

Interview With **Ben Inker**
Head of Asset-Allocation Group, GMO

The Charms of Cash

by Lawrence C. Strauss

FOR A PORTFOLIO CONSISTING OF STOCKS, BONDS and cash, smart and timely asset-allocation decisions are a key driver of good performance. Ben Inker, who is head of the asset-allocation group at the Boston money manager GMO, favors holding a lot of cash. He maintains that bond yields are too low, for the most part, and that equities aren't that attractively valued. An exception is high-quality U.S. stocks, which have trailed the market for many of the last 10 years.

Inker, 40 years old, who joined GMO in 1992 straight out of Yale University, where he earned a degree in economics, maintains that the market isn't compensating investors enough for taking on risk. Hence, his big cash position and defensive posture. Inker's group oversees about \$37 billion; the firm has \$103 billion under management. One measure of the firm's asset-allocation strategy is the **GMO Benchmark Free Allocation** fund (ticker: GBMFX), which has acquitted itself well. The fund, which is closed, has a five-year annual return of 7.14%, putting it in the top quarter of its Morningstar peer group. *Barron's* spoke to Inker last week by telephone.

Barron's: What's your basic advice to investors in these tricky and challenging times?

Inker: Now is not a time to be shooting for the moon. Now is not a time to be taking a lot of risk, because the markets aren't paying you that much for taking that risk. Obviously, bonds don't have much of a place in a portfolio at today's yields, but equities aren't that great, either. So don't be afraid to hold some cash. If you are going to own stocks, own the ones where you don't have to imagine an incredibly bright future in order to make nice money from them.

How do you go about putting together your asset-allocation recommendations?

We try to find asset classes which are trading cheap, relative to fair value, and we expect to hold on to them for a few years as they come back toward fair value. We make sure to avoid anything that is trading very expensively. It doesn't make a lot of sense to say, "I'm going to have 70% of my money in equities at all times," or even, "I'm going to run with the volatility at 10% at all times." It makes sense to

take more risk when the markets are really paying you a lot for taking risk. And if you are sitting at a time where markets are overvalued and you aren't really getting paid much for taking risks, as is the case now, don't be afraid to move to cash, with the recognition that you will get better opportunities in the future. And it is a very good idea to have free cash available to exploit those opportunities once they come up.

So there isn't any shame in keeping your powder dry?

Absolutely not. We think there is a lot of benefit to keeping dry powder. Right now our cash position is at about 30%.

When it comes to how investors think about asset allocation, what do you think some of the common mistakes are?

There are a few things that people tend to get wrong. One of them is an obsession with comparing stocks to bonds. So if you are in a situation like today, where bond yields are very low, people say, "Well, that makes stocks look cheap." It doesn't make stocks cheap. It is possible for stocks and bonds to be simultaneously cheap or simultaneously expensive. So you really don't want to fall into the trap of assuming that because bonds stink, you should be in stocks. Another thing that people have a tendency to do is that since it can be so frustrating waiting for value to work, they tend to assume that it isn't worthwhile betting on value with regard to asset allocation. Instead, they assume that you are much better off making a bet on something like what the global economy is going to do next year. People, if they could just be a little bit more patient, would do a lot better by buying and holding cheap assets and waiting for the market to come around.

How do you define value?

With regard to stocks, fair value is a valuation level at which you could get a decent return for the stock. That means that at fair value, you should be able to get an annual real return of 5½% or 6% from developed stock markets. In order to do that, stocks need to be trading at a multiple of normalized earnings which is consistent with that. You want to see a price/



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earnings ratio on normalized earnings of around 15 times, maybe 16 times, if you are lucky. With bonds, it is even simpler, because you know what the coupon is. The questions are, do you know what the coupon is, what is inflation going to be, and is the resultant real yield sufficient?

What are your current asset-allocation recommendations?

In absolute return-oriented portfolios, where our opportunities are largely in stocks, bonds and cash, we've got about 42% of our money in stocks. About half of that is U.S. high-quality stocks; the other half is pretty evenly split between non-U.S. stocks in the developed markets and in the emerging markets. We've got only 10% in traditional bonds today, primarily in sovereign debt of New Zealand and Australia, since those are the only bond markets that we think are offering decent value. The rest of the money is either in low-volatility hedge funds or cash. For us, that's a pretty low risk level. We've got less money in stocks and less money in bonds than normal. That is because stocks are somewhat expensive and bonds are pretty close to disastrously expensive.

Briefly, what's to like about the bond markets in New Zealand and Australia?

We look for a couple of things in a bond market. One would be a decent real yield. We would like to be getting paid at least two [percentage] points better than expected inflation in the market over the next 10 years. And we would like to have a country that we think is in a position to actually pay its debts. When we look around the world today, you can find some countries like Ireland and Greece, which are paying at least 2% above inflation, and you can find other countries like Germany and Canada, which are probably in a position to pay their debts. Unfortunately, there are only two countries that offer both, and they are Australia and New Zealand.

Looking at GMO's seven-year forecast, things look pretty weak for bonds, with the only positive return occurring in emerging-market debt. And that's only a 1.1% annual real return. It sounds like you don't see much opportunity in fixed income, period.

We think that bond yields are too low and that the global economy will eventually come back. We think that inflation will likely prove broadly normal over the next 10 years. If not, the risk is that it will be higher than normal. And with bond yields as low as they are, if inflation becomes higher than normal, we are going to get pretty lousy returns for bonds. Actually, the U.S. bond market isn't the worst of the lot, although it is pretty bad. Bond markets like those in Japan, the

United Kingdom and Switzerland are even worse, because they have some combination of even lower yields, higher inflation or a greater inability to envision how they are going to pay their debt.

Moving back to equities, GMO's seven-year forecast for small-caps in the U.S. is negative. Why such a pessimistic view?

Unfortunately, small-caps have done too well. They recovered very strongly from the lows of 2009. They had another really good year in 2010, and their P/Es are high. Their profit margins are pretty good, but we don't see any reason to believe that they are going to get a lot better.

One thing about small companies is that they don't actually grow all that fast in aggregate, and they are pretty vulnerable should profit margins drop lower. And we think that eventually, profit margins will actually have to drop lower from here. So small-caps look about as expensive as we have ever seen them, in absolute terms—a little bit less ugly than they were in 2007, but, otherwise, just about as bad as we have ever seen them.

GMO is forecasting a 5.1% annual real return for high-quality U.S. stocks over the next seven years. Haven't we been waiting for this ship to come in for a long time?

Yes, we have been waiting quite a while for high quality to beat the market. It did beat the market very nicely in 2008 and in the beginning of 2009. What makes us excited about it, quite honestly, is that since 2004, high-quality companies are a little bit behind the Standard & Poor's 500, and they have gotten quite a bit cheaper. So what we really like to see is if you have a group that is underperforming, at least you would like to see that the value is compounding as well. So if you look at what happened with value stocks in the 1990s, they had underperformed the market by a lot by the end of the decade. But their relative valuation was getting cheaper and cheaper. By 2000, they were trading at the lowest valuation versus the market that we had ever seen.

And if you adjust it for the change in valuation, they had actually been fundamentally outperforming all along, and that is what we are seeing with quality stocks today. They have underperformed quite a bit since the market low of 2009. But over the longer period, they have underperformed modestly. But they have been steadily getting cheaper. And now, for the first time we can see in history, we can buy these stocks at an absolute discount to the rest of the market. They are trading at lower P/Es, but they normally trade at a 15% or 20% premium on P/Es. Unfortunately, even though they have lagged in the recent market rally, they have still gone

up, and that means they probably aren't cheap in absolute terms. But big high-quality companies are the only thing that's worth owning in the U.S. stock market.

Why do you still see upside in emerging-market equities?

Because it still looks decently valued to us. So we are most excited about the areas that are cheap. And it has less to do with expectations of stunningly strong economic growth. India probably will have very strong economic growth for the next five or 10 years. But it is trading at a high valuation level. Countries trading at high valuation levels tend to underperform regardless of what happens to their gross domestic product. But there are other markets, like Korea or Russia, which are really pretty cheap. Russia is trading at five or six times earnings. It isn't that Russia doesn't have an almost unending list of problems. But for five or six times earnings, we are willing to put up with a lot of trouble.

What's your sense of the overall valuation for U.S. stocks?

At the moment we see the market trading at about 16 or 17 times trailing earnings, which doesn't sound so bad. It is a little bit higher than we would like to see, but not hugely higher. The problem we see, though, is that profit margins are awfully good, even though the economy isn't in great shape. For corporations, times are very good. But we think that, sooner or later, those profit margins are going to come down. So the P/E on normal profits is more like 19, and we would rather it be 15.

What are a few areas you are keeping an eye on as potential investment opportunities?

One of them is the peripheral European countries. Everybody knows about their problems. The good news is the stock markets in general reflect that. We would love to see another bout of angst which drives these stocks to even lower valuations. But when we look at countries like Italy, Greece and Ireland, we are seeing some intriguing value. But we would like them to be a little bit cheaper than they are now, because they do have some massive problems. And the bigger the problems, the bigger the bribe we want to see in the form of low valuations to buy. But we think we understand the problems.

So if the valuations get a bit lower, it becomes a buying opportunity. The other place would be Japan, equities in particular. The world also knows about Japan's problems. It is trading very cheap on an asset basis, or relative to the book value of the companies. But people have grown old and died, it seems, waiting for companies trading cheap

on an asset basis in Japan to start making decent returns on equity.

What could change that?

One of the things we are looking for in Japan is whether the government is actually getting serious about ending deflation. We think that could do a world of good to Japanese companies, not least the banks. You don't need a lot of inflation. But if you could get inflation just up to zero or 50 basis points, versus deflation, you could see some real expansion of profit margins. And if you saw that, given today's valuations, there is some significant upside. However, we are not yet confident that the government has either the will or the political power to get it done. But if they do, this is probably one of the more interesting buying opportunities that we are likely to see.

GMO's forecast calls for managed timber to have an average annual real return of 6% over the next seven years. Could you talk about the pluses and minuses of that asset?

It can be a very valuable asset, because it does operate on a somewhat different cycle than other assets do, so it provides decent diversification. It should do reasonably well in the event of inflation, because you do own a real asset. And, finally, it is an asset where an awful lot of what you need to know to understand what the returns are going to be is determined by the price you paid. You know how many trees you bought. You know how fast they grow.

So if you know what you paid, you know an awful lot. We've got an expected real return of around 6%. That's OK. But it is not brilliant, even though it is the highest [return among the assets in our forecast]. But the big drawback with managed timber is that it is a very illiquid asset. You have got to own the trees directly. It doesn't do you any good to own forest and paper products companies, and, unfortunately, it doesn't do you a lot of good to even own a timber real-estate investment trust. You want to own the trees. And if you own the trees, you are stuck with them.

Where does timber fit into your asset-allocation framework?

It isn't actually something that we put directly into our asset-allocation portfolio, because once we put the client in, they are stuck there for 10 years, and I don't want to make that decision for my clients. I'm happy to talk to them about it and to recommend that they do it. But if they are going to be stuck there for 10 years, they need to have signed up directly.

Thanks, Ben.