. Unless sovereign governments mend their ways, we face a volatile and difficult future. Few politicians are willing to make the difficult fiscal policy choices that are necessary to reform their respective economies; thus, monetary policy appears to be the only game in town to stimulate economic growth.

Within two or three years, I expect that it will be obvious that QE policies will have failed miserably. Stunted economic growth, with elevated unemployment or under employment, will force the hand of many countries. How to stimulate economic growth when fiscal policy reform is off the table and QE has failed? I would argue that the last arrow available in the quiver of economic stimulation is currency policy. A general competitive devaluation of a country's currency will be all that remains. Both Japan and Europe are proceeding down this pathway. Should they be successful in their currency devaluations, this will force the hands of other countries. In the last two major international currency episodes, 1980-1985 and 1998-2001, the dollar proved to be the currency shock absorber. A review of the US Dollar Index graph will demonstrate this. Unlike these previous episodes, I don't believe a similar outcome is possible since this country has far more systemic imbalances, when compared to those prior periods, and thus, a smaller rise in the dollar's value will elicit a more immediate negative response. So my recommendation to you is to keep a very close watch on the currency markets over the next few years.

This has been a decidedly negative outlook but I let the data lead me to the conclusion. Despite this, how can you take advantage of it? With heightened pressures to be fully invested, I believe the utilization of liquidity as a proactive investment strategy is warranted. There will come a time when it will be wonderful to be investing again. My recommendation to you is the classic value saying--be cautious while others



are greedy and be greedy when others are cautious. Market volatility is bound to increase materially so an elevated liquidity position will afford you the opportunity to be greedy when the time is right.

As I enter the twilight of my career, I hope that I have attained some degree of wisdom as well as demonstrated an element of investment courage. As Norman Cousins said, "Wisdom is the anticipation of consequences." They are always there but you may not be aware of them. And as for courage, I like one of our former local resident's views on the topic. Mark Twain said, "Courage is resistance to fear, mastery of fear, not absence of fear." Attain wisdom and demonstrate courage and you are well on your way to becoming a successful investment professional.

Thank you.

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