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→ INVESTOR'S GUIDE 2012

→ INTERVIEW BY GEOFF COLVIN

ADVICE FROM THE EXPERT ROUNDTABLE

WHERE TO INVEST NEXT YEAR? FIVE TOP MONEY MANAGERS SHARE THEIR WISDOM.

↓ **Bob Doll** *Chief equities strategist, BlackRock*

↓ **Mary Ellen Stanek** *Chief investment officer at Baird Advisors, head of Baird Funds*

↓ **Rajiv Jain** *Managing director and head of equities, Vontobel Asset Management*

↓ **Jim Moffett** *Chief international strategist, Scout Investments*

↓ **Richard Bernstein** *CEO, Richard Bernstein Advisors*

SO VOLATILITY is the new normal. We're pretty clear on that after the past few years of market turmoil. But how do we move beyond today's palpitations to make long-term investment decisions with confidence? At a time when few if any asset classes have seen steady performance, it's hard to know what choices can help us sleep at night.

That's why we've gone to five investing experts—all of whom have ably weathered recent storms—for some clarity and context. Rajiv Jain is head of equities at Vontobel Asset Management and manager of the Virtus Foreign Opportunities Fund. Bob Doll is the chief equities strategist at BlackRock Advisors. Scout Investments' Jim Moffett also runs the Scout International Fund. Mary Ellen Stanek is chief investment officer at Baird Advisors and supervises its bond funds. Rich Bernstein runs his own advisory fund and manages Eaton Vance's Richard Bernstein Equity Strategy and All Asset Strategy funds.

Although *Fortune*'s roundtable participants have expertise in different sectors, moderator Geoff Colvin found consensus about the U.S. market, which this group thinks offers fresh opportunities. Here are edited excerpts from the discussion.

Let's start with the big, big picture. The consensus forecast seems to be slow growth at best in the U.S., probable recession or possible disaster in Europe, slowing growth in Asia. Are we looking at a few years of huge investing headwinds?
JAIN: We feel that people are still too optimistic. I think we're really at a point where the banking system needs to recapitalize in a massive fashion. And I think people are way too optimistic on China. It is an environment where I think you just kind of hunker down.
MOFFETT: We're underweighted in Europe—in European financials in particular. But we're a little more optimistic. We think that you need to separate financial markets from economies. At some point the Europeans will finally put in some form of monetary easing; the Germans will finally admit that if they don't, they're going to sink with the rest of them. China looks to be easing. And in many ways the easing drives financial markets as much as the underlying economics.

So we're looking at a tough world economically. Where do you see opportunity in an environment like this?
DOLL: You want survival-of-the-fittest stories? I think one way to get at that is free cash flow. Companies with free cash flow, particularly accelerating free cash flow, have the opportunity to maneuver in difficult times. So that's the first criterion. The second is preferring the U.S. because U.S. growth is accelerating while the rest of the world is decelerating. From a portfolio standpoint, we want some balance. Our favorite area is technology, where we like names like **Symantec** and **Dell Computer.** Among the giants, **Microsoft** is our favorite. We wish we knew exactly what was going to happen with the cash. But the risk/reward ratio is interesting. We also like some of the health care service companies, like **United Healthcare** or **Aetna.**
MOFFETT: We like some consumer stocks that are headquartered in challenging countries, like **Inditex,** the Spanish retailer that we know as Zara in this country, or **Luxottica Group,** the Italian company that makes eyeglass frames and runs Sunglass Hut and LensCrafters. Both do a fair amount of business in this country, and a very small portion is in their home market. So that's good. One of our favorite stocks is **Hellenic Bottling,** which is the Coke bottler that covers Eastern Europe—

"YOU WANT SURVIVAL-OF-THE-FITTEST STORIES? I THINK ONE WAY TO GET AT THAT IS FREE CASH FLOW." —BOB DOLL

Wait a minute. Hellenic means Greek. But you still like them?
MOFFETT: We still like them. They do 7% of their business in Greece. The rest of it is everywhere from Italy to Moscow. And as the standard of living rises in Eastern Europe, they're going to drink more Coke, we hope.
JAIN: Our view hasn't really changed much over the last four years. We have not owned any continental European bank or any U.S. banks in the global portfolio. The leverage is way too high. Having said that, there are opportunities, names like **British American Tobacco** (BAT). It gets 60% of earnings from emerging markets, it has started buybacks again, and it's yielding around 4½%, with a margin of 35%. I don't see why it can't go to 40%. We still like private sector banks in India like **HDFC Bank,** which is selling around 16 times forward earnings. It's not the cheapest bank, but its tangible equity is 10% of assets. Deutsche Bank's is at 2.5%.

Is the U.S. still "the best house on a bad block"?
BERNSTEIN: Yes, very much so. I think that people are just coming to the realization that the credit bubble was not only a U.S. event. In Europe people are finally waking up to the fact that there was a huge credit bubble there. And I still don't think that people are aware that what's fueled the emerging markets in the last three or four years has been even a bigger credit bubble. So I think the U.S. is the shining star in all of this. We've gone through a lot of our deflation of the bubble already. The S&P 500 has now outperformed the emerging-market index for four years—it's down 14.5% since the end of 2007, vs. a decline of 41.1% for the Morgan Stanley BRIC index.
DOLL: In the U.S. some of this bad news is in the price. The U.S. has fared better than virtually any other place in the world by going down less, in part because of the safe-haven status but in part because we are one of the very few economies that has actually accelerated during the course of this year. The second quarter was stronger than the

first, the third quarter was stronger than the second, and it looks like the fourth quarter will be stronger than the third. We're heading in a direction different from most of the rest of the world, and that's why we like the U.S.

Can I make a comment about U.S. consumers? Boy, are they making progress. If you look at the debt service ratio at the peak, 14¢ of every income dollar that came in the front door had to go out the back door to service the debt. That number's down to 11.

Rich, what are your views on big-picture asset allocation?
BERNSTEIN: I think that there are a lot of opportunities right now around the world. Volatility always signals a change in leadership, right? Much like 2000 with the tech bubble, you go in, it's all tech and telecom and media, and come out and it's emerging markets and gold and REITs and all these other asset classes people weren't prepared for. I think we're there again. People are looking backward, and they're upset because the old leadership isn't performing well, instead of trying to figure out what the new leadership is going to be.

I think if you really want to play the leadership change, the place to look is in U.S. small-cap stocks. If we're correct that credit bubbles around the world are going to deflate, the U.S. is where you want to be. So in our view, you can't get more exposed than buying U.S. small-cap companies. They have a lot of the properties right now that commodities and energy and emerging markets had 10 or 11 years ago. I'm not going to tell you they're cheap. But in terms of ownership, I think they're decidedly under-owned.

We've been hearing for years that interest rates have to go up, and that bonds are a bad investment. Today interest rates are lower than ever. Mary Ellen, what gives? And where do you see opportunities in fixed income?
STANEK: Trends tend to last longer than people expect, and that's clearly been the case in U.S. interest rates. On the U.S. Treasuries side, we think those interest rate levels are artificially low. If you look at some of the other sectors, we find ourselves today with some very attractive valuations on intermediate corporate bonds and U.S. investment-grade corporate bonds vis-à-vis Treasuries.

Rating agencies rate companies. They don't rate the individual bonds. With banks, where we would not want to be shareholders in a lot of the names, as a bondholder we are far more inherently better protected. When you look at additional capital requirements reining in the risk-taking activity and more regulatory oversight, all those things have enhanced our position as a bondholder, yet those bonds are on sale. We see very good relative value in investment-grade credit. **Goldman Sachs'** bonds are trading at 400 to 450 basis points off a comparable Treasury, and you can capture a name that's going to be just fine and do well over a full cycle.

Rajiv, you are not a fan of Chinese banks. Tell me why.
JAIN: We don't understand the accounting. It's very, very aggressive. One of the things I always say is, "Even I can give out loans standing on the street corner. The question is whether I get it back." There has been a massive amount of lending to these state-owned enterprises. And a lot of the big infrastructure projects are not even covering the interest expense. That's usually a bad, bad combination.

Yet on China's future in general, you're less gloomy?
JAIN: I think there are two parts to China's economy. One is the state-owned, infrastructure-led part, and the other is the consumption-driven part, where there has been improvement in the lives of a billion-plus people. We like the Macau gaming companies or **Baidu** or beer companies like **Tsingtao.** I think those are structural-growth stories. On the other side, we don't own any commodity names—or any basic materials anywhere in the world, for that matter. If you look at multinationals, like the ABB Group and Siemens and BMW, we would not touch any of those; they basically have to give away the technology IP when they manufacture in China.
BERNSTEIN: The stories of the Chinese economy may well come true, but as an investor, I might not make any money there. I'm immensely bearish on China as an investment. As U.S. companies have been deleveraging over the past four, five, six years, Chinese companies have been levering, and I think that the credit bubble there is more endemic than ours ever was. People don't like Fannie Mae and Freddie Mac, but they love China, and I don't get that. It's Fannie and Freddie on steroids.

"HIGH-QUALITY EQUITIES ARE THE PLACE TO BE—THE COCA-COLAS, THE MCDONALD'S, THE BATs OF THE WORLD." —RAJIV JAIN

"THE KEY [TO INFLATION] IS WAGES. WITH VERY HIGH UNEMPLOYMENT, THERE IS NOT ANY WAGE INFLATION." —MARY ELLEN STANEK

Let's assume that individual investors are more comfortable with broad asset allocation than they used to be. If you're a 40- or 50-year-old today, where should you go?

STANEK: I think you'd overweight in equities, with a good mix between the U.S. and the global markets, and then barbell the risk. You can use high-yield bonds. They've been increasingly interesting as spreads have widened, now right around 750 basis points. It's more equity-like risk, but you're more senior in the capital structure than you would be with straight equity. And there's still a place for bonds. I would underweight bonds, but stay with high quality and intermediate. Stay short in intermediate so that you can protect yourself in case of a rise in interest rates.

Looking ahead to 2012 and beyond, many bond investors may find municipals make more sense because it is more likely that tax rates are going up than down. Our one caveat is that state and local governments are facing significant budget challenges, and we predict more ratings downgrades.

BERNSTEIN: It used to be that if you think of diversification as a seesaw, there were lots of assets on one side of the seesaw, and lots of assets on the other. And now most assets have moved to one side of the seesaw. Treasuries are the only major asset class that provides diversification right now. There is no other choice. And I think what's amazing is that despite the fact that this has been the case now for five or six or seven years, people still hate Treasuries. Yet even during the summer they were the only asset class that really appreciated. Gold didn't help you. What people have really missed is that as the yield on Treasuries has come down, the diversification properties have gone up because of durations. You don't have to hold as many as you used to to get the same oomph out of that diversification.

JAIN: I think you have to have some fixed income, especially in countries that have the ability to take some policy action. And we do feel that the high-quality equities, especially the consumer-driven ones, are the place to be, the mom-and-pop names that everyone can understand and latch onto—the Coca-Colas, the McDonald's, the Nestlés, the BATs of this world.

I think gold is an extremely under-owned asset. We can't buy it in the mutual fund, but investors should have some, respecting the inflation risk out there. As a percentage of an average total portfolio it's under 1%, but in the 1980s it was up around 5%.

DOLL: In August I saw for the first time in the 30 years I've been managing money that the yield on the S&P 500 was higher than the yield on a 10-year Treasury. It's saying either we're heading for a depression, in which case I want to own Treasuries and don't want equities, or maybe I don't know, and need to own some of both. On the other hand, I could lock up 1.88% for 10 years in that 10-year Treasury, or I could buy the S&P 500 1.88% current yield. To not prefer that second piece of paper, I have to assume that 10 years from now stocks are lower than they are today and/or no company in the S&P 500 has raised its dividends for 10 years. I think they're ludicrous assumptions.

The fact that we have lost a decade is a good thing for equities at this point. In the U.S. we spent the last decade with earnings basically going straight up and P/E ratios basically coming straight down. The market went nowhere. We have an entry point now that's far more intriguing, and therefore the probabilities are that at this entry point you're going to do a little better.

What are you thinking about inflation?

JAIN: Everyone is printing money. Inflation may not happen, but you've got to respect some probability that we may not be able to control things once the genie's out of the bottle.

STANEK: In our minds the key is wages. With huge, very high unemployment and underemployment levels here and globally, there is not any wage inflation—in fact, just the

"WE'LL END UP IN A STALEMATE. EVERYONE'S ASSUMING THAT [THE ELECTION] WILL SOLVE OUR PROBLEMS. IT WON'T." —JIM MOFFETT

opposite. And with all that slack, we believe that inflation will stay contained longer than people expect.
DOLL: I think the critical component is credit. The housing bubble is a great example. You get abnormal credit creation in every wacky mortgage you can think of. You get abnormal appreciation in home prices. But it's really hard to get a lot of inflation when you're on the downside of a credit bubble.

What do people think the star performer will be next year?
MOFFETT: I'm looking at the U.S. as probably the best market. And within that, I'd make a pitch for technology.
JAIN: I think Brazil is the single best market to be in. If you look at the last 30 years, 20 years, 10 years, it has been one of the best markets, because they pay a lot of dividends. There's a lot of great stuff. I mean, you can find a regulated utility selling at seven to eight times earnings, with a 6% to 7% yield. It's a net creditor country, right? Well, I don't know of too many in the Western world or in Europe. And then the multiples are very low, and interest rates are high, so they have room to cut rates. Stocks are very attractively valued.

We're sitting at this table a year from now. What's the big issue we're all going to be talking about?
MOFFETT: We'll have just had an election, and we'll wind up in a stalemate. A different mix of players, but everybody's assuming that 2012 will solve all of our problems. It won't.
DOLL: I think we'll be talking about how, gee, the world held together yet again. It had bumps along the way, but it held together, and maybe equities will have done a little better. That would be nice.
JAIN: Maybe we'll have seen the European situation get worse. I think we are in this long-term muddle where multiples went from single digits in 1982 to trading at 30 times earnings in 2000, and we're going back to eight, nine times earnings. And I think we just have to get used to living with this.
BERNSTEIN: I think the story in the U.S. is people are going to be happier than they thought they were going to be. They may not necessarily be happy on an absolute basis, but they're going to be happier than they thought. So I think U.S. stocks are going to surprise people because of that. If the U.S. continues to get better, and the rest of the world doesn't implode, I think U.S. assets are going to do very well. I think it will be a reasonable year for the dollar. I think it will be a reasonable year for small-cap stocks. And—maybe surprising people—I think it will be a reasonable year for lower-quality bonds, things like munis, high-yield debt.
STANEK: I would say we will continue to talk about the debt, but hopefully we've got one year under our belt in terms of seeing the positive signs of this financial deleveraging, particularly here in the U.S. As tough as this slogging and prolonged slower-growth period coming out of the credit bubble is, it's actually quite therapeutic in the long run. Hopefully those seeds have been planted, and we'll wait for the next bull market in equities.

> **"IF CREDIT BUBBLES AROUND THE WORLD ARE GOING TO DEFLATE, THE U.S. IS WHERE YOU WANT TO BE." —RICH BERNSTEIN**

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