



Bob Rodriguez – We are Witnessing the Development of a “Perfect Storm”

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by Robert Huebscher

Robert L. Rodriguez was the former portfolio manager of the small/mid-cap absolute-value strategy (including FPA Capital Fund, Inc.) and the absolute-fixed-income strategy (including FPA New Income, Inc.) and a former managing partner at FPA, a Los Angeles-based asset manager. He retired at the end of 2016, following more than 33 years of service.



He won many awards during his tenure. He was the only fund manager in the United States to win the Morningstar Manager of the Year award for both an equity and a fixed income fund and is tied with one other portfolio manager as having won the most awards. In 1994 Bob won for both FPA Capital and FPA New Income, and in 2001 and 2008 for FPA New Income.

The opinions expressed reflect Mr. Rodriguez' personal views only and not those of FPA.

I spoke with Bob on June 22.

In a recent quarterly market commentary Jeremy Grantham posited that reversion to the mean may not be working as it has in the past. What are your thoughts on mean reversion?

There will be a reversion to the mean. We are in a very difficult and challenging time for active managers, and in particular, value style managers. Many of these managers are fighting for their economic lives.

Given that I am no longer involved professionally in managing money, I believe the standards in the industry are being compromised; monetary policy has so totally distorted the capital markets that you are now into an eight-year period that is unprecedented in the likes of human history.

The closest thing we have had would have been between 1942 and 1951 when the Fed and Treasury had an accord to keep interest rates low. Things were basically being manipulated for the sake of the World War II effort. With the renewal of inflation after the war, there was a war between the Treasury and the Fed and an accord came together. But that is the only time we've had a period of nine years of

manipulated, price-controlled interest rates.

This was something I told my colleagues upon my return from sabbatical in 2011: what could unfold was controlled, manipulated and distorted pricing that disrupts the normal functioning of the capital markets. The cycles that Jeremy would be referring to about the reversion to the mean can be distorted for a period of time.

But I do not believe the economic laws of gravity have been permanently changed.

At a Grant's Conference last year Steven Bregman asserted that indexation in general and ETFs in particular were factors in the under-performance of active managers and are potentially a bubble. Are you familiar with his work and what are your thoughts on ETFs? What is driving the flow of mutual fund assets to passive strategies and what can or should fund companies do in the face of this trend?

I go back to a speech I gave in 2009, Reflections and Outrage, and buried within that speech is a section that said that if active managers did not get their act together then the likelihood would be that passive strategies would continue to take market share. When you have a market that is distorted by zero interest rate policy, David Tepper said it very well many years ago, he said, "Well, you've got to ride it."

It's a rocket ship that's going up. If you are fully invested in the right areas, you have a shot at outperforming. But if you are an active manager with discipline and looking at the valuation dynamics in the capital markets and have been doing so for several years, then you will be carrying elevated levels of liquidity if you were allowed to do so. As such, you will underperform.

Active managers have not demonstrated a value-add to an appreciable extent over the last 20 years. When I look at what happened prior to 2000, if an active growth manager could not see the most extraordinary distortion and elevated, speculative market in history, when will they? In the lead up to the 2007-2009 crisis, value managers did not cover themselves in glory. If you looked at what their ownerships were, they were very much in large banks and various types of depository institutions that were going to get crushed in the credit downturn. If they couldn't acknowledge or identify the greatest credit excess in history, when will they?

I'm picking on both growth and value style managers for missing two of the great bubbles. This led to capital destruction. Now we have a clueless Fed that has never known what a bubble is and has accentuated them by carrying out a policy of insanity of QE. Markets are going straight up predicated on that.

The public looks at that and says, "Why should I pay higher fees to managers who can't outperform or can't even identify a major speculative blow offs. I might as well be fully invested. I might as well be in an ETF index fund."

Thus, since 2007, indexing or passive activities have risen from approximately 7% to 9% of total assets to almost 40%. As you shift assets from active managers to passive managers, they buy an index. The

index is capital weighed, which means more and more money is going into fewer and fewer stocks.

We've seen this before. If you didn't own the nifty 50 stocks in the 1970s, you underperformed, so money went into them. If you were a growth stock manager in 1998-1999 and you were not buying "net" stocks, you underperformed and were fired. More and more money went into fewer and fewer stocks. Today you have the FANGS and you are driving more and more money into a narrower and narrower area. In each case it has not ended well.

When the markets finally do break, as they always have historically, ETFs and index funds will be destabilizing influences, because fear will enter the marketplace. A higher percentage of assets will be in indexed funds and ETFs. Investors will hit the "sell" button. All you have to ask is two words, "To whom?" Index funds and ETFs don't have any cash. The active managers have been diminished in size, and most of them aren't carrying cash for fear or business risk.

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The *Wall Street Journal* has reported that central banks from Switzerland to South Africa are investing their reserves in equities. How should investors respond to the participation in the price discovery system by players that can print money and may not be performance-driven?

The last thing I ever wanted to do as a professional was allocate capital to areas that government was buying. With governmental-driven decisions there are no pains. Look at the rank stupidity of Dodd-Frank, and Paulson, Bernanke, and Greenspan. They were clueless. They helped drive a system off the tracks. What penalty they have paid? None! They get to keep their pensions.

But when you have central banks deploying capital and their cost of money is zero, they destroy the capital-asset pricing mechanism; they destroy comparability; the distortions continue.

As a dedicated contrarian, the last place I want to have money is where governments are deploying the capital because they are so totally distorting the market.

How did the discipline of value investing as you practiced it at FPA, change over the course of your career, particularly since the financial crisis?

It's an interesting question and I've asked myself that many times.

The markets moved more slowly prior to this century – the ebbs and flows, the decision-making and the conveyance of information. With the advance of electronics and the internet, the speed of dissemination of news accelerated. I don't believe that judgments have improved; just the speed has accelerated and the time frames of patience have shortened.

I bet my entire business in the spring of 1998 when for the prior 11 or 12 years I ran my mutual fund, the FPA Capital Fund, on fumes, with 1% to 2% cash and sometimes even less than 1%. Had you held liquidity, with short-term bond yields in the high-single to double-digits, you would have underperformed the stock market by anywhere from 900 to 1,100 basis points. By 1998 the consultant

mantra was “fully invested.”

I went out in the spring of 1998 arguing that the markets were becoming excessive, and they continued to do so. I sought permission to move my liquidity limits from 7% to 10% which were the typical maximums, to upward of 30%. I had to fight every client on that. By the spring of 2000, without losing any money and avoiding the carnage, I took a little bit over a 50% reduction in my assets under management. I got fired. In 2007-2009, I did far more preparation and communication prior to that crisis and entered it with 45% cash.

In the first phase of a debacle like what went on in the financial crisis, it doesn't matter whether you are a virgin or are the opposite. When they raid the entertainment house and you happen to be a person walking out of the church right next door you get caught with all of the people there.

In the aftermath they find out, “Oh, you shouldn't have been there.” Well, it's the same way in a crash; virtually everything gets hit. Then in the second and third stages, the real values start to unfold and you get a greater differentiation. That is what happened with my fund between 2007 and 2009 and subsequently.

A cash level of 45% was a real tough for clients to handle. I had one client say, “Please stay fully invested and just do your thing like the others.” I said, “No, the price you ask me to pay is too high. By being fully invested managing your money I will contaminate my thinking, which will negatively affect my other clients. I'm sorry, that's a price too high to pay.” I said, “Where do you want me to return the money?” He said, “Let me think about it.” The next day he said, “Okay, you've got flexibility.” But I still took over a 50% contraction in assets.

Looking at the two prior major cycles, it is far more difficult for a value manager to hold liquidity today in light of the policies that are being deployed. These are the worst policies both fiscally and monetarily in human history.

If I were managing money, or given my background of pain-and-suffering and being redeemed, my liquidity allocation would be north of 60% today.

So-called “smart-beta” products have become very popular, particularly those that incorporate a quantitatively-driven value strategy based on the Fama-French factor models. For investors that want a value-oriented portfolio, what concerns should they have with these strategies?

I have never seen a quantitative strategy succeed longer term. They are predicated on models. The models are predicated on history. When history changes, they have to develop a new factor model.

We witnessed that in the last cycle. There was an article that said on a Wednesday, we had a 1-in-10,000 year event. On Thursday, we had a 1-in-10,000 year event. On Friday we had a 1-in-10,000 year event. A former colleague wrote an email that weekend and said, “I have a quick question to ask. On Monday, are we safe for the next 30,000 years?”

All of these things are meant to enhance or give an essence of how you are going to try and minimize risk and enhance return. When you are in an environment where the lead person, the Federal Reserve, has its foot on the scale and is distorting the information coming out of the capital markets, when interest rates can go to zero, what is the hurdle rate for budgetary capital allocations? You negatively impact the price comparison in the asset-pricing model. This is highly disturbing.

By the way, I wrote a piece in 2008 before the Fed even knew they were going to balloon their balance sheet. It said they would have to increase the balance sheet by at least a trillion to a trillion and a half. They haven't got there yet.

After 45 years of watching the Fed, the only Fed chairman that that was worth spit was Paul Volker. The last great central banker that we had in the last 110 years other than Volker was J.P. Morgan. The difference is, when he tried to contain the 1907 crisis, he wasn't using zeros and ones; he was using his own capital. As long as you have anointed ones, the Federal Reserve is no different than the Soviet Union. They are an organization like all organizations that have internal pressures and they have to come to a consensus, and so they do.

That is not how you make your greatest decisions.

If there is one piece of investment advice you would offer to a young professional embarking on a career now, what would that be?

I will give the same advice that I got when I was a very young professional back in 1973. I was two years into the field and a gentleman spoke before my investment class. After everybody had walked out, I walked up to Mr. Munger and I asked him, "Sir, if I could only do one thing that would make myself a better investment professional, what would you recommend?" He responded, "Read history, read history, read history." I have done that over the years. Had you read about the banking crisis of 1907 and what preceded it in the 1890s, you would have recognized it in a form in 2007.

If there is one piece of management advice that you could offer to that same person, what would that be?

You must have two things – discipline and integrity. Compromise either and you will fail.

That's true in all walks of life.

Yes, but it's very easy to use the justification that this time is different.

The world has changed. I gave a speech in 2001 to some pension advisors. I said, "Look at you people out there." I hadn't shown them my chart yet but I said, "Look at what we have just gone through. We had the greatest, the highest level of computerization in the history of man, the most timely acquisition to information, the highest percentage of advanced degree professionals and college graduates in the field, and we got an outcome no different than 1974, 1929, 1907. There is something more here going on."

Then I held up two hand-written stick figures – I was not a good artist. They were cows and they were talking to one another. One cow said to the other, “Glad we’re not part of the herd.” The other cow said, “Yes.” The next exhibit was an aerial shot. It showed the two cows are in a ravine, so they can only see themselves. But all around them is the herd. I looked out and said, “People, whether you realize it or not, you are the herd. All you have to understand is one word, now let’s say it all together. Moo.” What a way to influence friends and make new clients.

How are you investing your personal assets?

I am at my lowest exposure to equities since 1971. They represent less than a fraction of one percent. Liquidity is north of 65%, all in Treasury-type securities, nothing beyond a three-year term. I do not trust what is going on, and I’ll circle back on that in a moment. The balance is in rare fully paid-for physical assets.

Circling back, after I stepped down from daily money management at the end of 2009, I took a sabbatical. One of my goals was to meet a gentleman by the name of David Walker, the former comptroller general of the U.S. He wrote a book called *Comeback America* that I read in January of 2010. I sent my review to Dave. Two days later Dave called me and said, “My name is Dave Walker. Is this Bob Rodriguez? If so, I want to thank you for your review.” That’s how we came to know one another. I’d used his work for over 10 years. For the next three and a half years I was a sponsor of his program, *Comeback America*. We closed it down in 2013, a complete unmitigated failure.

Think about the budgetary battles of 2011; the only thing that was cut was defense. Two thirds of the expenditure cuts that were going to get controlled under the system would not occur until after 2016. Funny how that worked. In the presidential debates, only one candidate used a word that I think has now left the English language, “sequester.” That was Bush and it was to eliminate sequestration to raise defense spending.

The 2016 election was one of the most important elections in the last 80 years. Back in 2009 I said if we do not get our economic house in order sometime between 2014 and 2018, we could see a crisis of equal or greater magnitude than 2007-2009. I also argued that we would have a substandard recovery that would be no better than 2% real GDP growth for as far as the eye can see. Productivity and capital spending would be substandard. All of those have played out.

Here we are in 2017. I have seen absolutely nothing that would give me any degree of confidence that Washington will get its act together. We are into a period of expanding deficits. We are hitting a time where the entitlements are worsening in terms of their funding status. We are in a decade that is unprecedented from anything that we’ve seen before with monetary policy and fiscal policy.

Why on Earth should I allocate capital into a system where the scales are completely manipulated, price discovery is distorted, and the Fed doesn’t have a clue what’s going on? They’ve missed every economic forecast for the last nine years straight. Why would anybody pay any attention to what those people are doing?

I have confidence in one thing. The Fed will blow it.

My thoughts are very much analogous to those of Lacy Hunt. Where Lacy and I would part company would be when the deflation hits, he would argue that we will be in a dis- or deflationary period for an extended period of time, thereby, you should own 30- and 20-year Treasury bonds.

I'm not so sure about that. It worked in Japan because it has a very cohesive society. That is not the case in the United States or in Europe. Our patience will be far shorter. At some point, in no more than one to two years, the Fed will panic and panic big time, and we will see QE on steroids. We will see monetary inflation. Lacy and I have a similar view. But the really big question is what the outcomes will be on the other side. Both of us could be very right, or very wrong, or partially in between.

I am managing my estate in a hedged fashion because what we are going through is without any precedent in human history. How can anybody have confidence that their particular view is the right view?