

SPECIAL ISSU

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## INVESTOR'S GUIDE 2005

THE 20 BEST BARGAINS IN THE MARKET

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for Stocks,  
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**PLUS  
STOCKS  
THAT  
ALWAYS  
WIN**



# THE ROUNDTABLE

(clockwise from bottom left): ISI's Jason Trennert; Strategic Investment Group's Hilda Ochoa-Brillembourg; GMO's Jeremy Grantham; Citigroup's Hersh Cohen; Merrill Lynch's Steve Milunovich; moderator David Rynecki







# WHAT'S AHEAD FOR 2005?

We gathered five sought-after investing pros and asked them to polish up their crystal balls. And boy, did the sparks fly.

BY DAVID RYNECKI

**Where are stocks and bonds headed?** We went straight to those who make it their business to predict such things: five respected—and opinionated—portfolio managers and analysts. In the bullish camp are Hersh Cohen, the chief investment officer at Citigroup Asset Management, and Jason Trennert, chief strategist at the well-regarded research shop ISI Group. Facing off are Jeremy Grantham, chairman of investment firm GMO, and Merrill Lynch tech-stock guru Steve Milunovich, both of whom contend that stocks are overvalued. Global strategist Hilda Ochoa-Brillembourg, a former World Bank official who now advises influential clients as CEO of Strategic Investment Group, offers a worldwide perspective. Read on for their lively debate—plus where they are putting their own money now.

**Jason, you're bullish for 2005. Why?**

**TRENNERT:** Because companies have an inordinate amount of cash on the balance sheet. That is going to lead to good things for the market, like share repurchases, increased capital spending, dividends, M&A. Yes, the P/E on the market is relatively high. But inflation and interest rates are far below what they've been on average over the past 50 years. Perhaps the most compelling argument is that tax rates on both capital gains and dividends are far below what they've been almost

since the tax code was invented in 1913. So the chances of a real problem in the stock market are limited.

**Jeremy, you disagree. You recently told FORTUNE that we are "still unraveling the greatest bull market in history."**

**GRANTHAM:** The market is too high priced. The average P/E is about 20.8 times trailing earnings. More vulnerable than P/Es are profit margins. Margins are 7.2% on sales. The long-term average since 1932 is 5%. Profit margins are the most



provably mean-reverting [measurement] in finance. If profit margins don't go back to normal, capitalism has broken down. I hope they come down quickly, because the quicker you get the pain out of the way, the quicker you get decent returns to compound. We should all be in the business of welcoming cheap asset prices so that we can compound our wealth in the long run. Bond people get that. Asset-allocating people get it. But the stock market people simply don't get it. They say, "The stock market's doubled. Whoopee, we're rich!" Everyone else says, "My asset class has doubled; now I get a miserable return." I don't know why stock investors don't get it that expensive is bad and cheap is good.

**TRENNERT:** Part of the reason is that stocks have outperformed other asset classes over the past 100 years.

**MILUNOVICH:** I tend to be on Jeremy's side. It's scary to me that the world's greatest power is the world's greatest debtor, and that every household is responsible for about \$430,000 worth of debt. Whether that hits the stock market, I have no idea. I think it's hard to manage money with that belief in your mind, but at some point I think this is all going to come home to roost.

**Hersh, you don't have the luxury of pessimism. You are paid to own stocks.**

**COHEN:** Well, I can have cash as an asset tool, and I did in the late 1990s when it seemed to me that greed had taken over. But I think the three-year bear market between March 2000 and March 2003 washed out most of the excesses. It was a bear market comparable with the other great bear markets in history since the 1920s. Three things determine the direction of the stock market: earnings, interest rates, and psychology. Psychology is important only in extremes. I think we're far from an extreme now. If you want to worry about something, worry about interest rates. But I think we're not even close yet. I'd worry about 6.5% or 7% ten-year Treasury notes, because that's when the money would start getting sucked out of the stock market by pension funds.

**Hilda, what do you think about the notion that we are still unraveling the bull market?**

**OCHOA-BRILLEMBOURG:** I agree with Jeremy. The key question is the pace at which it unravels. It would appear it is a gradual unraveling, and there is still some room to accrue 5%, 7%, or 8% rates of returns over the next six to 12 months. So where do you park your money? Two years ago there were extraordinary places to park your money. Right now there are fewer places, but there are some.

**COHEN:** Jason talked about companies being loaded with cash, which is right. Dividend payout ratios went from 50% throughout the '60s and '70s down to 25% or 26% or 27% by the late '90s as option-based compensation became popular. Companies have enormous amounts of cash. They can do three things. They can raise the dividends. They can buy new shares. Or they can make acquisitions. I think the era of big mega-acquisitions is over. Companies will spend their cash buying shares. They'll do capital expenditures. I think blue-chip stocks have the ability to raise dividends on a pretty aggressive basis, which should provide a reasonable return for people and also provide some downside protection.

**MILUNOVICH:** Even technology companies are getting over that psychology of "Real men don't pay dividends."

**COHEN:** Thank God.

**Those are positive signs, but a lot of folks wonder what they're supposed to do when the memory of the bear market is so fresh.**

**GRANTHAM:** What you have to do now is live to fight another day—protect your assets. If you feel you have to own stocks, make sure that they're foreign stocks. If you absolutely insist on owning U.S. stocks, make sure that they're high quality and they're not exposed to any sort of debt crisis. The balance sheets of smaller companies particularly have really deteriorated badly, and there's a huge risk. And beyond stocks you should consider international bonds, government high quality, intermediate, no big risk. If you insist, you could earn a little bit on REITs. Although they're overpriced, they're not as overpriced as the rest of the market, and they have a semi-respectable yield. And if you are lucky enough to have access to conservative hedge funds, I would certainly do that.

**What is the S&P 500 worth?**

**GRANTHAM:** About 16 times earnings, which is about 725. Currently it's a whole lot higher. When I go back to look at the so-called washout, what I see is a market that came down to 18 times normalized earnings. Then it staged a spectacular rally. I just want to point out that the great bubbles in history—1929, 1965, 1972, and Japan—all went screaming through the trend line and stayed [down] there for years. What happened this time? We shot up 42%. The characteristic of the end of the great bubble is conservatism, capital preservation, and caution. What was it this time? It was the most speculative year in history. Everything that had to do with junk did well.

**COHEN:** Because stocks were cheap. They were coming back from bankruptcy levels. Corning got down to \$2 a share.

**GRANTHAM:** Flaky little Internet stocks went up—43 times was my favorite one.

**TRENNERT:** Those speculative periods were exacerbated by significant policy mistakes. And this time around, the difference has been with the Federal Reserve and the administration. I want to bring up this tax on capital gains and dividends. It is a seminal change for investment in equities. Those two things—the amount of liquidity the Fed provided and the tax cuts the administration provided—gave stocks a natural floor.

**GRANTHAM:** That is the reason you have a great bear market rally. You throw money at a system, you throw low rates, you throw tax cuts, you will give a reason to goose the market up. It's not a justification for high prices.

**COHEN:** The government avoided the mistakes they made in the '30s. That's the whole point. In the '30s they raised taxes to close the deficit. They put up trade barriers. The Fed accidentally contracted money. They avoided these mistakes this time. We needed a fiscal stimulus; we got a fiscal stimulus.

**OCHOA-BRILLEMBOURG:** There is no doubt in my mind that U.S. government policy, both monetary and fiscal, has been for the past 20 years one of trying to reduce the risk premium in the U.S. capital market. Is that bad, or is that good? Well, it's probably both. If they reduce it too much, they're removing the immunities that investors should develop over time to protect themselves—caveat emptor. Everyone has now relied on the

**"Earnings are going to go up. If you want to worry about something, worry about interest rates."**

**—Cohen**





U.S. government's either supplying liquidity or supplying a fiscal policy and reducing interest rates when things get a little ugly. It's worked. And as long as you have juice to throw to the system it will continue to work.

**GRANTHAM:** Almost every great bubble has been accompanied by the same claims—that this time it's different. The other guys made mistakes. This time we haven't.

**COHEN:** Who's claiming this time is different?

**GRANTHAM:** You are. You're saying the last time they made mistakes, but this time we haven't made any mistakes.

**COHEN:** I'm saying this time looks the same as other bear market bottoms. It looks the same as the 1974 bottom. It looks the same as the 1962 bottom.

**GRANTHAM:** But this time it's different because we didn't make any mistakes, according to you.

**COHEN:** I didn't say we didn't make any mistakes. I'm not saying it's a perfect picture. But bear market bottoms are made when people discount the worst possible case.

**GRANTHAM:** They were barely chastened this time. They went charging back into growth stocks last year. Growth stocks led the parade last year. Tech led the parade. Internet survivors led the parade. Stocks below \$5 with no earnings and no prospects were up 120%. Serious blue chips with yields and assets were up 14% or 15%. This is one of the biggest discrepancies between junk and quality we've ever seen. This is an incredibly unchastened market. This is an aggressive, speculative market.

**OCHOA-BRILLEMBOURG:** Do any of us think that we're going to get great returns from the U.S. equity market looking forward? I don't think so. So we all agree that the returns are not likely to be more than 4% or 5% yield on average and could be zero to minus 3% or minus 4% over the next seven years.

**GRANTHAM:** And the question is, can you make a handsome return over the next two, three, four, five years? That chance is very slim.

**Steve, what about this question Jeremy raises? I see Google is trading above \$165 a share, which is about 200 times earnings. Have we learned anything about technology stocks?**

**MILUNOVICH:** On one hand the valuations are still fairly rich. Historically, you could buy tech at ten times earnings and sell it at 15 times. Today tech sells at about 20 times next 12-month earnings. The premium over the S&P is about 38%. The average historically is about 30%, but that includes the bubble years. So you could say it's ridiculously overvalued, I guess, but I would still say it's fairly expensive. And remember, that doesn't even include expensing options, which is going to remove 20% of your earnings. On the other hand, in the case that you mentioned, Google, it's not so easy, because here you do have a world-changing event in the Internet.

**TRENNERT:** Maybe this is where I part company with everyone here. I actually think technology will be seen next year as one of the few places where you can get growth. And in many ways we're toying with the idea that 2005 will look a lot like 1995: You get a Fed-induced mid-cycle slowdown in the economy, and then investors start to, believe it or not—I'm sorry to say this, Jeremy—actually shift more out onto the risk curve to get growth. I think it's going to be in tech. I think it's going to be in media. I think that like it or not, technology is a competitive advantage that the U.S. has. Intellectual property is a competitive advantage that the U.S. has. And I would be willing to bet that technology as a percentage of the S&P and as a percentage of our economy is likely to move higher over the next five to ten years. Now, the

question then becomes, what price do you pay for it? But I don't see the prices right now as excessive.

**Jeremy, you've been arguing that the presidential cycle is a major issue for investors to recognize.**

**GRANTHAM:** Let me do my version of Billy Beane and the Oakland Athletics by looking at the odds. Since 1932, the first two years of the presidential cycle have been down in real terms for 19 times out of 37. In years three and four, you've lost money five times, never very seriously. In year three you've never had a loss bigger than minus 2% because in year three they stimulated the system. The nice thing about the presidential cycle—it's the easiest thing in the world to understand. Stimulate like mad in year three. Coast with low volatility up to the election. And then tighten the system so you can play it again in year three.

**COHEN:** To say because it's happened 19 times out of 37 times, that to me is as dangerous as saying that this time is different.

**GRANTHAM:** How do we think they're going to restimulate in year three from here? I mean, rates can hardly go lower. Money can hardly become more available. And taxes can hardly be cut.

**MILUNOVICH:** Two things are somewhat different, and they're negative. First of all, you've got a combination of Fed tightening while profit growth is decelerating, which is a somewhat unusual combination. And second, you've got negative real interest rates.

**TRENNERT:** Look at 1985, 1989, 1993, 1997—all first years of Presidents' terms that were all positive returns. So that's recent history. And this President looks like he's just getting warmed up in terms of stimulus. They're talking about private accounts for Social Security. They're talking tort reform. They're talking about a flat tax. All of these things you may think will be disastrous longer term. In the short term, though, it's hard to see them being bad for stock market returns.

**Let's discuss the global picture. Is the U.S. still the most important market to be in?**

**OCHOA-BRILLEMBOURG:** It is the largest capital market, and there are very few other places in which to hide if you're a big creditor of the U.S. Where are you going to put your money? In euros? Yes, they're doing that, clearly. But Europe doesn't look great ten years from now. They've got huge pension liabilities that they're nowhere near funding. And they're facing a slowdown in their economy. There is a better place to invest than U.S. equities, and that is small European equities over the next year or two. In terms of what's going to look great ten years from now, emerging markets have a lot more room to appreciate. They have younger populations. They have higher growth rates. They have much better values.

**“Given my general cautiousness, I’m about 70% in cash—with some commodities in there.”**

— Milunovich

**“Technology will be one of the few places where you can get growth. In some ways 2005 will look a lot like 1995.”**

— Trennert





HILDA OCHOA-BRILLEMBOURG



But look at China's having raised rates and the specter of another emerging-markets crisis.

**OCHOA-BRILLEMBOURG:** China is not an immediate great bet. Taiwan is an immediate great bet. South Korea is an immediate great bet. But if you're talking about the next ten years, if you're talking about finding assets that are not just good for the short term but also good for the long term, emerging markets are great.

**GRANTHAM:** Their finances have never been better.

**COHEN:** It's interesting. You worry about speculative U.S. stocks going up, and yet you'd rather invest in countries where you can't know the economy. You can't know the politics. You can't know the possibilities of terrorism. You can't know the currencies. I don't see the consistency there in terms of riskiness.

**GRANTHAM:** I'm paid to take that risk. These markets trade at 14 times earnings, a very handsome discount. Second, their GNP growth rates are twice those of developed countries. Third, they have improved financially over the past ten years immensely. During the same period, we have deteriorated immensely.

Ultimately, the question comes down to, What do I do? I'm 35 years old; I have two kids. I need to pay for college, and short term I need to make sure I don't go broke.

**TRENNERT:** You want to have an equity bias to your portfolio to meet those long-term liabilities with something that's going to grow. Buying bonds, lending the government money at 4.25% for the next ten years, doesn't strike me as the most prudent thing to do. Bonds seem quite expensive to me. Real estate seems pretty expensive. Equities, of the three major asset classes, actually seem relatively attractive. So I would have an equity bias, and I would focus on companies that pay dividends and that have the ability to grow dividends significantly over the next five, ten, 15, 20 years.

Any examples?

**TRENNERT:** We've developed something called the Thrifty 50: Companies that can grow dividends, that have strong free cash flow, that have relatively low levels of debt—such as UPS, Nucor, and Sherwin-Williams.

How can I protect myself and also make money?

**GRANTHAM:** I think most people can't be persuaded to keep less than 50% or 60% of their portfolios in equities. So I would say 45% in foreign developed and emerging equities, 5% in U.S. REITs, 10% in global commodity stocks or the equivalent, 20% in foreign government bonds, and 20% short-term securities.

"There is a better place to invest than U.S. equities, and that is small European equities over the next year or two."

— Ochoa-Brillembourg

What is Merrill Lynch telling people to do?

**MILUNOVICH:** Corporate spending on computers is gradually improving, while consumer spending is weakening. Therefore, I'd want to have exposure in some of the enterprise names—Oracle, Computer Associates, Xerox, and SAP. We see security continuing to work next year—Checkpoint and McAfee. In technology we're shifting from a period of innovation to deployment, so ease of use is becoming more critical; consider Apple and Navteq, which is involved in GPS maps in cars. Outsourcing will continue—IBM and Infosys are two names there.

**COHEN:** Great U.S. equities are the core. We like companies with the ability to raise their dividends on a regular basis. 3M, for example, with a high return on equity, a 45-year history of raising its dividends every year, products that everybody uses, exposed to the many growth areas. Lots of business overseas. It's a little tough here because we've had a run-up in some things like Johnson & Johnson and Kimberly-Clark and Procter & Gamble. But those are core stocks that I think you'd look for reactions on.

**GRANTHAM:** I completely agree with you. If you have to buy U.S. stocks, I would definitely buy the great companies.

**OCHOA-BRILLEMBOURG:** My portfolio would be less extreme than Jeremy's, although oriented toward the same type of assets. I would have 20% in municipals. I would have 20% in cash or hedge funds and 30% in international equities, of which 20% would be developed and 10% emerging. And I would still hold 30% in U.S. equities.

Where are you putting your own money?

**OCHOA-BRILLEMBOURG:** I have 30% in hedged strategies. I have about 20% in real estate. I own about 5% in private equity funds, venture capital, and private equity. And the rest I have invested in a similar fashion to what I've described here.

**TRENNERT:** I'm overwhelmingly exposed to U.S. domestic equities. I think after talking to this panel I should probably diversify into foreign equities. But I still believe that equities provide the best

"Can you make a handsome return over the next two, three, four, five years? That chance is very slim."

— Grantham



potential returns.

**COHEN:** I have about 50% in tax-free bonds backed by the U.S. government, and 50% in the kind of stocks I talked about and the funds that I and my company manage.

**GRANTHAM:** I have 50% in hedge funds, very cautious ones. Two-thirds are run by [my firm] GMO, one-third outside, 20% in emerging-country equity, 15% in small-cap interna-

tional equity, 5% in forestry, 10% in foreign bonds. I also have minus 10% in S&P contracts [in other words, he's short].

**MILUNOVICH:** I'm not allowed to own technology stocks I cover or mutual funds that have a high component of those stocks. Given my general cautiousness, I'm about 70% cash, with some commodities in there.

**GRANTHAM:** Wow. **F**

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