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REALITY CHECK

By

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Thank you, Mark, and thank you all for taking time out of your busy schedules to share a day with FPA. This is an opportunity for you to gain a better insight into how your money is being managed. I urge you to challenge the respective managers and their teams of analysts with your questions. I'm sure that if any go unanswered, Mark and his team will be able to track down an answer for you. All questions are fair game so hit the teams hard and often with them!

Pardon me for getting a little bit sentimental now because a lot has changed since I joined FPA 31 years ago. From a small $1.6 billion single product firm, we have grown into a diversified $30 billion company with the greatest depth of analytical and investment management talent in its history. I am proud of the fact that we have never lost sight of our core principles. Our value-driven, independent thinking and disciplined investment culture permeates all aspects of what we do. We sincerely thank you, our partners, for the trust that you have demonstrated by investing with us. We hope and expect to be able to protect and grow your capital in the volatile markets that we anticipate will be the norm in the future.

Now on to the fun stuff!

As many of you know, and for those of you who don't, I've been a harsh critic of the fiscal and monetary policies that have been deployed these past several years. Since returning from my 2010 sabbatical in 2011, I've been very cautious about capital deployment, as many of my successors will confirm. In light of the stock market's astounding rise since 2009 and five years of near zero short-term rates, I've reassessed and challenged my basic fundamental understanding of how the financial markets operate. I've seen the error of my ways and I believe I've been reborn. To achieve this new state of understanding and peace, I've had to do something that no self-respecting, able-bodied and semi-sane money manager would do, though my partner's would probably take issue with this statement. You know, don't you? To have a manager actually say he's WRONG!

I want you to know I've been wrong. Yes, wrong! Yep, I blew it! Shame on me! God that feels good. I feel so much better now. I've come to the realization that the only way to succeed in this new financial world is to convert. Convert to the philosophy that valuation and prudence are of little importance. The only thing that matters is to trust in, you know who? Trust in the Gods of the all-knowing and all powerful. Trust in the God of qualitative monetary forecasting and policy implementation and everlasting blather, the FED. Trust in the Gods of fiscal policy management and leadership, our members of congress and the president--paragons of fiscal rectitude. I've converted. My conversion feels good. I'm at peace. I'm free. Now I can run with the "Risk-On" crowd. The crowd feels good. I feel the love, the affection and the psychological support it provides. What more can I say? Ah, its crowd pleasing. At that moment, I realize I've just awakened from a bad dream. Not a bad dream of trusting in the Gods. Oh no! I mean THE BAD DREAM of actually being a money manager who lowers his defenses and admits to, of all people, a client, that he has made a mistake. Thank God I haven't lost all good sense.

Yes, we live in an investment world that hangs on each and every word of the Fed and other governmental luminaries. How absurd is this? Why should it be so? When I reflect upon the Fed and its former chairman, Ben Bernanke, how would or how could anyone, with half an ounce of sanity and intelligence, have any confidence or faith in their economic forecasts and monetary policy?

I believe it is time for a REALITY CHECK.

Need I remind you of what the Fed and Bernanke said?

- Bernanke is quoted in both 2005 and 2006 Fed minutes that, in his opinion, there is no housing bubble.
- In both April and June of 2007, Chairman Bernanke said there would be no contagions from sub-prime credit. I argued differently.
- The Fed's June 2009 economic forecast envisioned real GDP growth of upwards of 4% to 5% in 2010 and 2011, though they did caution it could be lower. Actual: 2010: 2.8%, 2011: 2.1%. The Fed has been consistently overly optimistic in its economic growth forecasts.
- Unemployment would decline, though somewhat slowly, to a long-term 4.5 to 5.3% level, without any adjustment for a potential decline in the labor participation rate.
- Chairman Bernanke assured us, in his November 4, 2010, Washington Post op-ed, that QE would lead to an economic "virtuous" cycle through the wealth effect. We're still waiting.

In contrast, back in 2008, 2009 and 2011 my forecasts were:

- June 2009, a sub-standard economic recovery will occur.[1] I subsequently clarified "substandard" as approximating 2% real growth. Actual outcome: 2.2% since 2009. It was 2%, until the Bureau of Economic Analysis revised its method of estimating GDP in July 2013 that created $500 billion of additional economic growth out of thin air.
- Also, the recovery will be accompanied by elevated levels of unemployment that are structural in nature. Result: we've had the worst employment recovery since the Depression. The unemployment rate looks better than it really is because the labor participation rate has fallen 3.4 percentage points since December 2007.
- I expected little bang for the buck from the 2009 $831 billion Keynesian economic stimulus plan that wasted money and time on one-time quick-start gimmicks such as "cash for clunkers" and an $8,000 one-time credit to buy a home.
- QE and ZIRP will not lead to a robust economic cycle and it will likely be accompanied by many negative unintended consequences. This is yet to be determined on the unintended consequences.
- Pre-tax margins will not experience a robust recovery. I was wrong on this one; however, much of the margin improvement has been driven by lower interest and wage costs that may prove to be non-sustainable. Labor compensation is currently at the lowest level of National Income since 1948.
- Finally, my Treasury debt forecast of between $14.6 and $16.6 trillion by the end of 2011, versus $10 trillion at September 30, 2008, proved to be right on target.

[1] *Reflections and Outrage*, Morningstar Keynote Speech, May 29, 2009, Robert L. Rodriguez

This comparison of the accuracy of my forecasts, versus the Fed's, hopefully lends a degree of credibility to my comments and forecasts that follow.

Last year I delivered a speech entitled "Future Shock" to the USC graduate student investment program. I borrowed the title from Alvin Toffler's popular 1971 book. It coined the term "information overload." I explained how, as a young investment professional, I was "future shocked" by two major events. The first was the demise of fixed exchange rates in August 1971 that were established under the 1944 Bretton Woods Agreement. Investment professionals, the Fed and academics were mostly surprised by the unintended effects caused by floating exchange rates. Second, the oil embargo of October 16, 1973 was a game changer since it led to a near tripling in oil prices within three months. What was the stock market's initial reaction? The Dow Jones Industrial average actually rose in the week after the initial 43% price increase, before it began its collapse to its December 1974 low. We failed to understand the implications of these events and how they were interrelated. It was a failure of the first order. Out of this crucible of chaos I was forged into a dedicated value investor, forever changed.

In light of my experiences, I tried to convey to the students what I thought might be their Future Shocks and how they could influence and disrupt the business and financial world they were about to enter.

The first one I suggested would be the Fed's policy of Quantitative Easing. Since its initial implementation in November 2008, subsequent rounds have been larger in scale. Like a drug addict, their effects wear off and then a new fix is required. We are assured that the Fed can taper and potentially reduce the size of its securities' holdings, which are estimated to peak this year at a staggering $4.5 trillion, without any economic or financial market disruptions. New strategies are being discussed as to how this withdrawal process may be handled. I believe financial system excesses are now developing as a result of the unintended consequences of QE. How might they disrupt the Fed's exit strategy? Do I have confidence in a Fed exit strategy? No! Why should I have confidence in an institution that could not recognize the greatest bubble in history, the housing bubble?

The second is what I refer to as ad hoc governmental intrusion which was exemplified during The Great Recession. The differential treatment of Bear Stearns, AIG and Lehman Brothers added to the severity of the crisis. Arbitrary prioritization of the standing of creditors and pensioners in the GM and Chrysler reorganizations also added to this confusion. What ground rules and standards will be used in the future? A high level debate is currently raging among the shareholders of both Fannie Mae and Freddie Mac regarding profit sharing. Should the public shareholders receive anything? The government technically owns 79.9% of each company but says it can take 100% of the profits. Is this fair or right? I am just a bystander in this debate. It was not always this way. I am proud of the fact that in January 2006 we concluded that both companies were insolvent and that we would not lend to them. We responded by liquidating 100% of our debenture debt holdings and placed both companies on our investment restricted list. I believe we were the only company to publically state this policy. Our prudence was not rewarded because the government eventually bailed out all creditors. Despite this outcome, we believe our view that they had become speculations, and not investments, was the correct one.

Today, we have another potential ad hoc governmental intrusion risk--the Dodd-Frank Law. When passed on July 21, 2010, it contained 848 pages and 360,000 words. On its three-year anniversary, it had grown to 14,000 pages and 15 million words, according to Davis, Polk & Wardwell. As of May 1 this year, of the 398 rulemaking requirements, only 52% had been met. I recently reviewed a near two-inch thick "summary" of the Volcker Rule.[2] What a joy! Does anyone have an idea of how all this will unfold?

[2] *The Volcker Rule: Commentary and Analysis*, Dechert LLP, 2014 Edition.

I know I don't. As an example, our fixed income team has seen a dramatic withdrawal of bond market liquidity, as these rules have been clarified. What will it be like in a chaotic financial market? That's easy to answer--much worse. Will Dodd-Frank help to protect and stabilize our economic system? I'll let history answer that question: Theodore Burton aptly wrote in 1902, "On committees after a crisis or depression, these committees take testimony and collect voluminous information from many sources. In all their testimony there is an evident exaggeration of the efficiency of laws and governmental action in remedying the difficulty."[3] One hundred and twelve years later we are still doing the same old thing. Government and its regulations will always be late to the party.

Now I come to the real meat and potatoes.

During the past several years, I've warned about the dangers of uncontrolled government debt and entitlement liability growth. I spoke to the late Senator Warren Rudman at the 1996 UAM Management Council meeting and first suggested 2005, or possibly 2013, as the likely dates when these issues could be addressed. In January 2010, realizing that time was growing short, I contacted former Comptroller General David M. Walker since he had become a thought leader warning about the dangers of fiscal excess. I had the honor to participate in, and help fund, his national speaking tour on this subject. For three years, we plotted strategy. In the end, we failed. Back in early 2010, we both thought a real and substantive fiscal restructuring had to occur no later than 2013. We debated which month. When July came and went last year, nothing of substance had been achieved other than some sequester cuts, and these, too, have been modified and delayed by the December 2013 Bipartisan Budget Agreement. You hear very little about this topic now.

In 2009, I forecasted that, if nothing were achieved by the end of 2013, the likelihood was that, between 2014 and 2018, we would face increased financial market volatility that would end in a crisis of equal or greater magnitude than The Great Recession. Now that we're here, have I changed my thinking? No! In my opinion, we are living on borrowed time. Pun intended. Both Dave and I believe we failed because the message we carried just wasn't direct enough and it was too nebulous a concept. As a side note, Dave closed down his ComeBack America Initiative organization last year, where the mission was one of educating the public about the dangers of debt and entitlement liability growth.

We concluded that something more personal must impact the electorate before it wakes up to the dangers of governmental excess. Some of you in the audience may take issue with what I have to say now.

Our nation has been led by two fiscally irresponsible presidents, George W. Bush and Barrack Obama. Both have presided over the largest increases in Treasury Debt as well as establishing new entitlement programs.

Passage of the Affordable Care Act, in my opinion, is a fiscal and political nightmare. It has changed the political dialogue in this country for the worse. By creating another entitlement without first addressing those that have been eating away at the fiscal soundness of our country, we have in essence levered up an already highly levered system.

Its ineffective and incompetent implementation, in addition to governmental overreach, may awaken the electorate to the risks of an overly intrusive and excessive government. I can't think of anything more

[3] *Financial Crises and Periods of Industrial and Commerical Depression*, Theodore Burton, 1902, p. 65.

personal than healthcare. How might the electorates' dissatisfaction be registered, should implementation problems persist? Possibly, it will be through the ballot box this November.

Until the electorate registers its dissatisfaction with excessive government, the fiscal mess will continue to worsen. Should the electorate "revolt," my dower view could change. I define revolt by how many seats in the senate shift. During the past 80 years, I believe we've had two revolts which marked major turning points in the political direction of this country. Twelve seats switched from Republican to Democrat in 1934, while twelve swung from Democrat to Republican in 1980.[4] Our Washington consultant, Washington Analysis, believes probably only 4 to 6 seats will shift to Republican this November. If this occurs, divided government will continue and then we will have to wait until the 2016 presidential election for a clearer outcome. In this case, I believe the next president will not address the fiscal mess in 2017 because it would still be considered too divisive an issue; thus, 2021 would be the more likely timeframe—after the second term presidential election. In my opinion, this would be too late.

If ten senate seats were to swing from Democrat to Republican or Independent, this would represent a tectonic shift, potentially setting up the possibility that the next president could consider addressing the fiscal mess in 2017 in conjunction with the congress. It will require both sides coming together.

I believe the odds favor the first scenario. If this is the case, the Fed will remain active with a monetary easing bias so as to offset the structural impediments in congress. With a $4.5 trillion securities' portfolio, how much flexibility will it have, particularly if a financial crisis develops and additional QE is required? Will the bond market remain quiescent to an ever expanding Fed portfolio or will it revolt via escalating longer term interest rates? With the likelihood that without a fiscal restructuring before 2021, by 2024, total US debt should be upwards of at least $25 trillion and more likely $28 trillion versus $17.5 trillion currently. Total net interest cost will likely rise to between $1.0 and $1.2 trillion versus the CBO's $227 billion fiscal 2014 estimate.[5] A combination of rising rates, eroding entitlement trust funds and lower remittances from the Fed, account for this increase unless the Fed can maintain its interest rate repression policies. It is difficult to say, but I would place the odds of a bond market revolt at greater than 50%. There are other well respected bond managers who argue that interest rates will remain low or continue to decline due to the effects of demographics. For the first time in this country's history, a succeeding generation is smaller than the previous one. We've never seen this scale of debt and off-balance sheet liabilities, in combination with a rapidly aging population base. This trend is also occurring in several other developed countries. History has shown that, when government financial obligations become too large to service, the most likely solution is to resort to the monetary printing press. I do not believe the financial markets are factoring in this potential risk.

Whenever I am confused about potential outcomes, I generally look back into history for some guidance.

Walter Bagehot wrote in his "Essay on Edward Gibbon," in 1856, "Much as been written on panics and manias,…….but one thing is certain, that at particular times a great many stupid people have a great deal of stupid money." I believe this is now occurring in many areas of the financial markets. For example, the Wall Street Journal carried these story titles in their May 23 edition: "Investors Show Little Fear" and "Penny Stocks Fuel Big-Dollar Dreams."[6]

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[4] Party Divisions of the United States Congresses, Wikipedia.
[5] Congressional Budget Office, Updated Budget Projections: 2014 to 2024, p. 3.
[6] *Wall Street Journal*, May 23, 2014, p. C1

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At FPA, throughout our various products, a defensive mindset is prevalent. Equity portfolios are holding sizeable levels of liquidity, while our fixed income product remains anchored to a very short duration. We hope that you appreciate our focus and concern on protecting and growing your capital and that you will have the patience to see our thinking vindicated.

Before I close, I would like to leave you with these two thoughts. Norman Cousins said, “Wisdom is the anticipation of consequences” while according to Mark Twain, “Courage is resistance to fear, mastery of fear, not absence of fear.” I believe these two traits are required to be a successful investment professional and that our investment teams have them.

Thank you and I hope your thinking will be stimulated by my comments here today.