

A Dash of Insight

Below is the full 2010 *Bespoke Roundtable* Q&A with Jeff Miller of [A Dash of Insight](#).

1) What has surprised you the most and least about financial markets in 2009?

My biggest surprise was the short honeymoon for the Obama Administration and the stock market reaction. One of my most important investment themes is the need to separate your political viewpoint from your investing. I am a political agnostic when it comes to investments - I want to make money no matter who is in power. The key is to figure out the likely policy impacts and the right stocks.

Many pundits, including the most vocal in financial media, do not like Obama's policies. It is normal for everyone to "spin" the news, but this was like a continuation of the election campaign. Helping along, the Obama team was slow and indecisive on the big issues and had trouble with the confirmation of some major appointments. It was not a good climate for investors, since it helped to create a general sense that we were headed for a depression.

I have my own objections to some Obama policies, but I am a realist. Political compromise s are not loved by anyone, but it is the essence of the American political system.

The immediate and steep decline in the financial markets was not predicted by many. After all, the election results had been known for months. The early year selling, leading to the March bottom, was deeply influenced by the partisanship of Congressional debate.

The result? The market started the year in a deep hole. It was tougher to reach my own "initial target" of the pre-Lehman market levels.

For me, the least surprising thing was the general improvement in the economy and stocks throughout the year. We are experiencing fiscal and monetary stimulus beyond what anyone could have imagined a few years ago. We all know that these are lagging effects, so the gradual improvement was predictable - at least once we averted a complete credit collapse.

2) What do you believe are the most important lessons to be learned from the 08/09 financial crisis?

This is a big question, and it deserves a careful answer.

To begin with, you would draw a different conclusion by looking at both years than by looking at only one. Let's take 2008 by itself. Even those of us with plenty of experience have only a few big crises to work from. My own experience includes the '87 crash and the '89 mini-crash, but I was not yet a manager. I did very well in 1998 and again in 2000-01, as well as many other smaller instances. This experience did not help much, nor did it help other veteran managers, because the traditional playbook did not work. In October of 2008 there was already "blood in the streets." Warren Buffett was applying his concept of buying when others were fearful. It did not work and there were many more "false bottoms."

The most important lesson of 2008 is very specific. We learned what happens when you get a complete cessation of lending in an economy that depends upon normal and sensible borrowing for regular commerce. Until the Fed got some emergency methods in place, the wheels of commerce ground to a halt. Business leaders started firing people. Policy makers foolishly decided that this was the perfect moment to take a hard look at illiquid securities (something that should have been done earlier) and mark them all to a non-existent market price. They allowed people to manipulate unregulated markets in Credit Default Swaps, buying insurance on the "lives" of companies they could attack. They allowed them to buy puts on these stocks and make fortunes while the companies went under and regular investors got hosed.

Before the fall of Lehman, we already had a weak economy, but this pushed us over the edge. There were policy mistakes, but the Bush team was dealing with very new problems. If they had done nothing, it would have been much worse.

Let me next turn the question around and talk about what is not the lesson. This was not a story about everything being in an asset bubble or Fed policy from the Greenspan era. I realize that some have an agenda, be it ratings or book sales, but I am focused on investment returns. Major economic and financial events create lasting psychological effects. There are plenty of people using this crisis to sell illiquid assets in gold, non-trading REITs or various structured products. It is a play upon fear.

To draw the best lesson, let me now look at both 2008 and 2009 together. I constantly evaluate investment models from the most talented sources. They would all love to find a model that made a perfect exit in 2008 and also worked well in all of the other years. It is not so easy. Their work shows that anything with strong results on a long-term basis takes a hit in 2008. The good models (like our trading model) gave sell signals, but then looked for those Buffett-like buying opportunities and did so too soon.



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When I suggest that 2008 included some unique circumstances, my conclusion is therefore based not only upon my personal experience, but extensive data analysis.

To summarize: The worst thing someone could do is to overreact to the 2008 experience, as many did in 2009. For most people, investment in stocks is the only way to build wealth that will stand up to inflation.

Investment advisors have a tough job in explaining this, especially with so many selling the high-commission alternatives like gold coins of a certain era or illiquid products that claim to protect against any decline while limiting returns.

3) How has the 08/09 bear market impacted your view on asset allocation and investing as a whole?

As I explained in the "lessons" question, I do not think that people should over-react to the 2008 experience. I started warning investors about housing values in 2005 - far too early as it turned out. The crucial factor here was the business credit collapse.

Most investors were far too heavy in real estate, since they got burned by stocks in 2000. This included my own clients who were not attentive to warnings.

In nearly every new portfolio I see there is a theme. A person who should expect to live for many years is under-invested in stocks and not protected for long-term inflation. 2008 has made it worse.

Too many investors are behaving like deer in the headlights - doing nothing to address their future needs.

4) What are the various indicators that you follow closely telling you right now about where the stock market is headed? Which indicator is the most significant in what it is forecasting?

I follow many indicators, reported regularly on my blog. I am one of the few willing to take a specific three-week market forecast and update it weekly. We use our own proprietary modeling for this.

I like to look at expected earnings - both for the market and for my own stocks.

I also follow economic forecasts, especially those of the Economic Cycle Research Institute (ECRI).

All of these indicators are quite bullish at the moment.



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5) Starting with 100% cash, how would you allocate it to various asset classes to start the new year?

In my business I treat each investor as unique and deserving special treatment. The "baseline" asset allocation varies with the circumstances - age, risk tolerance, and special needs.

With this in mind, I see this as a good time for stocks, so give that a plus 10% or so from whatever is the starting point. If you are normally 55% in stocks, this year should be 65%. The main alternative is corporate bonds and financial preferreds. These still have nice yields. You have to watch carefully if the Fed starts to raise rates.

6) What do you believe will be the dominant investing themes of 2010? What will be the biggest surprises of 2010?

I expect a general economic recovery with a lot of skepticism. It will probably extend all year.

Health stocks will do well after a resolution on health reform.

One of my surprise ideas relates to business investment. Businesses have held back for many years. Deferring upgrades was an easy choice last year. There will be catching up to do. Anything in the technology infrastructure will be good. Remember how everyone "bought ahead" to avoid Y2K problems? The next years were terrible for technology purchases. We are now seeing the opposite.

Energy is a possibility, but it depends upon the pace of economic growth. People do not realize how close we were to an energy tipping point before the recession. It would take very little to get back to a place where everyone is talking about peak oil and alternative energy. This might be a development later in the year.

7) What is your current view on Buy & Hold as an investment strategy?

There is plenty of criticism about Buy & Hold, since it has not worked over a decade or so. I expect to do much better for my clients, as I have over our history. A lot depends upon time frame. Those criticizing Buy & Hold are evaluating it at what is arguably a low point in the market. My own clients have differing returns depending upon when they joined, just as they would if buying a mutual fund.

Buy&Hold is a bad idea for two distinctly different groups:

- 1) Those who have the intelligence, skill, time (and many other qualities) to make their own decisions. I write about this frequently on my blog.*
- 2) Those who know how to pick a good investment advisor. Warren Buffett said that if markets were efficient, he would be selling pencils on a street corner. If you can find an advisor who can beat the market on a regular basis, it is better than Buy & Hold.*

With this in mind, for most investors Buy & Hold is a good idea. If you try to manage your own investments, the studies say that you will trail the market by 6% or so. Since stocks are attractive, you should buy an index fund.

8) What do you believe is the contrarian call on equities right now? The economy? Is investor sentiment currently misplaced?

There are many popular sentiment indicators, but they all have flaws. I talk to many clients and potential clients, and I also watch what is working in the media. There is a high level of skepticism about the economy. Many investors "missed the rally" and now believe they are too late to make significant gains. Many pros and leading bloggers hated the rally all the way, seeing it (incorrectly in my view) as disconnected from "the fundamentals."

In short, there is still a wall of worry, a pre-condition for the rally to continue ([link](#)).

9) Which sectors should investors be overweight/underweight heading into 2010?

The best sectors are cyclicals with good leverage on operating earnings, technology for the business reinvestment, and health care. Energy could be good later in the year. Having a touch of biotech is fine. Smaller companies with good pipelines are takeover candidates.

I do not see the point in buying "defensive" stocks in preference to corporate bonds.

10) What is in store for the US economy in 2010 (V-shaped, double dip, U-shaped)?

This is a popular question in TV interviews. Everyone is invited to swing outside his "happy zone." (This is one of my favorite concepts, drawn from Ted Williams, [link](#)).

This is really a question about which economic forecast is most accurate. Why? People are consumers of economic data and forecasts, whether they know it or not. Unless you have conducted your own independent research, you are just picking the right expert. I do not have my own economic forecast, but I have an edge in picking experts (forty years of experience in studying, building, and teaching about econometric models).

The best evidence suggests that we will have a continuing and gradual economic recovery. The data points will not all line up. Most economic data has "noise." Every time a report represents a slight downtick there will be a hue and cry. We can expect the debate about the economy to continue all year.

11) Will we see a jobs recovery in 2010?

Employment is a realm of special expertise for me. I have done extensive research in this area, and write about it frequently. I know just enough to be modest! The growth rate will be challenging to forecast.

Employment will track economic growth. There will be significant improvement in net job creation, but it will show up only gradually in the unemployment rate. Here's why. In 1999 we had a high point in labor force participation in anticipation of Y2K. Even the COBOL programmers who had retired were going back to work. We now have the opposite. Older marginal workers are retiring early and younger ones are going back to school. Immigration decisions (legal or otherwise) are adjusting.

Most people neglect the dynamics of the labor market, focusing only on the change in net jobs or the unemployment rate. That is only part of an important story.

12) The real estate market has seemingly taken a back seat in terms of media coverage at the moment. What's in store for real estate in 2010, and how will it impact your investment decisions?

Here is another area where we are all consumers, whether we know it or not. I have been generally disappointed with the contributions by the actual economists working on this subject. In particular, I would like to see someone looking at supply and demand curves for housing. Everyone talks about pent-up supply, and I am sure they are right. There are also many families hoping to buy homes.



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There is a national policy to support home ownership in a multitude of ways. Whether or not we agree with this, it is a fact of life.

My read of the imperfect data is that the market is stabilizing in most of the country. I also think that values overshot to the downside outside of the "bubble" areas of condo flipping.

Stabilizing housing is crucial to the economic recovery. So far, government policy has focused on this, and it will be a continuing priority. They will keep helping until the situation improves. I mean this not as a judgment about correct policy, but a prediction of what will happen.

I am not inclined to fight it, but I do not know how long it will take. There are plenty of foreclosures to work through.

13) When will the Fed begin to raise rates, and will this be too early, late, or just about right?

Let me start with some facts. The Fed has outstanding personnel and credentials, and a strong and diverse economic team - over 350 economists. Their process is very open, with transcripts available after five years, minutes after a few weeks, and considerable freedom for the scores of people involved to state their views. There are many appearances before Congressional committees. There are also many speech-making alumni who are free to offer criticism. There are more than 50 people sitting in at each specific meeting.

Fed bashing is a popular sport. This is mostly second guessing the decisions of those who had to make tough decisions. Some do not like the concept of a central bank. Others disagree with the decisions made. Some have personal or political motives.

Some even disagree about the Fed mission. These people would prefer that the Fed ignore threats to economic growth and emphasize concern over inflation, even though the dual Fed mandate is a matter of law. In addition, they want to substitute their own definition of inflation - usually related to changes in commodity prices or a similar measure.

I have some clear advice for investors: Ignore this background noise! If you want to make successful investments, the job is to predict the Fed, not to criticize the decisions.

Turning to the specific question, it would be presumptuous for me to guess when the Fed will start to raise rates, since they do not yet know themselves. The statement is that rates will be low for an extended period. If we knew how quickly the economy would rebound and knew when normal bank lending would resume, we would have our answer.

As to whether the Fed will act in a timely fashion, history shows that they have sometimes been too slow. The current membership is acutely aware of this fact, so perhaps they will do a bit better this time. As usual, the punditry is divided on what they should be doing right now.

14) How worried are you about inflation?

There is little reason to worry about inflation until we are closer to the normal trend of economic growth.

More importantly, it is clear that the Fed takes this viewpoint. Don't fight the Fed.

15) How worried are you about the decline of the dollar, and do you see the greenback making a comeback in 2010?

Currency values adjust to reflect trade imbalances, so it is a long-term story. Without cooperation from China, there is no easy answer. It is not a cause for concern if the adjustment is slow enough. In general, this is a hobby horse for extremists and it is easy to sell to a gullible public. Those advancing the argument always use the word "debase" and are either running for office, helping someone who is, or selling gold. I recommend that people consider the alternative viewpoint of someone like Bob McTeer, the former Dallas Fed President. He is a free-market guy and very conservative. He is also pragmatic and exudes common sense. I cite him often on my blog.

16) What are your current thoughts on gold - bubble, just the beginning, or just about fair valued?

Inflation fears and panic both drive gold prices. Both are currently overstated, but it is not a bubble. People see too many bubbles!

17) Oil has largely been forgotten given the current focus on gold and the dollar. Will the price of oil have a major impact on stocks and the economy in 2010?

We were near an important tipping point in the price of oil before the economic collapse. We'll see this again, but perhaps only hints of it in 2010. As a nation, and as a world, we are not very good at solving problems without a slap in the face.

18) We've just gone through a decade where emerging markets largely outperformed the G-7 countries. Do you foresee this trend continuing in the coming years, or will developed countries begin to make a comeback?

This is outside of my own happy zone so I have no strong opinion. The secular trend toward BRIC is obvious. Long term, I like to play international themes via US companies with strong international exposure. My ETF system often has trades featuring foreign ETFs.

19) Which emerging markets are you most/least excited about heading into the next decade?

One way or another, everyone should have some BRIC exposure. I use our TCA-ETF model to spot emerging themes.



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20) At the peak of the crisis, the prevailing theory was that Wall Street was dead as we knew it. After the rebound we've seen, many people think it's now back to business as usual. What are your thoughts on this?

There will always be bright people attracted to the best firms. The Street will meet demand - and perhaps create demand.

21) What will be the biggest impact Washington has on Wall Street in 2010?

Right or wrong, the Obama Administration focused on restoring confidence through capital infusions and stress-testing. There is an obvious need for a new policy to avoid the Lehman-type problem.

The critics attacked the stress tests. It now seems that they were wrong. The new capital requirements are very high. There will be more attention to the CDS market and ratings agencies. The policy debate reflects this experience, so the new rules will be better.

There is also a clear trend toward a government exit from direct investments. We should all note that this was not predicted by the many critics, who will be proven wrong in 2010. They are also wrong about the results of the investments, which many labeled as "expenditures" at the time.

22) What do you think are currently the biggest disconnects between Wall Street and Main Street? Wall Street and Washington? Washington and Main Street? How can we correct this?

There will be plenty of politics as we head into the mid-term elections. The Democrats are likely to suffer significant losses. Divisive themes will play an important role in campaigning.

The biggest public misperception is the purpose of government action. The "bailing out" of financial firms was not intended to help investors or management in the companies. Investors (at least in equity) were crushed and management teams were fired. The purpose was to stabilize the financial system. The average person does not see this.

As an investor, you can be political, or you can look for winning investments.

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23) Will the following be up or down (positive or negative) in 2010? Where noted, what are your 2010 year-end target prices?

-S&P 500: Up 17%

-Long-Term US Treasuries: 4.2% on the 10-Year Treasury

-Corporate Bonds: Prices down a little as interest rates rise.

-High Yield (Junk) Bonds: Less risk, but higher rates. Call the prices a push with a good return.

-Gold: No strong feeling. Probably near current prices or a bit lower with dollar strength and less fear.

-Oil: This could move higher with a stronger world economy. Trying to go out more than a few months is crazy.

-Dollar: I see some stability, but the long-term trend is lower. Call it about the same as now, given the recent decline.

-Average US Home Prices: I'll go for a ten percent rebound, but we will probably not see any strength until mid-year.

-China's stock market: Chinese stocks should improve, at least in line with the US. Call it up 20%.

24) Please provide readers with any stock ideas that you really like right now and for 2010 and beyond (and why).

Let me start with one of my favorite indicators - the number of attractive stocks I am following. I have a long list of great candidates. This has not always been true. Here are a few examples.

I like and am buying cyclical stocks with operating earnings leverage. Examples are CAT and ATI, but I have a good shopping list.

I have a health stock agenda depending upon the final shape of the legislation. I still like RMD. There are other specific plays, but it is too soon to make these calls. The shape of the legislation is changing daily.

Technology based upon the Windows 7 launch should be good. This means INTC and MSFT for starters, but other companies will benefit. ORCL has a good business with accretive acquisitions.

Everyone should have some growth stocks. AAPL is still attractive on a PEG basis, backing out cash holdings. There are other choices, but you should have something fitting this definition.

25) Do you have any other advice that you would like to share with readers heading into next year?

Thanks for inviting me! The questions were interesting and stimulating. My best prediction is that we will have a year with plenty of debate on politics, the economy, and the market. My best advice is that investors should focus on the market when trading and politics when going to the voting booth.