Bob Rodriguez on the Dangers in Today's Markets

By Robert Huebscher
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Bob Rodriguez, CFA, is the managing partner and chief executive officer of First Pacific Advisors. Based in Los Angeles, FPA manages $19 billion across five equity strategies and one fixed-income strategy. Bob joined the firm in 1983. He currently serves in a supporting role to the research and portfolio management teams for the Small/Mid-Cap Absolute Value (including FPA Capital) and Absolute Fixed Income (including FPA New Income) strategies, both of which he established in 1984.

I spoke with Bob on February 14.

You've handed off the management of the FPA Capital Fund and the FPA New Income Fund to others. What are your new responsibilities, and do you miss running a fund?

My responsibilities are as CEO and managing director, as well as an advisor to the funds and product groups I formerly managed. The firm has grown rapidly over the last several years. We expanded the management committee by the addition of Steven Romick in early 2009, who manages the Contrarian Value Strategy (including the FPA Crescent Fund). That was in preparation for my sabbatical in 2010.

I think more about larger issues. I pester my successors with comments and suggestions, but I am not in what I would call the security-specific selection arena, other than if I see them doing something in an area where I have some knowledge, I will provide free advice – which is worth about as much as I charge.

Do I miss managing money? Not particularly. I look at the time that I was off on my sabbatical and came back, and nothing has really changed. There was a major financial collapse with a desperate need for liquidity.

I have said to pension funds that you never know the value of liquidity until you need it or don't have access to it. They tended to get a sense of that in the credit collapse. Here in 2011 and 2012, memories are exceedingly short, and the bad behaviors that I saw before are alive and well today. It is a very difficult time to be managing money, particularly with the high-volatility, risk-on/risk-off environment that we are in.

I am going to come to some of the macro issues in a bit, but first, in the beginning of December last year you launched your first new fund in 25 years, the FPA International Value Fund. Why at that time?

We had been looking internationally at company-specific data. What portion of corporate revenues is international? How can that benefit our investments? Since many of us at the firm believed that the recovery growth rates in the US would be very much substandard, could we gain something more in this area?

The opportunity came via Steven Romick when Pierre O. Py and Eric Bakota became available. We went through a long vetting process that lasted for eight months. In all things, at FPA we wanted to create an environment that would enable long-term success for the strategy. We have committed to building it over time and very pleased with their progress thus far. Their style fits very much with many of the styles and philosophies at FPA. The cultural and investment fit is right and we are excited about the prospects for the strategy.

Let's talk about investing style. You were forecasting a global financial meltdown starting as early as 2007, and you moved to a large cash position. And for this prudence you received shareholder criticism and redemptions. From a business – but not necessarily an investing point of view – does it make sense to take an extreme position away from the consensus?

That is always a hard question to answer. When I speak to graduate students at the University of Southern California, I say, "Each of you is going to have to answer that question yourself." For me, investing comes first and what happens to the business comes second. If I didn't pay attention and do what was right investment-wise, I wouldn't have a business longer-term.

I got an early test of that in the 1980s, when a client terminated me and the account was one of the best at our firm. It represented a 50% to 60% loss of business in one day. It was because I was not willing to pay kickbacks to keep the account. I said, "What more can happen to me than that?"

In one way it was very negative, but in another way it was very freeing. I have never looked back.

In 2007, we went to our separate account clients and said, "We're taking the cash up. Your choice is either to stay or leave." Fortunately, they all stayed. That doesn't mean they didn't redeem some portion of their capital.

The volatility was highest in my equity mutual fund. It makes managing a fund more difficult, when you have sizeable shareholder redemptions. In 2007-2009, if I did not have a large cash position, I would have been selling into a very negative market environment, thereby hurting our own investments and harming our existing shareholders. I have no regrets about holding cash, and I don't think there were a lot of fund managers who did this.

More recently you've favored a number of oil and gas investments. Do you still like them for the long haul? What metrics do you look for when picking energy-related investments?

You have to break them down into whether they are exploration and production [E&P] or oil services, and whether they are oil-related or gas-related. Over the years we have had a dominant exposure in oil services, because it provided us a more diversified way of participating in the industry. I'm going back to 1999. It wasn't until 2006 that we started to put some money into the E&P companies with strong balance sheets, strong reserve positions and good cash flows. We had an opportunity to acquire several E&P companies during the fall of 2008 and the spring of 2009 when oil prices collapsed. Many of those companies now are up in the neighborhood of 300% to 500%, and we have sold upwards of 80%.

We also reduced our positions in onshore oil service companies emphasizing natural gas exploration, as opposed to those that are more offshore-drilling oriented. So the composition of our holdings has changed. Dennis Bryan and Rikard Ekstrand, my successors, currently like the oil service offshore industry more than the E&P or onshore drilling sectors. With the recent collapse in natural gas prices, we do not think the current price level is sustainable. It is the age-old question, “What is the cure for low gas prices?” Well, contraction in drilling eventually leads to supply constraints and higher gas prices. It goes through that cycle over and over again. We have reduced our energy exposure in the fund by approximately 25% to 30% over the last 18 months.

Why do you have an interest in energy?

We like it because of its growing scarcity and the cost of discovery – especially oil – is increasing. Non-US oil demand continues to escalate. During my sabbatical year off, one of the insights I had came after I traveled across Asia into Russia and through South America. One word described my view everywhere I went: traffic. It was amazing. When I was in Moscow this time versus 10 years ago, the number of car registrations was up 500%. You cannot go anywhere without a traffic jam. This was typical of any of the cities we visited. The emerging markets are expanding markets.

We like its long-term outlook. Oil prices are more a function of the international market whereas natural gas prices are set locally. We are still encouraged longer-term, but over the next one to three years we could see downside volatility in energy prices.

Let's turn to the macro issues. I understand your process for picking securities is bottom-up, but you are also well regarded for your macro thoughts. Jeremy Grantham has said the profit margins are freakishly high while Blackrock's Bob Doll thinks that current high profit margins are here to stay. What are your thoughts on that issue?

I would side with Jeremy Grantham. As I said in my recent speech Caution: Danger Ahead, approximately 73% of the improvement in profit margins was a function of two things: lower labor expense and the decline in interest cost. I believe the odds are low that the interest-cost benefits that corporations have achieved are sustainable for the longer-term. In terms of labor costs, you witnessed in Q3 and Q4 of last year erosion in labor productivity. Part of the growth in employment that you are seeing right now is because there is a lack of productivity improvement, which I believe will lead to higher labor expense. Unless corporations can pass this increase on, it raises a question about the sustainability of profit margins.

As a value manager, when you see an extreme outcome like what we have presently in profit margins, you have to treat the assumption that "this time is different" as a dangerous statement. Many, many investors have been burned by that one.

In that speech, you took a conservative view toward the US economy. But much of the recent news has been positive. The retail sales numbers show growth of about 5%. There's been job growth across virtually every industry, with the exception of housing and construction, and in state and local governments. Vehicle sales are up to 15 million per year. Corporate balance sheets are strong. The ECB is showing a willingness to respond aggressively to the problems in Europe. Have any of the recent data changed your views?

No. I was writing from a longer-term perspective. In the short run, interest rates are being manipulated and have been manipulated by the Federal Reserve. You have had tax policy that accelerated spending into the third and fourth quarters of last year, through the 100% depreciation write-off for capital equipment. Auto sales don't differentiate between an individual buying a car versus a proprietor buying a car for his business. I would argue the proprietor buying the car for his business would view it as a capital investment, and thus, he is getting an incentive to accelerate his capital investment versus an individual. So there are some transitory elements in these numbers that may not continue.

The financial leverage that is building in our system is not sustainable. We are getting closer to a tipping point. This is a joyous period for the equity markets because central banks are pumping liquidity into their respective economies.

There is a price to be paid for these aggressive monetary actions. The excessive monetary intrusion the central banks are doing can be viewed as a form of cancer. The effects are not going to be seen until later. This analogy can also be applied to the fiscal policies being implemented in the United States and in several other countries.

If you went back to 2004-2006, when credit underwriting standards were being lowered, everything looked fine. The economy continued to grow, but there was a growing credit cancer underneath the system that our Federal Reserve Chairman didn't recognize. When it finally broke into the open, all of a sudden the financial system had to go into the intensive care unit.

We can go for a period of time doing what we are doing right now, but we have a window to start attacking our fiscal excesses, and if we don't we are going to pay a price for it.

In terms of attacking the fiscal excesses, you support Dave Walker's Comeback America 12 platform for reform. He supports a number of measures for how entitlements, such as Medicare and Social Security, need to be reformed. But he also calls for more-or-less across-the-board spending cuts in order to reduce our debt-to-GDP ratio. Does that necessarily abandon a strategy where the government might be able to foster a recovery through growth, with, say, infrastructure spending?

If you believe that, then I would argue that that you also believe in the tooth fairy.

There is no easy way out of this. It has taken us basically four decades to get into this mess, and you are not going to get out of it with just a simple infrastructure spending program. I've looked at the president's budget and, yes, it is a negotiating instrument, but, still, let's look at it between 2011 and the end of 2014. Under his budget, public-sector debt grows $1.5 trillion more than the Simpson-Bowles commission estimated. Obama has never really incorporated the commission's work publicly. Under his budget, it would not get to a lower level of public debt outstanding versus the Simpson-Bowles plan until 2018, two years after he is out of office, assuming he is reelected. Who in their right mind believes that is a realistic trend?

So it's a negotiating document. Let's not ascribe too much credibility to the Congressional Budget Office's analysis, because what was their forecast back in 2000? We were going to have a shortage of Treasury securities. I published a commentary back then, and I said, "How many believe in fairy tales?"

I viewed the Simpson-Bowles' economic growth assumptions as being too optimistic, but it was at least an attempt to get both sides of the aisle to come together. It was close, but it never got done. I got very discouraged when I gave the "Danger Ahead" speech on February 15, because just three or four days earlier Congress passed the payroll tax reduction. People don't realize that last year's payroll tax reduction was four to five times greater than the first year expenditure cuts called for under last year's August debt limit accord requiring $917 billion of expenditure cuts over ten-years.

If we are to reestablish fiscal balance, you are going to have to take hits now. It's just like your dad coming home from work saying, “My hours have been cut back. I can’t earn this money. We are going to have to make some cuts right now. I am not going to bet that my income is going to be up two or three years from now.”

That is the decision we have to make. Every study I have looked at says you get far more bang for the buck longer term if you attack your expenses earlier in the game, as opposed to tax increases. Otherwise, you pass a point where the necessary expenditure cuts are so onerous that you get into the classic death spiral – very much what Greece is in right now.

We have an example of someone who made the hard decisions. All we have to do is look north of the border to Canada. If you look at the Canadians in 1993, they were in the exact same fiscal position as the United States is today. They had their credit downgrade. Within four to five years they had balanced their budget, and within 11 years they had taken their debt-to-GDP from approximately 70% to 72% down to approximately 30%.

That is one of the reasons why the Canadian dollar is now trading at a premium as opposed to a substantial discount to the US dollar. Canada took approximately seven dollars in expenditure cuts per dollar of revenue increase. Dave Walker is proposing three dollars of expenditure cuts versus one dollar of revenue enhancements.

But Congress can’t even come up with even a few pennies. It is an absolute unmitigated disgrace. I don't see how financial markets, equities or bonds, do well longer-term if you continue to erode the fiscal integrity of our financial system.

I would add that there was a debate last year, when there were still eight Republican presidential candidates, in which none of them would sign on to a plan that would go as far as $10 of spending cuts for one dollar of tax increases.

People will say or do anything while they are running for office. The real measure is what you do when you have your hands on the controls of the ship of state.

You have advised investors to be patient and cautious with respect to equities and fixed income. Are there any asset classes that you believe are attractively priced now, sufficient to provide the margin of safety that you mentioned at the beginning of “Caution: Danger Ahead?”

For what I would call a generalized investment fund, I view the equity markets as marginally attractive. As I tried to explain in the speech, we have just gone through the longest decline in P/E ratios in over half a century. Many are saying the stock market is attractive, because over the last 50 to 70 years the average P/E was 15 to 16 versus 12 to 13 now; therefore we have a discount. I would argue that to compare historical P/E ratios over this period is inappropriate, given the fundamental structures of our system are so dramatically different in terms of leverage.

I try to remind people that at the beginning of the depression in 1929, US debt-to-GDP was 16% after 11 straight years of surplus. And at the beginning of 1942, World War II, after fighting depression for 12 years, we were at 41% debt-to-GDP, and we didn't have any off-balance-sheet entitlement liabilities.

What we are looking at today is so far removed from any of these periods that I don't think it is an appropriate comparison. If you have a company with slow growth expectations, peak margins and business volatility, what type of P/E is given it? Typically, it is a lower P/E.

This is analogous to what we are going through currently with slow economic growth, peak margins and a volatile business outlook. From day one of this of this recovery, I have argued that it would be substandard. The Federal Reserve's estimates have been off by 100%.

We are holding a high cash level in FPA Capital Fund; it is up around 31% to 32%. Some could argue it should be higher. Our managers have been selling three- to four-times as much as they have been buying this year. The cash builds up. At some point in time, there is going to be a dislocation in the stock market. It is during those times that we get an opportunity to deploy capital where the margin of safety is high and the expected rates of return are substantial, which is what we did back in 2008 and early 2009.

I believe Ben Bernanke should be replaced. He supported the unsound monetary policy of Greenspan from 2001 to 2003, and he didn't have a clue about the building real estate bubble in2005 and 2006, per the Fed's minutes. When I was giving a speech in 2007, "Absence of Fear," I argued that subprime credit was the canary in the credit coal mine and we had a major problem. And he said, "No. Subprime is such a small area, there will be no contagion." A year later he was taking extraordinary actions.

I look at the monetary policies being enacted in this country and by the ECB and I am worried. I don't know how we will get off of all of these large asset purchases. They are a narcotic. The ECB with its LTRO three-year loans to banks is no different than a drug pusher because it allows bad practices to continue.

I don't see how the US deals with this at this stage of the game. There is no precedent for what we are going through. The idea that we will muddle through is pretty much a consensus expectation, because if you say you are going to muddle through then you can go on about your daily routine of managing money.

When you said that you don't see how the US can do what it needs to do, are you referring specifically to how the Fed can contract its balance sheet?

Yes. Because I have studied history, and when you have price controls, such as Nixon had back in the early 1970s, what do you get? You get dislocations in the system. You have inappropriate capital investment. When the controls end, guess what? You get inflation. It happened after World War II, and it happened after the Nixon price controls. Jimmy Carter tried it for a little bit too.

Everybody looks around and says, “Hey, price controls are not a good thing to have.” Well, we have a form of price control today. It is the repression of interest rates by the Federal Reserve. By keeping rates down, through Operation Twist, they are interfering with the normal movements of the capital market. There are unintended consequences occurring right now, whether it is in pension plans, insurance companies, banks or managed money. At 2%, dividend yield looks attractive versus a 1.9% 10-year bond yield. But I would argue that the policies of the Fed will create unintended consequences that are not positive.

I advise my associates on the fixed-income and equity sides that there are excesses building in the system again because of these unusual and unwise Fed policies, and that we have to extract a higher margin of safety before committing capital. Many in the investment field are chasing returns now, as has happened before on numerous occasions. I don't see anything different today than in any other period – especially among professional managers.

What questions do you think financial advisors should be asking themselves right now?

The one that is the most topical is, “How do I invest my client's money right now to get them a return?” Unfortunately, the era of small returns is here. My focus is on principal protection. If you protect your client's capital, they live to fight another day.

I had an advisor in our office – not an investment adviser but a research advisor. I asked this person, who was traveling all over the world, where would you be going right now? He said he’d go into utility stocks with 4% yields. I said really? You would put your capital at risk in this kind of environment for a 4% dividend yield? He said, “If you don't, you are not going to beat inflation.” I said I know the risk I am taking if I deploy capital at 0% to 1%, and I can quantify that risk in my mind. But in other investments, even though they provide you a slightly higher current return, I can't quantify what I would call the investment risk.

For example, our bond fund is at about a one-year duration. We have been defensive and people can accuse us of not taking on enough risk. We are a repository for capital and for protecting capital through very difficult environments. The highestreturns we are getting currently are in the neighborhood of around 1.5% to 2% yield with a duration of around 1.5. I believe we are only seeing base hits in fixed income, and we know the tie goes to the runner.

I wish I could give you some better insight than that. But this is one of the most difficult investment environments that I've seen in my entire career. It is more difficult than the late 1970s and early 1980s, because we had a real Fed Chairman named Paul Volcker. He was hated by both sides of the aisle when he was raising interest rates. And he stopped inflation. He was making hard decisions to control an environment that was about to get out of control.

Since Volcker, the hard decisions of our Fed chairmen have been to pump liquidity into the system. Unfortunately, each time they have implemented this policy, it has taken more and more to achieve a similar result. Think about what they had to do with Long-Term Capital Management in 1998, versus what they had to do 10 years later. If we don't get our fiscal house in order, what will they have to do in 10 more years, particularly when, in 2018, some of our entitlement trust funds go to zero, or are in the process of going negative on a cash flow basis? We keep deferring the difficult decisions.

What information sources do you turn to for the best investment and macro insights?

I read as much as I can. I like to read opposing points of view. I've read Ed Hyman for many years, and I read Stephanie Pomboy at Macro Maven, plus David Rosenberg. I can name a number of people that I look to. But most of the time I am looking at hard data. I sit in a room and analyze things and come out of my cave to see how it stands up.

The one economist that had the most effect upon me about how to view the world was Kurt Richebacher. He was very well respected by none other than Paul Volcker. I had many conversations with him and subscribed to his letter for the better part of 18 years before he passed away. He opened my eyes in ways that I hadn't looked at previously in my studies.

I am looking at the fixed-income markets and asking, what are those markets trying to discount? I would say macro and particularly the governmental macro issues have been taking on a larger element of my thinking over the past 20 years.

I am sure from your background that you remember the Gramm-Rudman-Hollings balanced-budget act. I had the opportunity to have dinner with Warren Rudman in 1996. I told Senator Rudman that I just wrote to my clients that the first time we are going to be able to attack Social Security will likely be in 2005, and after that it will probably be 2013. This was in 1996. And Warren Rudman said to me at that time, “I don't disagree with you. We are running simulations. We are looking at probably sometime between 2003 and 2008 when things start to get messy.”

And this was before the hyper-expansion and debt growth in the US.

As we've gone through this debt explosion, the pendulum of my focus has been swinging more toward this area because of its likely negative impact i upon trends in the United States and worldwide. In a company, the higher the leverage, the less margin of safety you have. As financial leverage continues to increase in our economy, in order to risk capital, I need to have a higher margin of safety, through considerably higher yields for bonds, or lower P/E ratios for equities.

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