

PETER BERNSTEIN

World of Ideas

HOW DOES A MAN WHO WAS RAISED DURING THE DEPRESSION, HIS VALUES FORGED BY HIS EXPERIENCES DURING WORLD WAR II, VIEW THE WORLD OF BUSINESS?



PETER BERNSTEIN

Teacher, writer, editor, air force captain and investment consultant: these are just a few of the many hats Peter L. Bernstein has worn during his distinguished career. After graduating from Harvard University and a stint as a member of the research staff

of the Federal Reserve Bank in New York, Bernstein joined the Air Force and was a captain in World War II, assigned to the Office of Strategic Services in the European Theatre. A few years after the war ended, he joined Wall Street and went on to manage billions of dollars for individual and institutional investors. In 1973 he established Peter L. Bernstein, Inc., an economic consulting firm for institutional investors. A year later he founded the highly respected *Journal of Portfolio Management* and was the publication's first editor. He remains Consulting Editor, and today also writes and publishes an analysis of the capital markets entitled *Economics and Portfolio Strategy*.

In 1997 Bernstein received the highest honour awarded by the Association for Investment Management & Research, the Award for Professional Excellence, and in 2000 received the James R. Vertin award recognizing individuals who have produced a body of research notable for its relevance and enduring value to investment professionals. As well as writing countless articles for professional publications and the popular press,

INTERVIEW BY BARB CLAPHAM

Bernstein is the author of eight books, including *Capital Ideas: The Improbable Origins of Modern Wall Street*, *Against the Gods: The Remarkable Story of Risk*, and his most recent book, published last year, *The Power of Gold: The History of an Obsession*.

I met recently with Bernstein at his home in New York City, where we discussed his philosophy of investing and the subject of his latest book—gold.



Given that the price of gold shows very little reaction to political events these days, do you view it as simply another commodity like copper or silver?

BERNSTEIN: The short answer to this question is yes, but there is a longer answer. The U.S. dollar has supplanted gold and now plays the role that gold played in the past. The dollar is the first line of defense and the currency of choice. The U.S. dollar is essentially a substitute for gold.

My whole intellectual orientation is that nothing is in place forever. What is today may not be tomorrow. I don't know whether it will be or not, but to say that gold will never be anything but a commodity would probably be wrong. Who can be that certain?

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restore it; maybe we won't have a crisis that big. In the event of a U.S. dollar crisis, then I think something will happen with gold.

One of the things that impresses me about gold—and I talk about in one of the last chapters of the book—is the trip of the price of gold from \$35 to \$850 an ounce. Unbelievable.

Yes, and Bette Midler asked for her fee to be paid in gold instead of cash.

BERNSTEIN: You didn't have to have much money in gold as a hedge against disaster to have it pay off handsomely. Just 4 or 5% of your portfolio in gold as a hedge would have worked out really well, and if it didn't work out very well, you only had 4 or 5% there.

Similar possibilities exist now. Given the price today, the output is just barely above the cost of production, and even there only for the lowest cost producers. There is a lot of shut-in capacity that would come out if the price went up. So, even a very small position, and I wouldn't recommend anything more than 3% or 4%, can be a marvelous hedge against total chaos.

Do you think that a manager can have exceptional skill at either stock picking or market timing, and can beat the market over the long term?

BERNSTEIN: That's a question that's never going to be solved. It is so hard to define skill. Yes, there are managers out there who may beat the market over 10 years. But a certain number of people are going to do it as a matter of luck anyway.

I have a different feeling about people who have skill.

Let's assume they have skill, and in all likelihood there are people who do, difficult as they may be to identify. I think that you shouldn't use them as specialists, but should say to those who can pick stocks or time the market, "Don't feel constrained with this particular area." If you are a terrific small cap manager, for example, I can't believe that skill is limited only to small companies. If you are that good and you see Dupont as a good buy, don't hesitate...

You have expressed the opinion that the longer the market is open, the more volatile it is. Does this mean that with the advent of the 24-hour global market we are forevermore going to have greater volatility in the markets?

BERNSTEIN: Other things being equal, yes. There could still be periods of low volatility, but they would not be as low as they would have been otherwise. There is an enormous amount of evidence to support this—the more the markets are open, the more trading there is and the more volatile they are.

Concerning the global economy, do you think it is preferable to have large currency areas, such as that of the euro? Do you think we will ever have one universal currency?

BERNSTEIN: I think that a trend in that direction is much more likely than any reversion to fixed exchange rates. Gold may come back as a store of value, but it won't come back as a standard, a means of payment. That means fixed exchange rates. Fixed exchange rates are doomed. We won't ever come back to that again. The world is too dynamic, it just doesn't work. And with capital movements, too, it just doesn't work. The idea of a common currency which eliminates the exchange problem totally, yes, I favour that.

It sounds as if you think Canada's floating rate system is a good one.

BERNSTEIN: Yes.

Because of the ability of this type of system to absorb shocks?

BERNSTEIN: Yes. If the exchange rate were fixed it would crack at some point, as we have seen over and over and over again. The whole lesson of history is that



fixed exchange rates don't hold. They are not fixed. What I think policymakers fail to understand is that when gold was the centrepiece of the currency system, the gold standard worked because the system was working. It wasn't that the gold standard made the system work.

Any thoughts on why the euro is so low? I don't recall anybody saying it was going to fall as low as it has.

BERNSTEIN: It is my feeling that the problem isn't the weakness in other currency, but the overwhelming strength in the U.S. dollar. The dollar pulls everything else. I think the euro at the current price is probably undervalued on a purchasing power basis. Europe is still a great place. Very creative people there and powerful economies.

In The Power of Gold you mention how since 1987, when the market recovered very quickly from a bear market, people tend to view dips in the market as buying opportunities. Do you think this is a dangerous mentality?

BERNSTEIN: Yes. I don't think you make any kind of decision without thinking. No trend is forever. This trend has been a very long one, one of the great ones in history, and just because something is going down doesn't make it good value.

I do think the environment is shifting now. The continuation of higher than average long-term returns in the stock market along with manageable volatility, which is really what buying on dips means, makes sense under one condition, which is that the underlying economic fundamentals remain in place; we don't have a slowdown this year or nothing bad happens. It is true that nothing bad has happened recently. Even when Asia fell apart, the developed world kept moving along.

But any other scenario than this ends up with negative returns on the three- to five-year horizon.

Buying on dips works when the economy is stable, but are you saying that if there is a slowdown...

BERNSTEIN: I don't think a slowdown is the end of the world. After a normal adjustment in the system excess capacity gets written off, people don't buy much, they hoard, the banks get more conservative. You can go through a period like that and emerge stronger at the

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end. I don't exclude a slowdown as a possibility, but it is only one of a number of possibilities that can develop.

Getting richer is great fun and very exciting, but surviving to me is kind of an overwhelming consideration. What most people and most institutional investors are playing with today is somebody's retirement 20 years from now. If I were in that position I'd want to be sure I survive.

What do you think about the active management of public retirement funds, such as those of the Canada Pension Plan?

BERNSTEIN: I have nothing against active management. I have a preference for passive management, but that doesn't exclude active management. They are not mutually exclusive. However, I have a deep concern about people who make decisions that imply they know what the future holds. We don't know what the future holds.

People tend to think the future will be similar to the immediate past.

BERNSTEIN: Or today, even the long run. Over the long run the right case has been to be 100% in equities, but the long run on which that decision is based consists of many episodes that are not likely to repeat themselves. For example, this last one since 1982 was accompanied by a decline of 1000 basis points in bond yields, which made a huge difference to the valuation of equities and to the whole tenor of the economy. Well, from 6% current rates you can't get a 1000-point decline in bond yields again. That was a non-recurring event that



future

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developed out of the decision finally to take arms against 20 years of high and rising inflation. I don't think we are going to repeat the errors of the 1960s and 1970s that led to that inflation. If we don't repeat the inflation, we don't repeat the opportunity that existed in 1982. So we've knocked out about 40 years from the long run. Prior to that was the prosperity which developed after the Depression and World War II. I don't really think we are likely to repeat 1929 to 1949. So, now we've knocked out another 20 years from the long run. Before that came the 1920s, which developed out of World War I, and you keep going.

The long run was a series of specific episodes, one of which led to another, and if we are not going to replay those specific episodes we really don't know what the long run is going to be.

Even though you don't know what the future holds, will you hazard a forecast on the price of gold?

BERNSTEIN: Gold has this magic quality in the worst of times as a store of value, because it is stateless money. In the mother of all crises, I would fully expect the price of gold to rise up again. A big collapse in the price from here is very unlikely, because current production is less than jewelry demand, and the difference is only made up by central bank sales. Take central bank sales out and the price would be higher than it is simply on a commodity basis. So, the risks of owning gold are small and the potential as things go along is enormous.

Gold strikes me as an extraordinary asset as a hedge today. You can't hedge using the U.S. dollar, because if everything is going wrong that's the thing that is going to be going the most wrong. That is what you would want to have the gold for.

Are you referring to physical gold or gold stocks?

BERNSTEIN: I think gold stocks are more interesting than physical gold because of the leverage and the earnings of the mining companies, but gold stocks depend on a functioning financial system in which you can trade them. I don't own any gold, but I have a very

small position in gold stocks. This is kind of a gut decision that you have to make.

Gold is so on the periphery, yet the magic is still there. Gold can't have been all that important for all these thousands of years, then suddenly not matter anymore. It is so low in real price and so scorned upon that it has to be interesting as an asset. That is where the great values are. They are not in companies such as Cisco, which everybody sees and recognizes and worships. The great values are in the things that nobody wants.

It is interesting to watch what Warren Buffett is doing; he just bought a gypsum company. It is the same idea. Who wants to own a gypsum company? So he bought it at a really cheap price. They make stuff that people need—you don't build a building without it, it is a basic. He may not have the rapid growth rate, but he is going to get an enormous return.

What about the stock market? Do you think we are heading for a period of lower equity returns?

BERNSTEIN: I think the lessons of the 1930s and the lessons of the 1970s, both of which were decades of terrible policy errors, have been very well learned, so a repetition of the worst in terms of economic mistakes is very unlikely. Even in a political sense we have learned lessons. To see France and Germany sit down together—30 or 40 years ago it would have been unthinkable. Therefore, the probabilities are that nothing totally horrible is going to happen. That today's expectations are too optimistic I think is likely, though.

My concerns are not economic concerns, but political concerns. I live in daily terror of terrorists, which has nothing to do with the stock market except that there are millions of people out there who are not part of our system and have no particular interest in being part of our system. North Americans in general are hated in the underdeveloped world. What kinds of chaos could develop from that and our ability to manage that, I don't know. So, my worry is not in the policy area, it is about something uncontrollable happening. I don't know if there is anything you can do about it other than sit and pray. ♦