Our Interview with David Darst

August 12, 2008

David M. Darst, CFA, is a financier, educator, and author. He is a Managing Director of Morgan Stanley and serves as Chairman of the Asset Allocation Committee and Chief Investment Strategist of the Global Wealth Management Group, with responsibility for Asset Allocation and Investment Strategy, and was the founding President of the Morgan Stanley Investment Group. His most recent book is *The Little Book That Saves Your Assets.*

We spoke with Mr. Darst on August 8, 2008.

One of the first concepts you present in your book is that "As investors, we need to know where markets are today, where they are in the current business cycle, and where they are from a long-term perspective." Can you briefly answer these questions, particularly with respect to the US equity markets?

> These are very critical issues. At Morgan Stanley, we are still cautious on the US equity markets. There are three things we would like to see. First, we need to see home prices stop declining and, second, the financial system ease up. Mortgage rates are still high and surveys of mortgage lenders continue to show tightening credit. Thirdly, we would like to see the US earnings recession bottom out. We have had four quarters in a row of negative earnings growth. We may not be in a classical economic recession, but we are definitely in an earnings recession.
>
> The good news is that oil is moving in the right direction. We also believe that gold below 900 is marvelous, and we think maybe the dollar is making a bottom. These are small victories, especially if oil prices remain steady.
>
> This is like moving your child into a college dormitory room. We are still moving in. We may have carried the bookshelves up the stairs and into the room, but the stereo system and luggage are still in the car.
>
> On a longer term basis, P/E ratios are cheap. I saw a chart this morning that says that the trailing P/E for the S&P 500 is down to 15, which is

equal to its long term average. This is not to say that it could go below this level, but it is coming down from 27 or so.

Yale Professor Robert Shiller says we should look at the 10 year rolling average of P/E ratios [see our article on this subject]. We are still way above long term trends, when measured this way.

It took a lot of time to get a 100 year housing price bubble, and it will take some time to get out and finished with the housing price correction.

Peter Bernstein, in his column in Sunday's *New York Times,* makes the point that the US economy in 2007 was hit with an unusual "trifecta" of spikes in oil and food prices and a collapse in housing prices. Bernstein argues that "a halt in decline of home prices seems *the* necessary condition to transform the system from despair to hope…" Do you agree with his assessments?

This is a fair call right now. Professor Shiller shows the housing prices are down about 15.8%, year-over-year, through May. If you go back further, from the top in housing prices, we are down 18%. Morgan Stanley, Goldman, and others expect the total decline to be 25% to 30%. Probably another 10-15% decline is coming. Nobody can call this. Of course, there is a local aspect, with places like Miami and Las Vegas hit harder than others. Bernstein is right on target. There needs to be a stabilization of prices, and inventories have to be worked off.

Moderate/Balanced[4]

	Strategic	Tactical	Tactical Range
Equity[6,7]	46 %	44 %	30-60%
U.S. Equity	30 %	29 %	20-45%
Large Cap Growth	11	14	
Large Cap Value	11	13	
Mid/Small Cap Growth	4	1	
Mid/Small Cap Value	4	1	
Non-U.S. Equity[8,9]	16 %	15 %	10-30%
Europe	10	8	
Developed Asia[10]	4	5	
Emerging Market Equity	2	2	
Fixed Income[11,12,13]	29 %	22 %	15-50%
U.S. Fixed Income	29 %	22 %	15-50%
Investment Grade Bonds[14]	29	19	
Short-Term Investment Grade Bonds[15]	0	3	
High Yield Bonds	0	0	
Non-U.S. Fixed Income[8]	0 %	0 %	0-10%
International Bonds	0	0	
Emerging Market Bonds	0	0	
Alternative Investments[16,17]	20 %	20 %	10-30%
Real Estate & REITs[18]	3 %	0 %	
Real Assets[19]	2	4	
Private Equity/Venture Capital[20]	–	–	
Managed Futures Funds[21,22]	4	4	
Hedge Funds or Fund of Funds[23]	8	10	
Inflation-Indexed Securities[24]	3	2	
Cash/Cash Equivalent[25]	5 %	14 %	0-20%
U.S. Dollar	5 %	14 %	
Total	100 %	100 %	

This is one of the reasons we have a higher-than-normal cash position. We are normally at 5%; now we are at 14% and we were as high as 16%. We remain cautious, but are willing to put a toe in the water with the equities markets. [Morgan Stanley's recommended asset allocation for high-net-worth Moderate/Balanced portfolios is shown to the right. They also have separate recommendations for Conservative/Balanced and Aggressive/Balanced portfolios.]

In your book, you advocate the use of the Asset Allocation Clock, which shows the asset classes that advisors should favor, based on their expectations regarding inflation and economic recovery. What is your forecast for inflation in the US and in major global markets? How much danger exists that the US will experience a period of hyperinflation?

Morgan Stanley is looking at a 4.6% CPI this year. We know these numbers don't reflect everyone's experiences. Individual budgets do not track the government's calculations. We are looking at 3.5% to 3.6% next year.

As for hyperinflation, advisors need to worry about it a little bit and have a mental check box for it. There has been huge monetary growth because of a flood of dollars into other countries. This has not been "sterilized," and has increased foreign countries' inflation rates.

As a result, the inflation rate for 42% of the world's 6.5 billion people is over 10%. Almost half the world is living with double-digit inflation.

I don't think we have a risk of hyperinflation, like the 10,000-plus levels in Zimbabwe. The bond market vigilantes have their hand on the steering wheel, alongside the Fed. It is like driving your car, if you start to doze off, your spouse will quickly put their hand on the wheel. The bond markets are the brakes and governors for inflation getting out of control.

> "The chances are that we saw a bottom in inflation and interest rates in 2003."

The markets have benefited from a 20-year tailwind, the result of increased trade, declining inflation, and interest rates, and decreased labor costs, and this has increased P/E ratios. I am shocked there has not been a bond-market rebellion over the risks of higher inflation. Sometime this may very well reverse.

The chances are that we saw a bottom in inflation and interest rates in 2003. The only thing that would cause us to alter our forecast is a global shock, such as war, new findings on climate change, or an epidemic like the bird flu.

Given the global economy, you advocate investors "have exposure to worldwide currency movements to offset the impact a depreciating currency can have on your investments." How should advisors structure portfolios to incorporate this exposure, especially since most academic studies show that currency-hedged portfolios do just as well over the long term?

I agree 100%. We don't want to be currency traders. I have seen portfolios with 20% or more exposed to currencies through asset positions and through cash. Currency exposure became easier with new ETFs. We try to keep pure currency exposure on its own to a minimum, and confine it to equity allocations in the developed and emerging markets, including Canada. Advisors need to help clients avoid currency speculation. Our currency overweights are done through products like international TIPs (symbol WIP). These State Street products are a few months old, and are good for people who want a little extra currency exposure.

We get currency exposure through assets and not through currencies themselves. Occasionally we get exposure through cash, and sometimes through foreign bonds.

The currency markets are dominated by traders and huge corporations. Advisors can't expect to pick them off and make a profit.

You lay out two basic approaches to asset allocation: Strategic Asset Allocation and Tactical Asset Allocation. How do you distinguish Tactical Asset Allocation from market timing? For advisors practicing Tactical Asset Allocation, how often do you suggest re-allocating funds?

When investors try every little tweak to attempt to catch the market, then they are market timers. It may be nice for brokers when they generate transaction activity, but if they overdo it they will drive clients away. Maybe a third of the new clients I meet have switched because of transaction activity that was too high.

Tactical Asset Allocation is when something gets out of whack in a pronounced way and on a relative basis, and we take advantage of the opportunity.

For example, financial stocks have fallen. Through yesterday, on a year-to-date basis, they are down 27%. Since October 9, they are down 41%.

At the sector level, we then apply three tests to gauge the opportunity. First, we look at the fundamentals. In the case of financials, these are still under pressure as institutions continue to de-lever. Then we look at value. We'd like to say there is a green light for financials, but nobody knows for sure what their earnings will be, so really it is a yellow light. Lastly, we look at the psychological factors. At big turning points, such as the dot com bubble, psychology can be 60% or more of the driver behind price movements.

An example of good Tactical Asset Allocation was immediately after the crash of 1987. The Yale endowment called an emergency meeting and determined that nothing was "broken." The fundamental factors that affect market valuations were unchanged. So they put a ton of money into stocks, and did very well.

"Unless you have a better reason, yearly rebalancing is the prudent thing. I have listened to David Swensen (the manager of the Yale endowment) and he agrees."

Unless you have a better reason, yearly rebalancing is the prudent thing. I have listened to David Swensen (the manager of the Yale endowment) and he agrees. But if something gets way out of whack such as, say, interest rates spiking to 8%, then maybe both bonds and stocks would be worthy of a tactical move. We want to be judicious and appropriate, and not rushing to catch every little swing.

If gold fell to 600 or 700, we would put some additional money in that asset class, in a tactical sense. But we already have a tactical allocation to gold.

The most recent tactical allocation we did was on July 23, immediately after a number of financials announced slightly better than expected earnings. We put a couple of percent back into stocks.

We have been taught that market timing can only be done by those who watch the market every minute, like George Soros or Michael Steinhart. Most advisors should not try to market time; it is too hard. When things bottom out, the $3.8 trillion that is sitting in cash right now will move in and have a big impact.

In April the market was up 5%, and in May it was up 1%. We considered getting back on board, but decided this was a bear market trap. We did not see the preconditions I noted at the beginning of this interview, which are necessary to put you in a better investment frame of mind.

You state that "some of the greatest asset allocation and investment success stories have been made possible by keeping a sense of perspective and seeing the big picture." What are the key big picture issues that advisors should be looking at today?

There are several big picture themes that should influence everyone's investing decisions. These are related to the environment, water, alternative energy, raising living standards in the emerging markets, and the maturation of the Boomer generation.

First, people all over world are much more aware of the environment and issues like global warming. Related to this, I believe water presents an excellent opportunity [see our article on this topic]. There are five ways to approach water-related investing. I believe bottled water and utilities do not present opportunities as attractive as water issues exposed to filtration, purification, and desalination.

Whoever is elected President will need to move toward alternative energy. Solar and wind have gotten a lot of hype, so my advice is to be careful there. There will also be opportunities related to off-shore drilling.

The next big issue is the rising living standards among the two billion people living in emerging markets. For example, a big issue, which was overlooked by most of the world, was the election on March 22 of Ma Ying-jeou as President of Taiwan. He is our friend and, more importantly, a friend and not a foe of China. This will make Taiwan's reserves more investible. Taiwan has 2.5% the population of China, but 25% of the reserves. It will improve travel and strengthen northeast Asia. It also affects Korea, especially if that peninsula slowly reconciles. It may make Japan want to invest more in China (Japan is already one of the biggest investors in China). People forget that 30% of China's economy is consumption; the other 70% is exports. This will help the consumption piece.

"For example, a big issue, which was overlooked by most of the world, was the election on March 22 of Ma Ying-jeou as President of Taiwan. He is our friend and, more importantly, a friend and not a foe of China."

This could be as big as the Berlin Wall coming down - what I would call a "Kissinger moment." The impact of the fall of the Berlin Wall was the opening of new markets, and the same can happen here. In fact, while celebrating the opening of the Olympics, we should also be celebrating the 30th anniversary of Deng Xiaoping ascending to leadership in China and tilting the whole country to capitalism.

There are big picture opportunities to serve the Boomer generation. They want to feel, look stay young, but they don't want to pay. Generic drugs have a long term opportunity. There are also opportunities in pet care (Boomers want companionship) and dental services.

I read Alan Greenspan's book, *The Age of Turbulence*. Many people dismissed it as the kiss-and-tell musings of the former Fed chairman. But they missed so much. The most chilling part is that Greenspan said that 55 of the 76 million members of the Boomer generation are responsible for their own retirement investing. But they don't know it. They get statements but don't realize they are responsible for their asset allocation. I am really concerned about this. A Wharton study of 1.2 million defined contribution plan members showed that 92% have not made a change in their asset allocation in several years.

As individual investors and advisors, the only things we have to level the playing field are our common sense and basic observation skills. We need to keep our eyes open, read, and listen - with skepticism – and have an advisor we can trust (which I refer to in my book as an "Uncle Frank").