

## Consuelo Mack WealthTrack - Original Air Date: October 21, 2005

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**CONSUELO MACK:** This week on WealthTrack-- how much are you gambling with your financial future? How subject are your investments to the roll of the market's dice? In a WealthTrack exclusive, we'll ask influential economic consultant, money manager, and risk expert Peter Bernstein about market risk and how to protect yourself against it... next on Consuelo Mack WealthTrack!

Greetings, and welcome to WealthTrack

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Our focus this week is investment risk, how to figure out what it is and most important, how to successfully deal with it.

We are honored to have one of the world's preeminent experts on risk, Peter Bernstein as our featured guest, for an exclusive WealthTrack interview....He will join us in just a moment.

We received several reminders this week as to why risk is always a timely topic.

Oil and energy stocks which have been this year's best performers are now faltering as global demand for energy finally seems to be easing in the face of record prices...oil fell below 60 dollars a barrel for the first time in several months.

Then there was the fourth largest bankruptcy in U.S. history. Investors from around the world gathered in court to battle for their share of Refco, the giant futures broker that fell apart after accusations of financial fraud. Refco just went public in August when it raised 670 million dollars from unwitting investors.

Both bond and stock investors have been on a rollercoaster following developments at General Motors and Ford... the two companies announced huge quarterly losses as consumers shunned SUVs and light trucks, their most profitable products. But there was rejoicing when GM announced an agreement with its unions to slash healthcare costs for retirees by three billion dollars a year.

And the stock market giveth and taketh away... the S&P 500 had its biggest one day gain in six months on Wednesday only to give it all back on Thursday.... It is higher on a year over year basis, but more than 15 percent lower than it was five years ago...

Market risk and how to deal with it is next on Consuelo Mack WealthTrack.

The topic of this edition of WealthTrack is risk, specifically financial market risk.

And we are honored to have the man who is considered to be the authority on the subject with us.

His name is Peter Bernstein. He is an economist, money manager, seminal financial thinker, historian and author of many books, including the world-wide best seller, "Against the Gods: The Remarkable Story of Risk" Peter Bernstein's twice-monthly analysis of the economy and the capital markets, 'Economics and Portfolio Strategy,' is read by investors who own or manage assets worth more than \$5 trillion.

Joining Peter is Robert Arnott, the editor of the 'Financial Analyst Journal.'

He's a prolific writer on the subject of portfolio management, several times in collaboration with Peter Bernstein.

He is also chairman of the asset management firm Research Affiliates.

He is running PIMCO's All-Asset Fund, the first global fund to invest in alternative liquid markets in addition to stocks, bonds and cash.

And our third guest is another Bernstein, no relation to Peter, Richard Bernstein, Chief U.S. Strategist at Merrill Lynch, parent company of WealthTrack's underwriter. But Rich got here on his own, he has been ranked one of 'The Street's' top strategists for 13 years running. His most recent book is called 'Navigating the Noise: Investing in the New Age of Media and Hype.'

Welcome to all of you, it's just terrific to have you here.

Peter Bernstein, especially terrific to have you.

You wrote the book, I mentioned, on the history of risk, and you lived through depressions, recessions, bull markets, bear markets, inflation, deflation.

What do we need to understand about risk?

**PETER BERNSTEIN:** I'll try to begin with a very simple definition. And see where that -- where we go with that. Risk means more things can happen than will happen, that there is a range of outcomes out there. This is a fancy way of saying we don't know what's going to happen, but it's a good way to think about it. If more things are going to happen than will happen, how large is that range, what are the extremes of it, what are the best kinds -- risk means good things as well as bad things.

**CONSUELO MACK:** Right.

**PETER BERNSTEIN:** What's the upside, what's the downside? What are the consequences to me if I do something wrong and the outcome is different from what I want, different from what I expect? This is how you begin to think about it. It really kind of begins with this idea, first of all, we don't know what the future holds. This is -- heads always shake up and down when you say that, but we tend to act as though we do know, but we have to keep reminding ourselves, particularly in this business.

Particularly, you only look at the last week's news, and we don't know what's going to happen. So you have to think about where am I placed in relation to the possible range of outcomes and where the surprises might be.

**CONSUELO MACK:** So as an investor and a money manager, how do you handle risk from an investment point of view?

**PETER BERNSTEIN:** I begin with something different from the probabilities or that range of outcomes, but really saying if I do this or I don't do this, and I'm wrong, what are the consequences. This is a way to begin. If I decide I'm scared of the market and I don't go in, and it goes up through the roof, how much difference is that going to make to me? Or if I do go in the market, and it goes down, what is that going to mean to me? And so -- because you know it's going to do one or the other. And what difference does it make? The first thing is to think about consequences of being wrong because all of us, every day, are faced with the possibility that the decision we make, no matter how carefully reasoned, can turn out to be wrong. And then what does that mean to me?

Often, not much. Often a whole lot. And so they kind of gray the decisions that way.

**CONSUELO MACK:** What do you see is the biggest risks in the financial climate today?

**PETER BERNSTEIN:** There are always a lot.

**CONSUELO MACK:** Right.

**PETER BERNSTEIN:** There are always a lot, so just talk about the biggest ones.

I think it's the level of debt. In terms of American business, debt is low, and they're in very good financial shape. But households, as we know, are very heavily in debt, and the United States government is very heavily in debt, and in debt to foreigners to an increasing degree, which is a serious problem. It means that we're continuously going to have to produce just to service that debt. The problem with debt is that if something goes wrong in the economy, the debt - it's like a stiff crust, and if you break it, the whole thing can crumble. Now, this is not a forecast. But you asked me, what are the biggest risks, I think this is where the real risks lie.

**CONSUELO MACK:** So how do you plan, as a money manager and as an investor, to protect yourself against that risk, that very serious outcome, if in fact, the crust breaks and all hell breaks loose?

**PETER BERNSTEIN:** Suppose I bet that's going to happen, and make a big bet on it, and I'm wrong.

**CONSUELO MACK:** Right.

**PETER BERNSTEIN:** It could be very costly. But it has to be part of your -- of the structure of your decision making. I think there's a time when you have a kernel of securities based on optimistic expectations. By and large, the most awful things don't happen, and then some investments on the outside to cover those extreme outcomes.

This is kind of the structure that you use. I don't think you make disaster the core of your investing because if you -- that's a very expensive decision to make if you're wrong.

**CONSUELO MACK:** Now, you've been an early proponent of the theory that stocks and bonds -- stocks, especially, I think -- are going to deliver low returns. After the terrific returns we saw in the 80s and 90s that essentially we're talking about lower returns going forward. How low, and why do you feel that way?

**PETER BERNSTEIN:** How low? Who knows? Just not high.

One thing bothers me about this view, that there's very little opposition to it.

**CONSUELO MACK:** And it's not going to be with our other two guests either.

**PETER BERNSTEIN:** And that's dangerous. But it's very hard to make the case that returns will be, say, after inflation, more than 6% to 7%. That's the most optimistic expectation. We start from a point where we've had a very - a huge bull market in the 1990s, only part of which has been given back. Equities are still valued at historically high prices. Interest rates, I don't have to tell you, are historically low. And so you start from there, and there you are. I think something very important to think about this, that a period of low returns, you think, well, every year maybe we'll have 4%, 5%. It doesn't work that way. Low returns result from high volatility. You have a big year, and then a bad year, and the pattern of low return periods is high volatility, not low volatility.

It's a scary time.

**CONSUELO MACK:** So you've actually have been writing about -- and again, earlier than most other people have -- about alternative investments and how important they can be in an investor's portfolio. So what are the alternative investments that you think that we should all own?

**PETER BERNSTEIN:** Alternative investments for individual investors are not the same thing as for institutions because --

**CONSUELO MACK:** Right.

**PETER BERNSTEIN:** They're not liquid. They're not transparent. If I were advising individuals of, you know, not enormously wealthy people, I would say even to go easy on these things. You can invest in real estate with REITs; you

can invest in timber with individual stocks. But the hedge fund kind of thing, I don't think it's for individual investors. I would just stay away. It may be interesting, and a lot of people have done well in it, but that doesn't mean that you as an individual are going to pick right, and if you pick wrong, you're in big trouble.

( laughter )

**CONSUELO MACK:** Rob Arnott, you're on the same page as Peter, as far as expecting low returns from stocks, and from bonds, as a matter of fact. You think the individual investors are at great risk right now because they tend to be overexposed to stocks in this country. How great a risk are they, number one? And where do you think individuals should be investing?

**ROBERT ARNOTT:** Well, I think the opportunities are pretty broad. There's a whole panoply of markets to choose among. Most investors have 90%, 95% of their money in mainstream stocks and mainstream bonds, and neither mainstream stocks nor mainstream bonds are priced to offer particularly appealing returns. Firstly, broaden your horizons.

Secondly, look for managers or strategies that can add modest, incremental value. Don't reach for sky. Reach for modest increments. And thirdly, look for asset allocation opportunity. Shift money out of markets that are popular, trendy, comfortable. The markets don't reward comfort. Comfortable markets are priced to provide inadequate, forward-looking rates of return. Move that money into markets that are more attractively priced, which often means they're out of favor.

**CONSUELO MACK:** Such as?

**ROBERT ARNOTT:** Well, one of the markets that I think is very interesting is emerging markets debt. If you look at emerging markets debt, the yield spread over U.S.

Government is low by historical standards, but it's still more than twice as high as the historical default rate, and these countries are -- have a positive balance of trade.

They're exporting more than they're importing. If they're getting more cash in, their debt is less risky. We also find that 15 years ago, none of the emerging markets' economies had investment-grade debt. Now, over 70% of the emerging markets, bond market, is investment grade. So I think this is an area where they're priced like junk bonds but they're not junk.

**CONSUELO MACK:** Now, in the PIMCO fund which I mentioned in my introduction to you, one of the statements that you've made in that is that you'll never put more than 50% of the PIMCO All Asset Funds in stocks.

**ROBERT ARNOTT:** That's correct.

**CONSUELO MACK:** Okay, now, there goes every balanced portfolio in the United States, which, you know, has a benchmark of 60% stocks. So why such a rigid rule, and why does the other 50% go?

**ROBERT ARNOTT:** Partly, we recognize that there's a whole array of markets to choose from. And most of the time there will be something as attractive as or more attractive than equity. So partly we recognize that diversifying outside of equities doesn't necessarily mean lower returns. Partly, we want our customers to recognize that by keeping the equity exposure below 50%, the likelihood of the strategy having a lot of volatility is sharply diminished. And lastly, you're right, practically everybody has the majority of their money in equities. Don't they need a vehicle that doesn't?

( laughter )

**CONSUELO MACK:** I wonder what you're talking about. All right, Rich, actually, I never thought I would call you a bull. You're not a bull. You're very cautious on the market, but when you listen to what Rob's saying, is that -- basically, less than 50% of your portfolio in stocks, does that make you more optimistic than in this group than you thought you would be?

**RICHARD BERNSTEIN:** I have to say, it's odd that I get introduced as a bull.

That hasn't happened in a long time.

**CONSUELO MACK:** Right.

**RICHARD BERNSTEIN:** I basically agree with the themes of what Peter and Rob have brought up. I look at it slightly differently. I look at it that I think the number one rule of asset allocation is the returns on capital are highest where capital is scarce. In other words, you want to be the provider of scarce capital, where nobody else will lend, you want to be the lender. And I think courtesy of partly the Federal Reserve's generosity over the past six, seven, eight years there is no asset class starved for capital.

Hedge funds, commodity funds, venture capital, private equity -- you name it -- everybody is flush with cash. I think what that says is asset returns across the board are going to be muted relative to people's expectations. In other words, low returns not only for equities but for everything. And I think what that means is it's a great time to be very broadly diversified. The opportunity cost of missing out on the asset class is extremely low because there is no "the asset class." Whereas most of my peers on the streets, strategists at other firms will argue you should have 50, 60,

70, 80%, 90% in equities, my argument is that basically says equities are going to be the asset class. I just think the probability of that happening is much lower than what people think.

**CONSUELO MACK:** One of the things you all seem to agree on is that dividends matter a lot. And, Rob, you and Peter -- and you, Rich -- you've all written about that. I'm going to ask you, dividends are at lows historically right now. The dividend payout ratio is at near-historic lows as well, so why do dividends matter still so much, Peter Bernstein?

**PETER BERNSTEIN:** They matter on a couple of scores. First of all, they're money in your pocket, even if it's a small yield. At a time when earnings, the reliability, the credibility of earnings is weak, the dividend matters because you really don't know what the earnings are. I also think if the present tax law persists -- which is open to question at this point -- but the tax on dividends is at 15% is the same as on capital gain. There is pressure on companies to increase their dividends. There have been a lot of dividend increases this year, companies that were not paying dividends have begun to pay dividends - Microsoft in a big way. I consider as part of the return and the likelihood is the dividends are going to grow faster than earnings because they start with such low payouts. So in any kind of a decent environment, this is going to be an important part of the show.

**CONSUELO MACK:** And I know you two both agree. It's such a treat to have Peter here. You two, I'm sure, have some questions you'd like to ask him as well. So, Rob, feel free.

**RICHARD BERNSTEIN:** I'll start, Peter, you're obviously the world's expert on risk.

There's a lot of people that have talked about the 'Greenspan Put,' the notion that the Federal Reserve will ride in like the cavalry and save everybody, and that has made people take more risk than they normally would. Do you agree with that? Do you think that's real?

**PETER BERNSTEIN:** Yes, I agree with that. I think there is this feeling that if there's another weakness in the economy they'll reverse the present policy, yes. But I think we got into this position for the right reason. I mean, I think Greenspan has made good decisions in this sense, and it comes right out of what I was talking about before, about consequences of being wrong. When the economy was weak during recession and there was a fear of deflation, I think Greenspan led the Fed on exactly that line of reasoning, that if we don't really flood the economy with liquidity, we get into deflation, we're going to be like Japan or worse. So we have to take the risk of creating too much liquidity, we have to take the risk of looking too easy because the consequences of the alternative would be awful. So I think we are in kind of a box at the moment. There is this 'Greenspan Put,' in the sense if the economy is weak, they'll be helpful. I think a lot of the rhetoric that's coming out of the Fed at the present time is to remind people, we are tough, we are going to fight inflation, we are here to tighten money if it's necessary. They're trying to remind people that there is that possibility. I think they're hoping to squeeze some of the housing bubble in the process, yeah. But I think what you said is absolutely right, but I think we got there for the right reasons.

**CONSUELO MACK:** Quick question, Rob?

**ROBERT ARNOTT:** Sure. One of the things that I think gets, even now, rather too little attention is the potential interplay between demographics and capital markets.

The baby boomer generation -- my generation -- is fast approaching retirement, the leading wave of the baby boomers are slated to retire in the coming three to five years.

And so a natural question is, as this begins to happen and as the largest generation of perspective of retirees in history, looks to be supported by a proportionally smaller workforce than we've seen historically. What do you see as the implications?

**CONSUELO MACK:** Really quickly here. I've got to get to our "One Investments" for our viewers. Go ahead. Implications.

**PETER BERNSTEIN:** This is a tough question. In terms of the stock market, Rob, let me deal with just one part of it. I don't believe that all these people reaching retirement is necessarily going to make the stock market go down because they're going to be liquidating their shares. Stock prices are set by expectations. Not by cash flows. This is hard to believe, but it's really true. These people came into the -- into the labor market in droves in the 1970s, and they were beginning to accumulate for the future, and stocks went down, not up. So I don't think it's going to have an impact of that kind. The more fundamental economic problems are very important and serious.

**CONSUELO MACK:** Quick questions to each of you.

One investment for a long-term portfolio, and Peter Bernstein, you said own a little bit of everything.

**PETER BERNSTEIN:** I would own a little bit of everything. I just want to take up one thing that Rob said that I agree with completely: you don't own only what's comfortable. What's comfortable is not the right way to invest. You must own things that you're uncomfortable with. Otherwise you're not really diversified. Things you're comfortable with represent one bet, and the purpose of diversification is to cover all the bets. It's not just a defense in strategy to be diversified. It's an aggressive one, too, because you'll be exposed to opportunities that you wouldn't be exposed to if you didn't try to get across the board.

**CONSUELO MACK:** That is a great point. That's a great point.  
Robert Arnott, your 'One Investment.'

**ROBERT ARNOTT:** Emerging markets debt I mentioned earlier. There are two Morningstar five-star rated funds in that area that merit mention.

PIMCO has an emerging markets bond fund and Fidelity does, too.

**CONSUELO MACK:** Rich Bernstein.

**RICHARD BERNSTEIN:** I said high-quality preferred stocks, which have been so ignored. Nobody follows them any more. Some of them are qualified for dividend exclusion, especially some perpetual preferred, and you have to stick with the high-quality ones, but I think you'll get some extra income here.

**CONSUELO MACK:** You were just saying yes, Peter, about that.

**PETER BERNSTEIN:** I think that's a great idea, yeah.

**CONSUELO MACK:** An "Uncomfortable Investment," would that be gold, for instance?

**PETER BERNSTEIN:** Yes, that would be gold, yes, for many people. You can buy them in ETFs. I think gold, a little bit can go a long way. If the world really begins to fall apart, the dollar is really in the kind of trouble that people say ultimately it will be, a little bit of gold can go a long way. The price is still not really high adjusted for inflation. So you can get a big bang for the buck. I think only a small position but one I think everybody should have. You can buy an ETF, iShares has an ETF.

**CONSUELO MACK:** Peter Bernstein, thank you so much for coming on WealthTrack and doing a television interview. You were just fabulous. It's great to have you.

And Robert Arnott, a treat to have you in the studio. Rich Bernstein, great to see you as well.

Near the close of every WealthTrack we suggest one action you can take to build and protect your wealth over the long term.

Today's action point: buy disability insurance. Why? It gets back to the subject of risk that we've been talking about. Around 30 percent of Americans age 35 to 65 will suffer a disability lasting at least 90 days sometime during their careers, and one out of ten of us will have a severe disability. Why does this matter? For most of us our ability to earn a living is the largest financial resource we have. It turns out that 48 percent of all foreclosures and a quarter of all bankruptcies are due to a disability. Many people assume they have disability coverage through their employer. But you had better check with your benefits department, you may or may not be covered or the coverage may be inadequate. For those who need to purchase protection, here are some tips: Buy through an insurance company that is financially strong. Go to our website [wealthtrack.com](http://wealthtrack.com) to find out how to do that...Try to get a non-cancelable contract...Look for a broad definition of "total disability"...And be prepared to spend between one and three percent of your annual income...disability insurance can be expensive—Prices vary according to your age, gender, health history and occupation-- but a long-term disability can be devastating to a family's financial health and the risk of it happening is far higher than a pre-mature death. On that note we'll conclude this edition of WealthTrack....Join us next week for another WealthTrack first, when research firm, AllianceBernstein unveils some new and revealing research on investor behavior. Yale professor Robert Shiller of 'Irrational Exuberance' fame and a pioneer in the field of behavioral economics will also join us, as well as Robert Kleinschmidt, manager of the top-rated Toqueville fund. In the meantime visit our website [wealthtrack.com](http://wealthtrack.com) for our guests' recommendations, past and present, and make the week ahead a profitable and productive one.