FIRST EAGLE
INVESTMENT MANAGEMENT

First Eagle Reflections

2018–2019 Edition

For Professional Clients Only

SUMMARY

WE'RE PLEASED TO SHARE THE SECOND EDITION OF **FIRST EAGLE REFLECTIONS**

In the 2017–2018 edition of *First Eagle Reflections*, we noted the distinction between volatility and risk, and the divergent paths they have taken. On the one hand, low equity volatility meant that the market marched steadily higher, thereby pricing increasingly optimistic scenarios into future expectations. On the other hand, the risk side of the ledger grew meaningfully over time across the spectrum of stretched asset valuations, inflated fiscal imbalances and thorny geopolitical tensions. Sooner or later, the dichotomy between volatility and risk had to correct, either with increased volatility and concomitant negative impact on asset valuations, or through the benign resolution of key risks. Over the course of 2018, many of the key risks came into sharper focus in the broader market, and we experienced an increase in volatility and consequent contraction in asset valuations. We see this increase in risk perception as a positive development over the longer term.

Emerging equity and debt markets have remained under pressure for much of the year. In particular, stocks in China generally suffered steep declines, with the equity market down nearly 20% in 2018 based on the MSCI China Index. Problems in China run deeper than the trade dispute with the U.S. China has been at the epicenter of the boom in global money-supply growth and debt creation, which has been the source of sustained economic growth not only in China but also across the globe. Even small downshifts in economic conditions could cause the debt cycle to turn viciously negative, and we believe investors are only beginning to understand and price the potential impact of this risk into asset valuations.

Europe continues to struggle with growth, and the rise of nationalism is starting to nip at the edges of the grand experiment that is the European Union—Brexit and the recently proposed Italian budget are striking examples, but the theme manifests itself in political trends across much of Europe. European unemployment is down, as it is in many regions, and commentators say that economic conditions appear benign, but we wonder to what extent economic conditions supported by negative real interest rates should be considered "benign." European banks' share prices are down substantially and could be the proverbial canary in the coal mine.

Conditions in the U.S. are in stark contrast with most large economies. The U.S. economy has recovered strongly from the Great Recession, and unemployment is at 3.9%,* a level last seen in the late 1960s. What worries us about the U.S. is the budget deficit, which is currently at 4.0%* and is expected to grow. This deficit is large relative to where we are in the business cycle, and it raises the specter of even larger deficits if the economy were to weaken. By comparison, when unemployment was last approximately 4%* in 2000, the U.S. had a budget surplus. It will take a few more quarters to determine how much of the recent growth in corporate earnings was the result of fiscal stimulus, including tax reform, and how much of that growth might be self-sustaining.

Generally, economies around the world did not use the upcycle since the global financial crisis to deleverage; if anything, the leverage that was applied to aid in recovery efforts has multiplied over time. As a result, debt (in proportion to GDP) is higher than in 2007-2008 for most developed markets. The recent increase in financial market volatility—across all asset classes, not just equities—is a sign that investors are finally beginning to factor risk into their assessments of valuation. This is a healthy, if sometimes nerve-wracking, process.

Our patient, long-term-oriented, "margin-of-safety" driven approach to value investing has led us in our view to be positioned appropriately for current conditions. We believe it is important to remain prudent and to proceed with caution while taking advantage of volatility by deploying capital into great businesses at sensible valuations.

We are thankful for the opportunity to serve you.

Regards,

MEHDI MAHMUD
President & Chief Executive Officer,
First Eagle Investment Management

*Source: Bloomberg (CBO, BLS). Unemployment as of end of December 2018. Fiscal data as of end of September 2018.

REFLECTIONS ON 2018... AND A LOOK AHEAD

WITH **MATT McLENNAN**

Head of the Global Value Team

Q

2018 TURNED OUT TO BE A PRETTY TUMULTUOUS YEAR; LOOKING BACK ON IT, HOW DO YOU THINK INVESTORS SHOULD VIEW THE EVENTS OF 2018?

In some ways the evolution of markets in 2018 was consistent with our concerns at the beginning of the year. When looking back at last year's global equity indices, two major features stand out. First, as we got into a late cycle environment, we witnessed what I would call a narrowing market trend. For at least the first nine months of 2018 the performance of the major global equity indices has been driven by an ever-decreasing number of stocks, primarily U.S. companies in the technology, consumer discretionary or health care sectors. Most of them are perceived as growth stocks, so their strong performance has resulted in underperformance for value-oriented strategies. The second feature, much more visible throughout the fourth quarter even if latent throughout the year, was a more volatile market environment, translating the effect of tightening policy around the world. The U.S. market was by far the best performing equity market in the world, but even within the U.S. there was almost a 20% drop from the S&P's high in September to its low in December; and, to some degree that may even underestimate the depth of the damage to stock prices: at one point over 75% of the companies on the New York Stock Exchange were trading below their 200-day moving average price.[1] There was a lot more damage beneath the surface of the market than was apparent from the indices themselves. This was even more true outside the U.S. The EAFE stock index was down 24% from peak to trough. Chinese stocks were down 30%+; some currencies, such as the Turkish lira or the Argentine peso lost more than 50% of their value in U.S. dollar terms. In a certain way, last year's environment reminds me a little of 1998.

1. Source: Bloomberg.

Q

OTHER THAN FRANCE WINNING THE WORLD CUP IN BOTH 1998 AND 2018, WHAT'S THE SIMILARITY?

Well, that's certainly an important parallel, but it's not the one I was thinking of. In 1998 you also had an environment where global equity markets, at least as expressed by the major indices, were booming. Then, toward the end of the year, a major hedge fund, Long-Term Capital Management, failed. That created a risk-off moment where indices fell pretty sharply. We've not had a similar failure this year, but we have seen a former titan of industry, General Electric, have its stock price go to single digits, a level not seen in over two decades. In 1998 we also had an emerging markets crisis, not Turkey or Argentina, like last year, but in Asia, primarily in Thailand and South Korea.

1998 was also a year where global equity indices witnessed the market narrowing effect with growth-labeled stocks from the technology, media and telecom sectors, mostly in the United States, driving markets ever higher; and value-oriented strategies underperforming. Just like 20 years ago, we saw last year increasing U.S. yields and a weaker gold price. Along with the flattening of the yield curve, there are similar patterns to the late 80s, the late 90s and the period preceding the global financial crisis. Seeing patterns like that doesn't necessarily portend wonderful things for the next four or five years. But, of course, there are also some material differences between 1998 and 2018.

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WHAT DIFFERENCES ARE YOU REFERRING TO?

In the late 90s PE ratios were a lot higher in the U.S. market than they are now, but the enterprise value to revenues was basically the same as it is now. What that means is that this time corporate margins are higher. And a primary reason corporate margins are higher is current U.S. fiscal policy. Back in 1998, the U.S. government was running a fiscal surplus. That's classically Keynesian: When the economy is running above trend, the government should run a surplus; when you're at the bottom of a cycle, the government should run a deficit. Well, in 2018, with the economy clearly above trend, the U.S. had a 4% deficit. That's a massive difference between now and 1998, and not necessarily a positive one. Easy fiscal policy has been very helpful for corporate profit margins. So, while PE ratios may look reasonable, margins are unusually high, and that is usually unsustainable. Based on enterprise value to revenues measurements, the aggregate valuation of equities today is pretty similar to where it was in 1998.

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Corporate profit margins are also high because of some ongoing trends. The shift to service-oriented economies from manufacturing will be more likely to generate local oligopolies. The emergence of huge technology platforms has accrued value, and high margins, to scale. The labor market globally has been choked with the entrance of a billion-plus workers from countries like China and India, which has materially eroded the bargaining power of labor. And cyclically, corporate confidence is high because of the fiscal stimulus mentioned previously. Of course, this has a consequence; as corporate profit margins have increased, wages have stagnated, fueling populist tendencies around the world.

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ANOTHER MAJOR DIFFERENCE BETWEEN 2018 AND 1998 IS THE OVERALL LEVEL OF GLOBAL DEBT, A SUBJECT THAT HAS BEEN A CONCERN IN PAST YEARS. HAS THAT CHANGED?

I think it's gotten more compli-cated, particularly for China. In the U.S. most of the excesses are in the sovereign sector, and governments have a way of amortizing and obfuscating problems over time. But China has seen a significant shift in the past 18 months. Until then a lot of Chinese credit growth had been coming from the shadow banking sector, similarly to what happened in the U.S. in prior cycles where we've had growth in the repo markets and in short-term asset-backed financing. As that started happening in China, the government has started to rein it in, and monetary growth has now been cut in half in China. Monetary growth has gone from around 15% to around 8%. The official statistics suggest that economic growth hasn't changed even though credit growth has been cut in half, so I think one must be a little cynical about the official statistics.

With the growth of credit cut so sharply, we wonder if it can return to the rates at which it was growing. In U.S. dollar terms, the Chinese money supply has gone from being half the level of the U.S., which makes sense as it's a smaller economy, to being roughly twice the size of the U.S. money supply. China's current account surplus has disappeared this year, its currency has started to depreciate, and in addition to that, you have the whole tariff debate. China's in an awkward situation, which may have something to do with President Xi deciding to do away with term limits. On top of all this, to stimulate prior growth, China has built a lot of infrastructure, arguably more than is needed. They're going to have to spend to maintain that, which will divert capital from more productive uses. The likely response will be to ease fiscal policy, and the IMF statistics suggest that is happening at a time when unemployment is at a cyclical low. That raises some real questions about the future path of Chinese growth.

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BASED ON ALL THAT, SHOULD A WORRIED INVESTOR FAVOR CASH?

Well, cash sounds like an obvious answer if you are worried about the state of the world, but you really must ask, "Cash in which currency?" And what worries me is I see most currencies being pretty sick. The U.S. runs a big current account deficit, an increasing fiscal deficit and the dollar has been held up by increasing interest-rate differentials. With the U.S. yield curve flattening, one wonders how long the U.S. dollar can continue to be the strong currency.

In the eurozone, things don't look that great either, with the populist government in Italy, Brexit and the open revolt episode in France. Japan has an even larger stock of sovereign debt than other developed economies, and we just discussed the issues in China. As I look at it, in every major currency the interest rates are also well below the rate of money supply growth, which means you are actually being diluted by holding that currency. So, you're not really preserving capital by holding cash.

Bridgewater Associates did a piece in 2012 in which they looked at 750 currencies that had been created since 1700. 80% of those currencies have disappeared. They also looked at the returns of the major currencies, those that represented 80% of world economic activity since 1850 and compared those to gold. Every currency had declined versus gold. A fairer comparison would be to study the returns to short-dated government bills in those currencies versus gold, and on that basis some currencies, including the U.S. dollar, did outperform gold, but only by small amounts. Interestingly, the outperformance came during the period when those currencies were linked to gold. Since gold was determining the rate of money supply growth, interest rates were basically money supply growth plus a spread, and that was reflected in short-dated government debt.

As the world has gone to freely floating currencies, we've consistently had periods in which interest rates have moved below the rate of money supply growth. That has been even more pronounced after the global financial crisis. Over the last 50 years, in the U.S., the average federal funds rate has been 5.3%, the rate of money supply growth has been 6.7%, and the price of gold has compounded at about 7.4%. It's hard for us to get enthusiastic about cash in this environment. You've seen cash levels drift down because of the bottom-up market turbulence, which has given us some discount investment opportunities, but gold has also drifted a bit higher in the portfolios, toward the higher end of our historical ranges. This decreasing cash but increasing gold exposure trend illustrates quite well the seemingly paradoxical current state of the world, a market environment that is simultaneously both attractive and unattractive.

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THAT SEEMS LIKE AN INTERESTING CONCEPT, HOW CAN SOMETHING BE BOTH ATTRACTIVE AND UNATTRACTIVE AT THE SAME TIME?

There was a famous thought experiment, called Schrödinger's cat, devised by a famous Austrian physicist that posited the possibility of having two opposite systems coexisting at the same time until one collapses into its definitive state. And that's sort of the way we must look at having both an attractive and an unattractive market simultaneously. On one hand we have the increase in volatility, the sell-off in risk assets, which has produced a more attractive investment environment as valuations have dropped. Unsurprisingly, as available discount opportunities have increased, the cash levels in our portfolios have decreased. However, we're not throwing caution to the wind. While today's investment landscape has gotten somewhat brighter, we have also seen tomorrow's macroeconomic and geopolitical landscape potentially darken, or at least not improve. Plus, even though there has been somewhat of a

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correction in prices, we still don't see a lot of latency in the longer-term fundamentals. Looking at unemployment rates, which are a lagging indicator of the state of confidence in the economy, in all of the developed world they are still below where they were in 2007, at the height of the last top of a cycle. It's only in the most extremely impacted areas like Turkey and Argentina that we've seen declining activity. So, while there may be more investment opportunity, there is also a great number of bad things that could happen—thus our higher exposure to gold.

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GIVEN THE RELATIVE UNATTRACTIVENESS OF MANY OTHER ASSETS AND THE VARIOUS MACRO AND GEOPOLITICAL RISKS YOU ENUMERATED, WHAT IS YOUR VIEW ON INCREASING EXPOSURE TO GOLD AND GOLD-RELATED SECURITIES BEYOND THE HISTORICAL BOUNDARIES?

That's a good question. It's something we reflect on within the team. We don't do anything rapidly, so anything we change we'd do in a very measured way. But we are open-minded about possibly increasing our exposure, given the sovereign risks that are out there. I recently sat with Idanna, our expert on sovereigns and currencies, and went over every major currency thinking about where to diversify our cash holdings. Mexico is offering yields above the rate of money supply growth in an arguably depreciated currency, but you have to deal with the risk of the new president. The problem is that political trends are so adverse and real interest rates are so repressed in most places that there's just not a lot of attractive alternatives out there. So maybe we come back to gold as the least worst choice. The beauty of cash in the short term is that it has no volatility. Gold has volatility. But, as you lengthen your time horizon, the volatility matters less, and the shortfalls of the yield on cash versus money supply growth matter more. We talk mostly about gold as a potential hedge, but it's really long-term money, so we are grappling with what we should do.

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YOU MENTIONED THAT IN THE FUNDS YOU MANAGE, CASH LEVELS HAVE BEEN FALLING, WHERE HAVE YOU FOUND ATTRACTIVE INVESTMENT OPPORTUNITIES?

The key word for us is selectivity! Don't overinterpret the decreasing cash holdings as us feeling structurally more bullish. The combination of above-average valuations, excessive global debt, a peaking economic cycle, widespread populist tendencies and an aging population across the globe sounds more like the seeds for to an equity market "ice age" than sound fundamentals for the next big bull run. Actually the ice age has already set in for many equity markets around the world. While the S&P 500 is trading roughly two-thirds above its peak levels of 2000 and 2007, if you look at the rest of the world the picture is different. The MSCI EAFE is trading around the levels it was 20 years ago. The Nikkei is trading above its 2000 and 2007 peaks, but still below the levels of three decades ago. In Europe, the Euro Stoxx 50 Index is well below its 2000 and 2007 peaks. So, we don't think just owning equity markets for the next decade, as one does through most ETFs, will necessarily end up being the most successful approach.

However, even during these decades of nominal ice ages for Japanese or European equities, a selective approach may have been able to produce attractive positive real returns. It's all about choosing the right companies at the right prices. In Japan you have companies like Shimano, FANUC or Keyence that have produced very attractive returns over the past decades, even as Japanese markets have been largely grinding sideways. In Europe, it's companies like Nestlé or Sodexo. Of course, we seek to avoid companies like Deutsche Bank, which has been heading in the opposite direction, touching a multi-decade low recently.

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Even in the United States, just owning the market is not necessarily as appealing as it might appear at first glance. There's an interesting paper that's soon to be published in the *Journal of Financial Economics* in which Hendrik Bessembinder, a professor of finance at the Arizona State University, has looked at the performance of every single stock in the CSRP database in the United States since 1926. He found that most of the stocks actually had returns less than T-bills! His point is that while the market as a whole in the U.S. outperformed T-bills, not all companies did. Some companies closed, some died; there is some survivorship bias in the U.S. market as well. The minority of companies produced the returns that enabled the market to outperform T-bills. During the same period, U.S. dollar cash (T-bills) underperformed gold. So that means the majority of stocks were not as good as gold. When reflecting on that, we think it sheds light on how we select the stocks that we do: We try to select stocks that have characteristics that make them as good as gold.

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WHAT ARE THOSE CHARACTERISTICS?

Rather than focusing on short-term earnings growth, we're focused on the persistence and duration of a company's market position. When we think about gold, we realize that it's impossible to destroy; it's the ultimate long-duration asset. We want companies that share similar characteristics like that—having unique features that explain the strength of their market position or have ownership of scarce real or intangible assets that are very hard, if not impossible to replicate.

> In a nutshell, everything we do on the fundamental side is trying to replicate the risk characteristics of something that's "as good as gold" rather than just looking for something that's statistically cheap.

Another attribute of gold that we seek to replicate in our equity investments is that gold is not managed; that is, there are no agency issues. Governments tend to resort to easy money, and too often so does the private sector. We focus on management teams that we think are disciplined and growing their business at a measured pace. In a nutshell, everything we do on the fundamental side is trying to replicate the risk characteristics of something that's "as good as gold" rather than just looking for something that's statistically cheap. When we believe that we have identified a business like that, we try to buy them when they also have a margin of safety in price. It's a combination of business attributes that create a margin of safety in the business and then also a margin of safety in the price at which the business is available in the equity markets.

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ARE THERE ANY SPECIFIC SECTORS, COUNTRIES OR THEMES WHERE YOU HAVE BEEN ABLE TO FIND DISCOUNTED COMPANIES EMBODYING THESE "GOLD-LIKE" CHARACTERISTICS?

As bottom-up investors, we don't really view classic market classifications like sectors or countries as a very valuable source of information with which to judge the quality of a business. Those classifications tend to be descriptive but not informative, at least not as to the merit of an investment. It is also probably safe to say that most industries and countries have the potential to have both great resilient companies coexist with more vulnerable businesses. The only difference is that the better businesses will probably exist for a much longer period of time. Therefore, we don't really have any material structural bias from a fundamental point of view toward one specific industry or country. Our bias will mostly be driven by valuations and as valuations in industries and countries evolve, so will our portfolios. Recently we've been finding slightly more investment opportunities outside of the U.S., but that's valuation driven, not based on any other considerations.

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IN OUR FAST-CHANGING WORLD DOMINATED BY GLOBALIZATION, FACTORY AUTOMATION AND NEW INFORMATION AND COMMUNICATION TECHNOLOGIES, DISRUPTION-RISK IS MUCH HIGHER. DOESN'T THAT INCREASE THE CHALLENGE IN TRYING TO IDENTIFY PERSISTENCY IN ENTERPRISE? AND HOW DOES THE TEAM MONITOR THAT DISRUPTION RISK?

Well, we all see disruption daily; the internet is certainly disrupting retail and disrupting media as did the automobile disrupted the horse and buggy business. The telephone likely had a negative impact on the mail business. There's been a lot of disruption throughout the march of mankind, but mankind is better off than we were. We look at this in terms of global productivity growth, which is two to three percent per year. The hard truth of productivity growth is that the existing class of companies won't control all the profits in the future because new companies will be created, new paths to markets will be created and new technologies will arise.

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We look at this in a Darwinian sense: Ultimately everything fades, except for gold. Sovereign regimes, businesses, currencies, they all have fade risk and throughout history they have all been vulnerable to disruption. So when we say we are looking for businesses that are "as good as gold" we're saying that we seek to identify those businesses that are on a fade path that is slower than average. Plus, we seek enough of a free-cash-flow yield to compensate us for that fade risk. We closely monitor what's going on in a company's ecosystem so that we are fully aware of the disruption risk, but we accept that in any system where productivity exists, you are going to have creative disruption. The rate of productivity growth isn't much higher than it was a decade ago or two decades ago, but the forces of disruption may have shifted. On the macro side today, it's populism; on the micro side it's internet disintermediation.

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TALKING ABOUT DISRUPTION, WE'RE SEEING AN INCREASING TREND OF CONSIDERING ENVIRONMENTAL AND SOCIAL AWARENESS WHEN MAKING INVESTMENT DECISIONS; THE SO-CALLED "ESG CRITERIA." DO YOU IMPLEMENT THOSE CONSIDERATIONS INTO YOUR INVESTMENT PROCESS?

I think it's a great development to see an increasing number of people being aware and concerned about environmental and social issues. We are all on the same planet here and we should make sure, individually and collectively, to hand over the planet to the next generation in the best possible condition. When we articulate our philosophy, we stress persistence and sustainability. Certain ESG issues matter a lot to us; as long-term investors some of these issues are even essential. Governance is extremely important to us, we are acutely aware of the agency issues presented by nonowner management and we try to mitigate those risks by identifying prudent management teams who exhibit founder-like, generational mindsets.

> We are all on the same planet here and we should make sure, individually and collectively, to hand over the planet to the next generation in the best possible condition.

Some other parts of the ESG criteria are more problematic. We don't want to impose our views on our clients or have one set of our clients impose their views on our other clients. So we look at companies that operate in industries that are legal, whether it's alcohol, tobacco, gasoline, coal or whatever, and we see that those companies are operating in some of the most regulated industries in the world. It would be very different if they were engaging in activities that were illegal. So we're wary of the discussion about avoiding sin, because we don't know where to draw the line without imposing our values on our clients.

Let me give just one example to illustrate the difficulties involved. In France, coal is viewed as a severely polluting industry that one should avoid, but nuclear power generation is not. France is one of the most nuclear power dependent countries in the world for electrical power generation. Just next door, in Germany, you have the opposite picture. Germany has made the decision to exit the nuclear industry as an energy source due to environmental concerns, but they remain heavily dependent upon burning coal to generate their electrical power. Who is right? Who is wrong? We don't think that an investor's portfolio is necessarily the right place to make this decision, and we don't think we are the proper people to make that decision either.

Another point, one that is very important, is that these industries already exist today. We need oil, it's the most consumed commodity on the planet; we can't just stop extracting oil today. The economy must evolve over time, so acknowledging that there are people who smoke today, who drink alcohol today, who drive gasoline powered cars today, is simply to acknowledge the reality of those industries existing in a legal and regulated framework. Then the question we confront is, are the companies we are looking at behaving in a responsible way? And the companies we own, we believe, are managing their businesses thoughtfully and are fully aware that over time they may well face transition issues. We don't have a blanket prohibition on anything that's legal. We look at the behavior of the companies and at what's being priced into the market price of the equity. That all goes back to the question of sustainability, and fade risk.

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OIL PRICES CRASHED IN THE FOURTH QUARTER OF 2018 WITH WTI DROPPING ALMOST ONE THIRD. WHAT ARE YOUR VIEWS ON OIL PRICES AND THE ENERGY SECTOR IN GENERAL GOING FORWARD?

Oil is a commodity, and commodities are volatile. We haven't tried to predict the oil price at any point in time; but we can make the observation that if the oil price is clearing at a level where the best companies are not profitable, it's likely to be higher at some point in the indefinite future. That's what happened in 2016, offering us a window to purchase what we think are world class companies like ExxonMobil or Schlumberger at cyclically depressed valuations. One of the complexities of the oil price is that it has a structural political component; it's one of the most important commodities in the global economy and arguably a lot of its price swings have some sort of a political backdrop. So, as the world becomes an increasingly complicated geopolitical drama, the oil market can be influenced by the actions of other participants in the geopolitical reality. But the companies that we've been able to add to the portfolio, such as top-10 holdings like Exxon and Schlumberger are, in our view, unquestionably leaders in the industry. And we love it when we can buy companies that are leaders in their industries at a time when their prices are depressed. They have endogenous integrity at a time of exogenous uncertainty. When else would it be a better time, as a long-term investor, to buy the leading companies in the oil industry? You don't want to do it when the oil price is strong.

> And we love it when we can buy companies that are leaders in their industries at a time when their prices are depressed.

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AS PORTFOLIO MANAGER AND HEAD OF THE GLOBAL VALUE TEAM, YOU SEEM TO CURRENTLY HAVE PLENTY OF REASONS TO STAY UP AT NIGHT. IS THERE ANYTHING THAT HELPS YOU TO SLEEP BETTER?

It's not all bad! We've talked a lot about disruption and fade risk, but if there is something that hasn't gotten disrupted or hasn't faded over past generations, it is human ingenuity, human know-how. This is arguably the most valuable scarce intangible asset today. With an increasing human life span and our seemingly unlimited and cost-efficient data storage and data sharing capacities, we are living in an unparalleled place in the march of mankind. In the past, there was a lot of knowledge that got lost. After the dome was created in Florence, people forgot how to build them. Everything is now categorized, although it's arguably becoming more difficult to disentangle the data from the noise. Thus, the challenge of coping with fake news.

But the most positive thing I can say is that humans have unlimited wants and needs. And that over time, as we need less resources to manufacture goods or to produce the food we need to eat, there will be new services that we create. Just think about today, the kind of services people engage with on a day-to-day basis, it's different. People have personal trainers, they have chefs who prepare food kits for them to finish at home, they have Uber drivers.... The complexion of the economy is going to change. Evolution is an essential part of being a human. Productivity hasn't stopped, companies haven't stopped retaining earnings. The tree rings of the system continue to grow. And to the point about increasing life span, life expectancy doubled on the planet in the last century. I mean, that is the greatest accomplishment of humanity, bar none. But a lot of that were pretty mundane things, like, wearing seatbelts!

From an investment point of view the most exciting things is that prices are lower in many areas. Price is the objective piece of all of this. Everything else is subjective. And we can't predict the future. At least prices are better than they were in early 2018. Bottom-up, we sort of just feel better about the portfolio than a year ago. We would've loved to be up in a down year for the markets, but the fact that we are not has meant that we've had more opportunity to put capital to at work in stocks. Because if we look at that part of our portfolio, where we worry about a more permanent impairment, where there has been fade in market-share position, it probably adds up to less than one percent. Hence, when we look at the stocks in our portfolio that didn't perform well last year, we think it's primarily due to the market discounting the cycle in certain sectors, areas where the market has moved to discount a more recessionary environment—ahead of it actually happening. So that makes us feel a little bit better, bottom-up, about what's already priced into our portfolio. The fact that global risk perception is a little bit more elevated is actually good news. It provides us with a bit more of a margin of safety, and a margin of safety is a key ingredient to sleeping well at night in a world filled with uncertainty.

ON THE EDGE OF SOMETHING NEW

DIVERGING GROWTH, RATE NORMALIZATION & VOLATILITY

Over this past year, we witnessed many developments in the fixed income universe and appear to be on the cusp of further changes. While recognizing that we don't have a crystal ball and cannot be certain what the future holds, we have carefully analyzed the current situation and want to share a bit of our team's insights. We spoke with **ED MEIGS** and **SEAN SLEIN,** portfolio managers and long-time credit experts; **ADRIAN JONES,** senior analyst focused primarily on investment grade debt; and **IDANNA APPIO,** our in-house sovereign debt specialist. With each of our interviewees having over 20 years of experience focusing on debt, each offers a seasoned view.

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TO SET THE STAGE, IT WOULD BE HELPFUL TO GET A HIGH-LEVEL UPDATE ON GEOPOLITICAL ASPECTS, FISCAL AND MONETARY POLICY, AND ANY NOTABLE GROWTH TRENDS.

IDANNA: 2018 was a story of diverging growth, with U.S. economic growth significantly above trend while other countries experienced slower growth. The perseverance of U.S. growth was in large part due to the tax stimulus, but as we enter 2019, there is less net stimulus in the United States and, on the monetary policy side, interest rates are near neutral. The question remains whether U.S. growth is strong enough to pull the rest of the world up or if the rest of the world will become a drag on U.S. growth going forward. There is a strong possibility that if U.S. monetary and fiscal policy become tighter and growth remains slower in the rest of the world, that these combined fundamentals could become a credible drag on global growth.

We began to see the effects of Federal Reserve policy normalization on global financial markets through rising rates. Additionally, the second-order effect of dollar strength has been increased volatility in emerging market geographies (Turkey, South Africa, Brazil) that have issued significant levels of dollar-denominated debt over the past decade. The strong dollar makes it more expensive to service those debts and potentially crowds out domestic investment. Trade tensions with China negatively compound the effect for commodity exporters concerned about a potential slowing of global growth.

We saw a pickup in market volatility this year and we expect even more volatility next year. The Fed will become a greater source of uncertainty as it will become increasingly unpredictable what the Fed's next moves will be. On top of that, the combined balance sheets of the Fed, ECB and Bank of Japan will start to shrink next year. The move to quantitative tightening from quantitative easing is a new experiment; we will have to see how financial markets react. If we do have periods of increased volatility and slower growth, particularly in the United States and other advanced economies, there isn't much room for fiscal or monetary stimulus so, it is a definite concern.

The continuing divorce drama between the United Kingdom and the European Union as well as the budget impasse between Italy and the European Union have been reminders that populism will remain a threat to the structure of the European Union for the foreseeable future. In short, the intersection of lower liquidity and greater uncertainty of outcomes has led to more erratic, less predictable market movements.

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HOW HAVE CHANGING CONDITIONS IMPACTED CREDIT? WHAT IS THE STATE OF THE FIXED INCOME WORLD?

SEAN: As Idanna alluded to, what we are seeing this year is a return of volatility—something that we haven't seen for the past several years. Volatility in the market has been driven largely by the normalization of monetary policy domestically, which has been transmitted through higher short-term rates and has led to higher long-term rates. The yield curve is continuing a flattening trend, along with the transmission of a stronger dollar that is filtering through emerging markets. I said a lot there, but essentially financial conditions are tightening. They're tightening domestically and that's filtering through the rest of the world. The situation is causing volatility and interestingly, the duration has been the bogeyman for the market; longer duration has suffered more this year relative to previous years.

ADRIAN: This is a big deal. Interest rate normalization has been most damaging to all the longer-dated debt issued with low coupons in the last few years, when rates were at or near zero. The prices of these bonds are going to be very sensitive to higher rates and/or wider spreads because they have duration; whereas short-duration paper is much less sensitive. This is the reason why our overall view has been to be very, very short on duration.

The normalization of monetary policy looks like it will continue for the foreseeable future. It will be fascinating to see if market conditions become volatile enough for a pause in the overall trajectory of tightening. Jay Powell, the new head of the Federal Reserve, has made comments suggesting he might be less responsive to market volatility given strength elsewhere in our economy, but we will have to see.

As always, the future is uncertain, and we are unsure of the Fed's next steps. These structural shifts in monetary environments take place over extended periods of time. We are in that intermittent transmission stage, where we're moving out of one world into another. We haven't gotten there yet. In my view, it is possible that when credit spreads widen out, the Fed may back off on tightening measures, but that doesn't mean spreads will come right back down again. Also, the Fed is less concerned about what happens to credit overseas and this is one of the reasons why we are relatively cautious on sovereign debt at this time.

IDANNA: There is a serious question of sustainability in certain countries and so we have been extremely selective when approaching potential opportunity. As rates go up, there is a real risk that we could have a situation that Warren Buffett described when he stated, "only when the tide goes out, do you discover who's swimming naked." We may see "naked swimmers" pop up more broadly, just as we witnessed with Turkey and Argentina. There are countries with vulnerabilities (e.g., too reliant on foreign capital to fund activity) that cannot be ignored when looking at investment opportunities. With U.S. yields going up, all other assets will have to reprice and with this, we have to determine who is structurally sound enough to handle this evolving rate environment.

Q

CAN YOU SHARE WITH US ONE OF THE MORE SIGNIFICANT CHANGES OR TRENDS THAT YOU'VE WITNESSED IN FIXED INCOME OVER THE PAST YEAR?

ADRIAN: The BBB space has grown dramatically, relative to other ratings due to: 1) an uplift in commodity and industrial-type credits that were upgraded from high yield because of cyclical factors and 2) a significant increase in BBB-rated credits downgraded from A-rated credits because they levered up for acquisitions or stock buybacks.

> The BBB space has grown dramatically, relative to other ratings.

So, there has been both a down-migration and an up-migration in credit. In my view, a lot of leveraging in corporate America has been from the A-rated credits migrating down to the BBB space, so there may be select opportunities to look for "rising stars" in these candidates. Typical to First Eagle's approach, however, we are focused on the identification and research of these opportunities so that if and when volatility shakes up the environment, we are prepared to invest.

SEAN: BBB paper now makes up somewhere around 50% of the corporate market. In any regime where prices have been artificially controlled, as the Fed has done, and repressed yields around the world, there will tend to be a mispricing of risk and a misallocation of resources.

At the same time, while investment grade seems to have levered up somewhat in the past 10 years, high yield hasn't deliberately levered up and it has been more of a refi-driven market. This is a bit surprising to us given repressed rates. We haven't seen the type of LBO issuance, the big levering up that was driven by private equity that we saw in the previous cycle. Instead, leverage in this cycle has not been deliberately increased, but it has drifted higher nonetheless. Given the elevated leverage and the imbalance that we've seen in triple B issuance, we moved up in credit quality and hunkered down. Additionally, building more cash is an option that may be monetized when spreads potentially become more attractive. It's noteworthy that as you move through the cycle and spreads compress, the price of that option gets cheaper. From our perspective, it's a simple, yet attractive tool to manage risk.

> Given the elevated leverage and the imbalance that we've seen in triple B issuance, we moved up in credit quality and hunkered down. Additionally, building more cash is an option that may be monetized when spreads potentially become more attractive. It's noteworthy that as you move through the cycle and spreads compress, the price of that option gets cheaper. From our perspective, it's a simple, yet attractive tool to manage risk.

When the market will turn, we don't know. We are in a new regime. We've had this extraordinarily accommodative monetary policy now for 10 years that's attempting to transition to a more normal policy regime. We're in the beginning stages. The Bank of Japan and the European Central Bank remain accommodative.

ADRIAN: I think the Fed faces a big conundrum. It is clearly determined to try to normalize our interest rate structure as aggressively as it can, yet it doesn't want to upset the economic apple cart in the United States. But the anchor of negative rates in Europe and Japan is really a challenge—it potentially caps how much the Fed can push up rates in the U.S. The same goes for its efforts to shrink its balance sheet after expanding it for so long under QE. In my view, it is going to be difficult for the Fed to normalize policy.

IDANNA: I agree, and I don't think we have seen the end of monetary policy experimentation. In the next downturn, central banks are likely to resort to more quantitative easing because policy interest rates will not be high enough to just rely on rate cuts for stimulus. Price signals and mechanisms are distorted.

Q

ON THE HIGH YIELD SIDE, YOU MENTIONED THAT THERE HASN'T BEEN A DELIBERATE PICKUP IN LEVERAGE AS IN PREVIOUS CYCLES. ONE EXPLANATION WAS RELATED TO PRIVATE EQUITY ACTIVITY. DO YOU HAVE ANY OTHER INSIGHTS ON WHY THIS DYNAMIC HAS BEEN DIFFERENT?

SEAN: Another significant reason has been the fact that this hasn't been a robust economic environment. There still is a fairly significant output gap. Also, in the wake of the global financial crisis, many highly levered companies that came close to dying in 2008–2009 have been cognizant of managing their balance sheets in a relatively conservative manner and have been reluctant to re-lever. Accordingly, M&A activity has largely been driven by strategic activity within industrial sectors; companies acquiring other companies or adjacent products in order to grow cash flow through cost and capacity rationalization. The slower growth environment made it difficult for private equity to compete with strategics, which is why the deliberate leveraging of the market through LBOs was muted in this cycle.

For most of the last decade in the post global financial crisis world, regulators have also paid closer attention to the level of leverage for syndicated deals in the leveraged loan market. This served to dampen the tendency of the market to tolerate greater leverage. With a new administration that potentially has a looser attitude toward macroprudential regulation, we're seeing a little bit more leverage emerge, particularly in the leveraged loan market, and covenants have become quite permissive.

ED: Yes, there is a stark contrast between the bond and the loan market that's worth noting. Sean had mentioned that the use of proceeds in the bond market has been relatively conservative from our point of view, at around 59% of HY market new issuance was refinancings. In contrast, loan market issuance has been 27% refinance with 72% dividend or LBO activity.[2] I think there has been a pretty significant future risk transfer from the high-yield bond market to the leveraged loan market.

All of this gives us more reason to be particularly careful in this environment. For instance, risk needs to be identified and analyzed when looking at a bond that was once rated A and now rated BBB. Particularly if the company is now BBB rated because they've levered up on a big acquisition and the risk of not having as many protections presents itself. It's very important to make sure that you are only dealing with an underlying company that has not only good cash flow coverage and stability, but also is committed to reducing any debt-backed investment. It is very important to think about active covenants and the protections that you have or the ones that you give up depending on where you are. Selectivity is extremely important.

2. Source: Bank of America.

Q

WHERE DO YOU SEE OPPORTUNITY TODAY?

SEAN: We are in a "hunt and peck" mindset at the moment. We are starting to see value emerge. Again, selectively and in pockets, but overall it seems as if many are overweighted in the tsunami of EM debt growth that has taken place at relatively attractive rates, compared to historical cycles. It seems that many have been reaching for yield and in particular, within the world of sovereigns and EM corporates.

IDANNA: Typically, emerging markets weather U.S. tightening cycles relatively well because higher U.S. interest rates are associated with strong U.S. and global growth, but in a world where we have higher U.S. yields and weaker global growth, it is not great for these countries. We think it is still a bumpy time and if we see interesting opportunities where we are getting compensated for the level of risk then we will take them but we don't believe that we have seen the worst of it and so we are being particularly careful.

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A RELATIVELY LARGE AMOUNT OF MONEY HAS BEEN ALLOCATED TO SECURITIES FROM A BETA PERSPECTIVE BY PASSIVE STRATEGIES THAT APPEAR TO BE INDISCRIMINATELY BUYING YIELD. THE RESULT MIGHT BE EXACTLY THE OPPOSITE IF THE ENVIRONMENT CHANGES, MEANING A LOT OF PASSIVE OUTFLOWS MAY TRIGGER AN INDISCRIMINATE SELL OFF. IS THIS A CONCERN?

SEAN: We remain concerned that the market is underpricing the magnitude and persistence of equity and rate volatility. Years of rate repression and subdued volatility across most asset classes has led many market participants into momentum strategies that involve reaching for yield. Accordingly, as investors extend bond tenors, global duration risk has also been significantly underpriced and underappreciated.

ADRIAN: That gets back to something that we talked about before. One of the major structural changes that has taken place in the market, because of regulation and the Volker Rule, is the dramatic reduction in the amount of inventory that's held on the balance sheets of the investment banks with which they can provide liquidity as a market maker (and make money doing so). I believe corporate bond inventory is down somewhere around 80% from the peak. Fed data last summer even showed inventories reaching zero for a brief time. In contrast, bonds outstanding have grown dramatically since the financial crisis. The result is a potential liquidity gap, where if you do get passive flows going negative, and if they go negative in size, there are not enough market makers and active investors on the other side to handle the passive selling. Therefore, the risk of a major market imbalance is a lot higher than you might expect. The Volker Rule and the reduction in bond dealer inventory may have made banks safer and stronger, but this has created perhaps a more brittle bond market. It makes us, again, more mindful of making sure that we are getting paid to take risk.

IDANNA: Yes, a potential liquidity gap is an absolute possibility and the issue has been further exacerbated as central banks shrink their balance sheet tightening global liquidity. And global liquidity impacts most everything that we are concerned with. We could see some dislocations as passive investors want to exit, which could provide some attractive opportunities for First Eagle.

SEAN: Any well-functioning market needs participants with differing time horizons and risk parameters. The banks had a shorter time horizon and a fluid level of risk tolerance in a pre-global financial crisis period. So, at times they were willing to act as shock absorbers to take risk when others wanted to shed it. Today, as Adrian has mentioned, their function has been reduced enormously due to legislative and regulatory fiat. The result is a smaller participating group with perhaps lower risk tolerance in a market that has grown quite a bit, and the majority of players have a longer timeframe, but that time frame can shorten in a hurry once you have flows.

> Unless you carry cash as a ballast can then provide the potential opportunity to play offense when everyone else is playing defense. That's critical.

Flows take the decision making out of the hands of the decision maker. Everyone becomes a short-term investor when you have outflows, whether you like it or not. Unless you carry cash as a ballast that can then provide the potential opportunity to play offense when everyone else is playing defense. That's critical.

There has been a generation, I think, of portfolio managers and traders who have grown up in the post-global financial crisis who haven't seen the type of illiquid markets that we could potentially see in the coming quarters or years.

ADRIAN: And ironically, when you think of the last two cycles that we have been through, 2008 was quite abrupt. There was a lot of dislocation right after Lehman went under, but other than the two or three-week period post-Lehman, where there was just massive dislocation, it didn't last long. It was a relatively short window. People have forgotten that when markets get disrupted and dislocated—due to a lack of liquidity—they can experience vapor lock in which there is just no liquidity and market making stops, as happened briefly after Lehman went under in 2008.

This also is exactly what happened in the stock market in 1987 when "portfolio insurance" created automatic, forced selling that swamped market making capacity. I don't know how many people even remember 1987 but I remember it vividly. People have forgotten the possibility of the equity market dropping 25 percent in one day and credit spreads blowing out proportionately. During that time, traders stopped making markets—desks went silent and you could not find a reliable bid for normally liquid stocks and bonds. Those with cash were able to buy stocks and bonds at valuations that seemed inconceivable just a few days before.

History has shown us that there is the potential for very large quantum gaps in pricing. I would submit that the current market structure is fragile enough, it's brittle enough, that a mini-crash scenario seems more possible than it has in a long, long time. This gives us more reason to play defense, hide out in high quality, short-duration credit and have a good dose of cash and treasuries as ballast. I think this next drop could be very swift to appear.

SEAN: In a world where market liquidity really hasn't been tested, where market structure is particularly unknown given regulatory changes, it will potentially pay to be the liquidity provider if there is a significant repricing of risk. As Matt McLennan has stated many times, we tend to be counter cyclical capital allocators. Duration, credit, and liquidity risk has dramatically increased and are underappreciated, and as a result, we have chosen to hide out, move up in credit quality and build more cash to increase deferred purchasing power. That way, we can allocate capital counter-cyclically at a time when, in our view, we are handsomely compensated to do so.

Q

WOULD IT BE FAIR TO SAY THAT THE MANNER IN WHICH YOU ALLOCATE WILL DEPEND ON THE VELOCITY OF A CHANGE IN THE MARKET; PERHAPS YOU WOULD DEPLOY CASH FASTER IF WE HAVE A FLASH CRASH BUT IF IT IS SOMETHING MORE CHOPPY, THEN MAYBE IT WOULD TAKE MORE TIME?

SEAN: There tends to be greater price discovery through a more volatile crisis than a slow drip because a slow drip is difficult to ascertain when it's over. Historically in leveraged credit, when there is a fairly significant drop, the primary market closes and then risk premium explodes across the board.

So, from our perspective, it is not necessarily an all clear signal, but it's a good marker along the road of the credit cycle indicating to us that the market is not going to stay closed forever and when it reopens, that risk premium collapses in a hurry.

Q

SO, YOU ARE PATIENT BUT ALSO WANT TO BE QUICK IF THE TIDE TURNS?

ADRIAN: Exactly. There may not be a slow drip this time because the markets have become more brittle. A major sell-off in both bonds and stocks just might happen more quickly than previous cycles. But we'll just have to see, we'll just have to watch. We don't forecast, we just try to maintain a healthy reserve of liquidity, and then we observe and respond to whatever individual, bottom-up opportunities the market presents us.

SEAN: And paradoxically, I think you'd probably agree, when a market corrects, and you see spreads blow out, it's easier to allocate capital. In a sense it's less stressful managing in an environment where you are buying well below recovery value in bonds or intrinsic value in equities than when you're in an environment where spreads are compressing and multiples are expanding.

ADRIAN: As long as you have cash to deploy.

SEAN: As long as you have cash.

ADRIAN: It's a lot more stressful if you need to sell something in order to buy something. And that's why the whole concept of countercyclical investing is so essential.

AS GOOD AS GOLD

Since 1864, First Eagle has helped its clients as they seek to avoid permanent impairment of capital through widely varied economic cycles. The focus on capital preservation remains central to our strategy today. To support this goal, we invest in gold bullion and gold-related securities as a potential hedge against extreme market events.

We sat down with First Eagle's **THOMAS KERTSOS** (Senior Research Analyst) and **MAX BELMONT** (Research Analyst) to help answer questions related to investing in gold bullion and gold-related securities.

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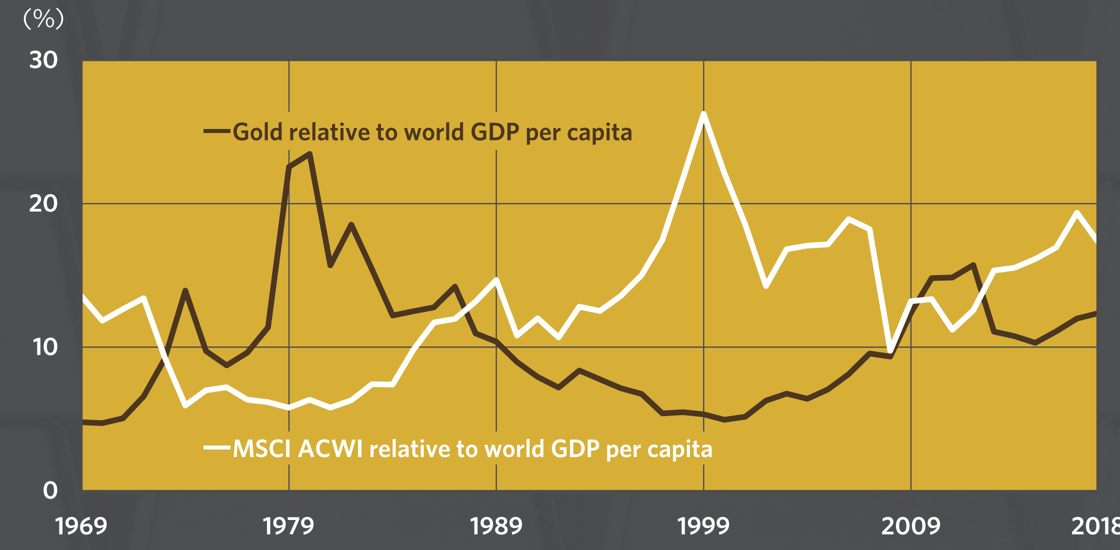
THOMAS, MAX, THANK YOU FOR JOINING US. THOMAS, YOU HAVE SPENT OVER 10 YEARS IN RESEARCH COVERING PRECIOUS METALS AND MINING, SO WE ARE VERY EXCITED ABOUT HEARING YOUR THOUGHTS ON GOLD. BEFORE WE DIVE IN, CAN YOU BACK UP AND EXPLAIN THE PURPOSE OF INVESTING IN GOLD BULLION AND GOLD-RELATED SECURITIES?

THOMAS: At First Eagle, we have a distinct philosophy regarding gold. We believe that gold and gold-related securities have unique risk/reward characteristics that may help preserve a portfolio's real long-term value and add diversification and resilience to a portfolio. We use gold bullion and gold-related securities as a potential hedge in our portfolios. We don't forecast the price of gold, and we don't buy or sell gold to speculate on its price.

> Historically, gold has had its highest value when real interest rates have been low and the economy has been either weak or experiencing inflation.

Historically, gold has had its highest value when real interest rates have been low and the economy has been either weak or experiencing inflation. These have tended to be times when economic confidence was low and when the private sector was skeptical of government. On the other hand, during periods of prosperity buoyed by cheap credit and general confidence in the system, when real interest rates have been high, investors have seen no need for a "safe-haven" asset like gold.

GOLD AS A POTENTIAL HEDGE



Source: Bloomberg and Conference Board as of December 26, 2018.

Gold hit its low point, relative to world GDP per capita, when the MSCI AC World Index was peaking during the late 1960s and again during the tech boom of the late 1990s. Conversely, gold peaked during the post-oil-crisis recession years of the 1970s and following the global financial crisis of 2008. Since 2009, we have seen a cyclical economic recovery around the world, with corporate profits generally rising, the U.S. stock market hitting new highs, and confidence returning to high levels. Unsurprisingly, the price of gold is currently around one third below the peak it reached in 2011.

> History, of course, has taught us that prolonged, seemingly euphoric markets are not everlasting, and we think it's imperative to be prepared for unexpected market disruptions.

History, of course, has taught us that prolonged, seemingly euphoric markets are not everlasting, and we think it's imperative to be prepared for unexpected market disruptions. Rare among assets, gold has a performance record that can be traced back over hundreds of years. In adverse macroeconomic and geopolitical environments, gold has managed to maintain its real value during both inflationary and deflationary environments. In our view, this makes gold and gold-related securities, a potential hedge against potential financial catastrophes.

Q

WHAT TYPE OF SECURITIES DO YOU USE TO GET EXPOSURE TO GOLD?

MAX: The majority of our gold exposure is in the form of gold bullion in our U.S. mutual funds and of physically backed gold ETCs in First Eagle Amundi Income Builder Fund and First Eagle Amundi International Fund. However, we also have significant exposure to shares of gold miners and gold royalty companies. We look to obtain access to the cheapest ounces, whether through the miners or through gold bullion. Gold bullion is free of many of the risks that can affect the gold mining companies, but when we feel that we are compensated adequately for those mining related risks, then miners offer an attractive alternative. In other words, depending on the valuation, we are willing to own gold both in the vault and in the ground.

Gold mining stocks also offer us diversification and help reduce also the potential risk of expropriation. We are mindful of the fact that in 1933, U.S. President Franklin D. Roosevelt officially forbade the "hoarding" of gold for U.S. citizens and required them to turn over their gold to the government. If history was to repeat itself and private gold holdings were once again nationalized, gold companies would very likely become more valuable as the only way to access the ounces of gold below the ground.

Gold royalty companies are another interesting subsector that we invest in. In exchange for an up-front deposit payment, gold royalty companies own the right to receive a percentage of mineral production from a mining operation. If valuation is favorable and if the management allocates capital wisely, a gold royalty company could have stronger fundamentals and be more resilient than many operating companies. Gold royalty companies have often been some of our best long-term holdings.

For these reasons, we think the optimal potential hedge is a diversified portfolio containing both gold companies and gold bullion.

Q

WHILE OWNING GOLD-RELATED SECURITIES MAY DIVERSIFY YOUR GOLD EXPOSURE, IT ALSO INTRODUCES SOME ADDITIONAL RISKS. WHAT IS YOUR APPROACH WHEN SELECTING GOLD MINERS?

THOMAS: Owning gold miners exposes us to traditional equity and mining risks, such as management risks, operational risks and environmental risks.

Since we view gold as a potential hedge, the most important element in our stock-selection process is our focus on resilience and risk management. We look at what can go wrong with the specific company. We try to determine how low the gold price has to go before it creates a financial problem for the business. In order to test its resilience, we look closely at the balance sheet, the cost structure, the quality of the assets and the specific technical and political risks it faces. Among other things, we want to see that the management team has a good track record in operational execution and in making good capital-allocation decisions, and that it is also conservative in its financial management. Another characteristic that we like in gold companies, especially since we don't forecast the price of gold, is duration; we focus on quality companies that have long-duration assets with long mine life and strong balance sheets.

> Mining businesses that invest in their social license to operate have often been our best-performing long-term holdings.

MAX: In addition, just as in every other First Eagle equity investment, we seek to invest only in those companies where we perceive a significant margin of safety in price. This starts with determining a gold miner's intrinsic value, which is inherently linked to its gold reserves and the gold price. Once we've built conviction about the quality of a company, we will invest in its shares only if they are trading at a material discount to our estimation of their intrinsic value.

Q

YOU MENTIONED ENVIRONMENTAL RISK. IN YOUR EVALUATION OF POTENTIAL RISK FACTORS, DO YOU ASSESS SUSTAINABILITY ISSUES? HOW MUCH WEIGHT DO YOU GIVE ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) WHEN MAKING INVESTMENT DECISIONS?

THOMAS: Sustainability is an integral part of our investment process. We intend to use gold-related securities as a potential hedge against serious disruptions in the financial markets. Since we don't know when our potential hedge may be needed, and we don't forecast the price of gold, we aim to make investments in companies with solid long-term prospects. In the gold mining industry, a company's commitment to sustainable practices may be critical to its long-term success.

We believe sustainability should be a high priority for gold mining companies because they need both a government license to run their mines and a "social license to operate" in a particular location. In applying for its government license, we think a gold mining company should strive for fairness and recognize that the spirit of the agreement may be more important than the letter. To gain acceptance from local stakeholders—including governments, community members, unions and employees—mining companies need to educate them on the benefits their mines may provide. They also need to demonstrate respect for the rights and needs of the local population and to protect the environment both during mining operations and after their mines will have closed.

> In the gold mining industry, a company's commitment to sustainable practices may be critical to its long-term success.

Environmental, social and governance (ESG) areas are central to our analysis of a company's quality, and they impact our decisions to buy and sell stocks. One mining executive told us, "If our local stakeholders are happy, then our shareholders will be happy, too." We're inclined to agree. Mining businesses that invest in their social license to operate have often been our best-performing long-term holdings.

Q

APART FROM THEIR VALUE AS A HEDGE, DO GOLD-RELATED SECURITIES PROVIDE ADDITIONAL BENEFITS?

MAX: Gold mining stocks have the potential to offer not only risks, but also opportunities. First, mining stocks have leverage to the gold price. Historically, both on the upside and on the downside, they have tended to move at roughly twice the percentage change of the gold price. This may create interesting opportunities to invest, at certain points in time, in undervalued gold equities. So, when gold miners are extremely out of favor and therefore heavily discounted, we will typically skew our gold exposure slightly more toward the gold miners, as we did, for example, in 2015. On the other hand, when gold miners experience a very strong rally, as in 2016, we usually take some profits, which reduces the relative weight of the miners.

Also, some gold companies have been successful in building value through time and grow their business, by successful operational execution, countercyclical capital allocation and strong exploration success. Our job is to separate the businesses that are doing well from the good businesses in this sector. We also do the opposite when the sector is depressed like it is now; separate the bad businesses from the good businesses that aren't doing well, as these two can be easily confused in a downturn. Actually, some companies today are in a better position than they were in 2011, when the gold price started to drop and have more ounces in production (per share) and in reserves (per share) than they had back in 2011, before the bear market in gold started. There is significant dispersion of share-price returns among gold stocks and that's why stock picking in this sector is very important. We try to understand which companies are the long-term winners in this industry and wait patiently for valuation to become favorable and acquire them at the correct price.

We also consider gold royalty companies, which we believe provide interesting investment opportunities, given that they have very attractive business models. In addition to having a capital-light structure, they are often able to retain a high level of optionality not only to potentially higher precious metal prices, but also to more ounces on the ground by securing financial deals with gold miners on properties with strong exploration upside. Overall, investments in gold royalty companies, when valuation is favorable, may provide two key benefits: the upside potential of a structurally great business model and the downside hedge potential of gold exposure.

> We try to understand which companies are the long-term winners in this industry and wait patiently for valuation to become favorable and seek to acquire them at the correct price.

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YOU MENTIONED THAT YOU USE GOLD AS A POTENTIAL HEDGE, BUT IT DIDN'T REALLY WORK OUT LAST YEAR. WHAT HAPPENED?

THOMAS: Gold was down -4% and gold miners down -11% in 2018 (FTSE Gold Mines Index) compared to -9% for MSCI World or -5% for the S&P 500. Thus, while it's not been a great year for equities, which have been volatile, it's been, overall, an even worse year for gold and gold miners. On first glance, some might be disappointed with the performance of gold bullion in 2018. A detailed analysis of what happened last year provides a more nuanced picture. In fact, gold behaved almost as one would expect based on overall market behavior.

Gold started the year at $1302.8/ounce and dropped to $1190.9/ounce by the end of September—a decline of -8.6%.[3] During these three quarters, global equity markets were driven by strong optimism about the U.S. economy, with the S&P 500 up +9%. But the momentum in the U.S. economy following the Trump tax cut also led U.S. monetary policy to diverge widely from the policies set in the rest of the world. While the ECB, the Bank of Japan and the Chinese monetary authorities remained very dovish, the slow normalization of the Fed's monetary policy pushed U.S. treasury yields higher. This attracted growing amounts of foreign capital into the U.S. dollar. The mix of economic optimism and higher U.S. yields (especially slightly increasing real yields) were strong headwinds for the gold price. Hence, its drop during the first three quarters of the year.

After equity-market growth narrowed to a handful of U.S. technology and Internet-based consumer names, a material reversal of that trend occurred in October. Suddenly, the market shifted its focus from the current strength of the U.S. economy to questions about the sustainability of that strength in an environment where the U.S. dollar and U.S. yields were up. As a result, equity markets corrected in October, with the MSCI World Index dropping -7.4%. Gold rebounded +2% in October and was one of best performing assets in our funds; it was also one of the few assets registering positive absolute returns during that month. Of course, compared to the drop it had registered until September, the gold price could not fully recover and still isn't in positive territory as of the time of this publication. So far, though, over the final quarter of 2018, as volatility spiked and uncertainty increased, gold performed fairly well.

3. Source: Bloomberg.

GOLD PRICE VS. US DOLLAR IN 2018

GOLD PRICE VS. REAL INTEREST RATES IN 2018

Source: Bloomberg as of December 26, 2018.

Q

GOING INTO 2019, WHAT IS YOUR OUTLOOK ON GOLD AND WHAT ARE YOUR VIEWS FOR GOLD IN THE COMING YEAR?

THOMAS: As mentioned before, we don't seek to predict the direction of the gold price. Actually, not only do we not forecast the price of gold, but we own gold to start with because we acknowledge that there are certain macroeconomic and geopolitical risks, certain known-unknowns but also certain unknown-unknowns in the market, that can affect significantly our capital returns that cannot be forecasted, not unlike the 2008 type of crises. That being said, we have seen that the gold price since the fall of 2015 has been very reactive to the Fed communication regarding raising rates or not and also to political and geopolitical developments globally. We expect these factors should remain critical for the gold price in 2019. Another important dynamic that started in June 2018, which does seem to influence the gold price are the trade negotiations between U.S. and China and the resulting tension, that has strengthened the U.S. dollar and has weakened the gold price. This dynamic is very important, as if there is further deterioration in U.S.-China trade relationship, which can further reinforce the trend of a stronger U.S. dollar and weak gold price in U.S. dollars. Still, though history has shown that trade wars slow down global economic growth, which means that any potential further escalation of trade wars between U.S. and China may be tough for the gold price in the short term, as they seem to strengthen the U.S. dollar and the U.S. stock market, but they should be favorable for the gold price in the medium long term, as trade wars may lead to slower global economic growth. As we have said in the past, the biggest catalyst for higher gold prices is a potential recession, and trade wars despite being tough potentially for the gold price in the short term, history has shown that they create exactly that, slower economic growth which is good for the gold price.

So, on the face of so many short-term conflicting trends globally, we do retain our stance on resilience and focusing on capital preservation in our gold holdings. Still, we believe that gold is an important asset to have in our portfolios, especially during this period of time. Rarely have there been more unresolved issues globally as right now, which could have important implications for financial markets and this during the backdrop of rising global debt, which makes the global economy so vulnerable.

MAX: While the performance of gold in the near term really looks like a random walk, there are a certain number of elements that make us believe that, beyond the hedge potential of gold, gold bullion might also be a source of potential real returns in the decade ahead and beyond. We are in a world with historically high levels of debt—especially sovereign and corporate debt. And a decade of near-zero interest rates and quantitative easing around the world has probably distorted some people's sense of risk. Hence, there is, arguably, a risk that major capital misallocations are hiding out. By consequence, liquidity or solvency issues, although difficult to quantify now, could emerge in the months and years ahead.

As Warren Buffett wisely said, "It's only when the tide goes out that you learn who has been swimming naked." It's been a historically unprecedented monetary tide, and as the Fed has started to gradually roll back its accommodative policy and as other major central banks have already indicated a trend toward tightening, several financial problems may emerge. Situations like GE on the corporate side or Turkey on the sovereign side might not be the last examples.

Situations like GE on the corporate side or Turkey on the sovereign side might not be the last examples.

On the other hand, it's also possible that global economic growth could remain robust for the coming decade, which would allow high indebted companies and countries of this world to survive. But if not, there aren't an infinite number of options for resolving excessive debt. A debtor can either take the pain immediately by accepting insolvency or delay the pain by getting bailed out. If it's a country, it can bail itself out by printing money. Either way, there is a risk of a material crisis and/or structural currency devaluation. In both cases, gold should perform relatively well in absolute terms and relative to many other assets.

The price of gold might, and probably will, be volatile in the near term, but as long-term investors, we feel very comfortable with our exposure to gold and gold-related securities and will be happy to take advantage of any episode of weakness in the price of gold to add some more to the portfolios that we manage.

ABOUT FIRST EAGLE

First Eagle Investment Management is an independent firm that is headquartered in New York City. We believe in flexible, benchmark-agnostic, absolute return-oriented investing that seeks to provide clients with downside protection.

Founded in Europe in 1864, First Eagle maintains a worldwide frame of reference that reflects its extensive business experience. The firm is committed to nurturing an investment-centric culture and views itself as a firm of investors, not asset gatherers.

Our interests are closely-aligned with those of our clients, and we share the same goal: seeking consistently strong long-term performance.

As investors, we combine caution with a passion for investing. As benchmark-agnostic managers, we have the courage of our convictions and do not allow consensus views or market sentiment to distract us. Instead, we remain committed to the philosophy which has guided us for over 150 years.

SEEKING TO PRESERVE WEALTH SINCE 1864

1864
Gebr. Arnhold (Arnhold Brothers) founded in Dresden

1931
Gebr. Arnhold combined with S. Bleichröder

1937
All business activities moved to New York under the name S. Bleichroeder

1995
Firm became an SEC-registered investment advisor

1999
Acquired majority share of Société Générale Asset Management Corp.

2002
Sold investment banking and global securities businesses to focus exclusively on investment management

2009
Renamed firm First Eagle Investment Management

2011
Acquired the High Yield Credit Team

2015
Private equity funds managed by Blackstone Capital Partners and Corsair Capital invested in the firm

2019
First Eagle's Global Value Strategy celebrated its 40th anniversary

155 years since the firm's founding

634 combined years of experience of First Eagle's investment team

40 members of our Global Value Team

Source: First Eagle Investment Management as of December 31, 2018.

AT FIRST EAGLE, we believe that our team is an invaluable asset that sets us apart from other firms. Our portfolio managers, research analysts and senior advisors have combined six centuries of experience in the industry; and, most importantly, share a temperament that is aligned with and supportive of our primary goal of long-term capital preservation.

We continued to deepen our research platform in 2018 and made some very strong hires to strategically prepare us for an evolving landscape. We have increased our resources in sovereign research. As debt imbalances continue to build in the world and have shifted from the household sector to the sovereign sector, we have witnessed fracturing of sovereign risk perceptions in some areas of the world, such as Turkey. In our view, this will become an even more critical area given the current geopolitical and sovereign debt backdrop. Accordingly, we have hired two additional sovereign analysts, both with extensive experience in the field. We also enhanced our fixed income capabilities, with the addition of two individuals who will focus on opportunities specifically in investment-grade credit.

Additionally, we've created a position to provide corporate access expertise in-house. Many asset managers depend on brokerage firms to provide access to corporate management. We visit over a thousand companies each year and corporate governance is extremely important to us, so we are very excited about extending our capabilities in this area. We now directly communicate with companies in which we are currently invested, as well as with those in which we are considering investing. This way we have all possible tools to message the unique elements of First Eagle directly to management, and to engage with each company's executives individually.

We begin the new year with a Global Value Team that has grown to 40 members–each person provides a unique set of abilities that together, create an unparalleled group that is prepared to invest in a world that could look quite different in the next decade than it did in the last.

We took some time to get to know the members of the team and to ask a few questions outside of the typical investment-centric world in which they usually dwell.

See the next page for what we learned about this diverse, global and accomplished group of investors!

FIRST EAGLE'S GLOBAL VALUE TEAM

A LITTLE BIT MORE… ABOUT US

Favorite dessert

CHOCOLATE SOUFFLÉ

Idanna Appio
Senior Sovereign Analyst

Recipe: Chocolate Soufflé

INGREDIENTS

- Unsalted butter, room temperature, for baking dish
- ¼ cup sugar, plus more for baking dish
- 8 ounces semisweet chocolate, finely chopped
- 1 teaspoon pure vanilla extract
- 3 large egg yolks, lightly beaten, plus 4 large egg whites
- ¼ teaspoon cream of tartar

DIRECTIONS

1. Preheat oven to 350 degrees. Lightly butter a 1½-quart tall-sided baking dish. Coat with sugar, tapping out excess. Set dish on a rimmed baking sheet.
2. In a large heatproof bowl set over a pot of simmering water, combine chocolate, vanilla, and ¼ cup water. Stir until chocolate is melted and mixture is smooth, about 10 minutes. Remove from heat and let cool to room temperature, 20 minutes.
3. Stir egg yolks into cooled chocolate mixture until well combined. Set soufflé base aside.
4. In a large bowl, using an electric mixer, beat egg whites and cream of tartar on medium-high until soft peaks form, about 2 minutes. Gradually add sugar and beat until stiff, glossy peaks form, about 5 minutes Do not overbeat.
5. In two additions, fold egg-white mixture into soufflé base: With a rubber spatula, gently cut down through center and lift up some base from bottom of bowl. Turning bowl, steadily continue to cut down and lift up base until just combined.
6. Transfer mixture to dish, taking care not to get batter on top edge of dish; smooth top. Bake souffle until puffed and set, 30 to 35 minutes. Do not open oven during first 25 minutes of baking. Serve immediately.

Favorite skyline

PARIS

Mark Cooper
Senior Analyst

Favorite quote

"NICE GUYS FINISH FIRST.

If you don't know that, you don't know where the finish line is."

—Garry Shandling

George Ross
Senior Analyst

Favorite form of transportation

SUBWAY

Alan Barr
Senior Analyst

Favorite cuisine

MEDITERRANEAN

Shan Wang
Research Analyst

Dream vehicle

KOMATSU 980E

John Masi
Senior Analyst

Favorite singer

JAZZ VOCALIST

GREGORY PORTER

Michelle Gutman
Executive Assistant

Favorite restaurant in the world

ABURA SOBA GINZA

TOKYO

David Wang
Analyst

Favorite places to visit

United

KINGDOM

Kevin Kuzio
Senior Analyst

BARCELONA

Mark Wright
Senior Analyst

IRELAND

Benj Bahr
Senior Analyst

Favorite pastime

READING HISTORY…

human nature is unchanged through the millenia

Sean Slein
Portfolio Manager

Favorite beach

PLAYA UVITA

COSTA RICA

Emily Howard
Analyst

Favorite sandwich

GRILLED CHEESE

Manish Gupta
Senior Analyst

Place of birth

BAD SODEN

GERMANY

Christian Heck
Senior Analyst

Favorite sport to watch

BASKETBALL

Michael Gayeski
Analyst

Favorite cocktail

OLD FASHIONED

Julien Albertini
Senior Analyst,
Associate Portfolio Manager

Recipe: Old Fashioned

INGREDIENTS

- 1 teaspoon raw sugar
- 3 dashes bitters
- 2 ounces rye whiskey
- Orange wedge

DIRECTIONS

Stir sugar, bitters, and 2 teaspoons warm water in a rocks glass until most of the sugar is dissolved. Add 3 ice cubes and pour rye over. Stir 20 seconds to chill cocktail and dilute whiskey. Garnish with orange wedge.

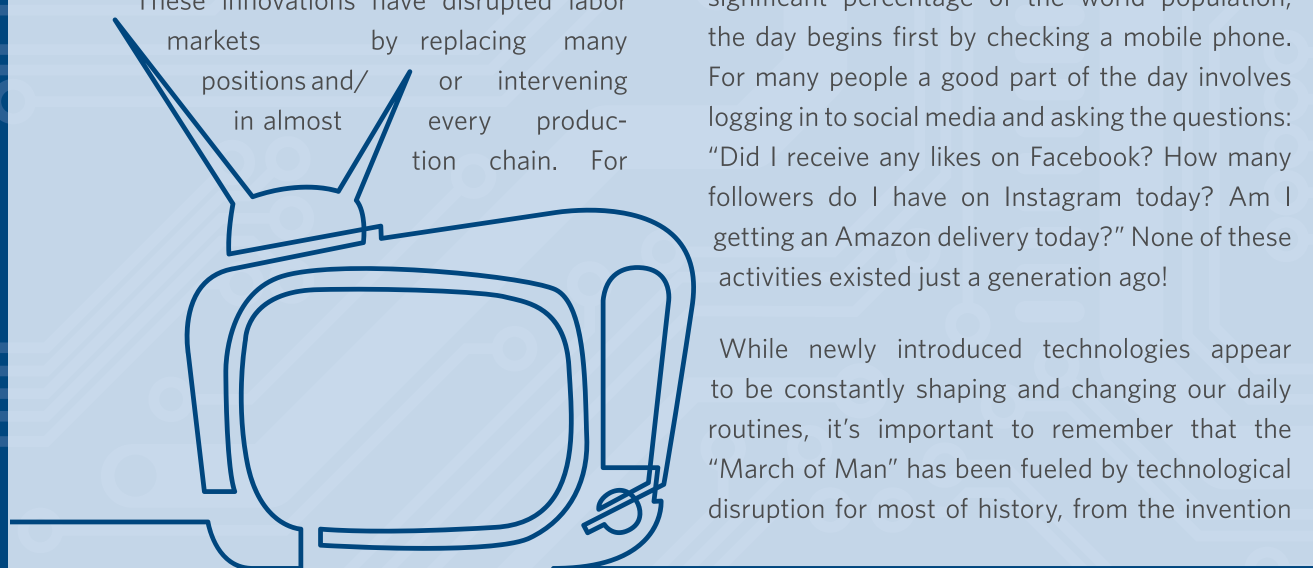
DISRUPTION WITH A MARGIN OF SAFETY

VALUE INVESTING IN AN EVER-CHANGING TECH WORLD

BY **MANISH GUPTA**
Senior Research Analyst

Today's world is marked by disruptive forces. Globalization, factory automation and modern technologies are swiftly changing all aspects of our daily lives.

These innovations have disrupted labor markets by replacing many positions and/or intervening in almost every production chain. For instance, at FANUC, a Japan-based manufacturer of factory automation and robots, they even have robots building robots. Information technology has had a massive impact on how people produce, consume, and behave; a disruption that's evident from the start of each day. For an increasingly significant percentage of the world population, the day begins first by checking a mobile phone. For many people a good part of the day involves logging in to social media and asking the questions: "Did I receive any likes on Facebook? How many followers do I have on Instagram today? Am I getting an Amazon delivery today?" None of these activities existed just a generation ago!



While newly introduced technologies appear to be constantly shaping and changing our daily routines, it's important to remember that the "March of Man" has been fueled by technological disruption for most of history, from the invention of the wheel to the steam engine to the telephone to electricity; each technology replacing what seemed a settled system. For instance, before YouTube and Netflix disrupted TV, radio disrupted the printing press and TV disrupted the radio.

The next wave of disruption may be around the corner! Perhaps it will come from quantum computing or from machine learning ("ML") or artificial intelligence ("AI").

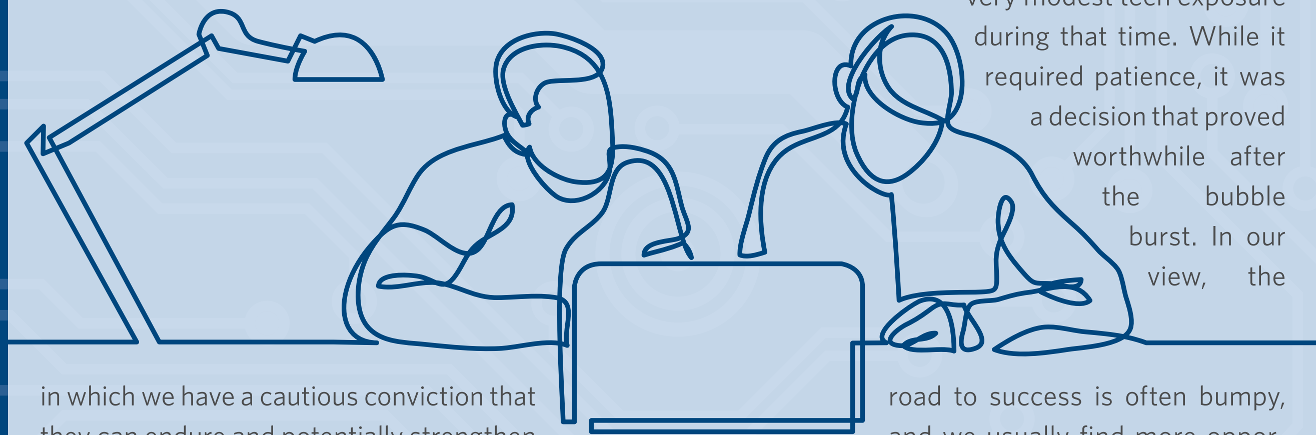
With each disruptive force, there is fade risk, the risk that the pre-existing technology becomes less relevant. Over time, everything gets disrupted, everything fades; companies, industries, currencies, and political regimes. For instance, ExxonMobil is the only company that has remained a top-10 stock in the S&P 500 over the past six decades. No other company has managed to maintain enough dominance in an industry over a long enough period to accomplish that feat.

Fade risk is constant but also dynamic, particularly when considering information technology. Apple and Microsoft are both disruptors that were nearly disrupted by one another! Microsoft almost disrupted Apple in the late 1980s and early 1990s. Many investors believed that Apple was going to disrupt Microsoft when it introduced the iPad. But here we stand at the end of 2018 with Apple and Microsoft accompanied by two additional disruptors, Amazon and Alphabet, representing America's biggest companies by market capitalization.

Will Amazon, Apple, Alphabet and Microsoft maintain their positions in terms of market capitalization for the next decade? There is no guarantee. The next wave of disruption may be around the corner! Perhaps it will come from quantum computing or from machine learning ("ML") or artificial intelligence ("AI"). We do not know for sure and we are not in the business of fortune-telling. However, it does appear that the next wave of change may occur at a faster pace; it appears that technological disruption in the world today is moving at a brisk clip. The ongoing accumulation of knowledge, amplified by our ability to easily and exponentially store, share and compute data cost-efficiently, is fueling today's disruptive engine.

Disruption takes time, but perhaps less and less. It took the gasoline engine car several decades to replace horse power. It took computers decades to become the most used consumer good. The Internet will soon be 40 years old. However, it took Facebook only five years to become the world's leading social media website. Facebook disrupted Myspace, which was a leading social media website until 2009. Since then, which was less than a decade ago, Myspace has slowly faded away.

At First Eagle, we believe that the future is uncertain. We observe how technological disruption is reshaping the world. We may observe the rising importance and value proposition of cloud computing or ML / AI. But we have no crystal ball to identify the world's top-10 market capitalizations in the next decade. As value investors, our objective has always been, first and foremost, to preserve the purchasing power of capital over the long term. Rather than trying to guess where and what is going to be the next innovation, we focus on understanding the implications that disruptions or disruptors may have in terms of fade risk. We do not invest on the basis of growth potential but rather, we invest primarily on the basis of price. Our investment philosophy has always been guided by an acceptance of the fact that fade risk is constant. We try to selectively build a diversified ensemble of companies, in which we have a cautious conviction that they can endure and potentially strengthen over the next decade. Persistency and resilience are business features that we highly value when considering investment opportunities.



At First Eagle, we tend to like the mundane, stable but persistent, rather than the exciting, uncertain and risky. We find consistent market position to be an attractive quality for a potential investment. For instance, we think it worth noticing when a company like Microsoft has maintained a global dominant leadership position in PC operating systems and in office software for the past two decades. Or when, for the past two decades, companies such as TSMC and Xilinx have dominated half or more of their respective core industries.

Of course, focusing on persistency rather than on potential growth requires patience. To determine the persistency of a business, we tend to observe how a company has behaved throughout various business and technological cycles. This requires us to stay on the sidelines, from time to time, when new rising stars shine. Recognizing our inability to identify investment opportunity—with a margin of safety—in the hottest sector of the late 1990s, the tech sector, we remained patient and had very modest tech exposure during that time. While it required patience, it was a decision that proved worthwhile after the bubble burst. In our view, the road to success is often bumpy, and we usually find more opportunities in the falling tech angels that, for one reason or another, are temporarily out of favor. Microsoft, Intel and Cisco Systems, which have all been top-ten holdings in our funds at one time or another in the past decade were purchased at times when their stock price had dropped significantly from the TMT bubble peak levels.

To determine the persistency of a business, we tend to observe how a company has behaved throughout various business and technological cycles. This requires us to stay on the sidelines, from time to time, when new rising stars shine.

A more recent example is our 2018 investment in Facebook. Following the Cambridge Analytica scandal, Facebook quickly shifted from being a stock market favorite to being a company whose business premise was in question. As its share price tumbled, markets offered us an opportunity to invest in a company that matched our subjective and objective investment criteria. With high and stable market share, Facebook is the relatively undisputed world's largest social media platform company. Its business model is, by definition, network driven, where scale becomes a structural competitive advantage, thus providing the potential for structurally high operating margins. Historically, the company has proven its capacity to efficiently monetize its network and has generated strong free cash flows. It also has a very sound balance sheet, even after doubling company headcount over the past two years. Controlled by its founders, Facebook has owners and management with a relatively elevated alignment of interest with their shareholders. Further, the company has already successfully managed a technological shift, from PC to mobile; and a generational shift, from Facebook to Instagram, proving in just over a decade that it has a certain level of persistency and resilience. It won't be easy to replicate Facebook. And if anyone comes near enough, Facebook might just end up acquiring them, as they did with Instagram; scaling up their platform. Pricewise, peak to trough, Facebook's stock price decreased by around 40% last year. The past year as stock prices reflected lower valuations offered us what we believe to be an opportunity to enter the position with a margin of safety.

Controlled by its founders, Facebook has owners and management with a relatively elevated alignment of interest with their shareholders. Further, the company has already successfully managed a technological shift, from PC to mobile; and a generational shift, from Facebook to Instagram, proving in just over a decade that it has a certain level of persistency and resilience.

Disruption is a wonderful growth engine. But disruption is also a wonderful value engine. In our view, this is particularly true for companies driving disruption and for societies as a whole, at least over the long term.

When it comes to tech, many investors dream of discovering the next disruptor, the next Amazon, the next Apple. It's traditionally viewed as a privileged playground for growth investors; paying the premium to capture the growth potential. At First Eagle, we like growth—but with a discount. Disruption with a margin of safety.

HONORING 40 YEARS OF INVESTMENT ACHIEVEMENT

WITH JEAN-MARIE EVEILLARD

First Eagle's Global Value Strategy reached its 40th anniversary on January 1, 2019. Since its launch by investor **JEAN-MARIE EVEILLARD,** when he was at a French bank, the Global Value Strategy has consistently followed a disciplined, benchmark-agnostic, value-oriented philosophy to investing. Jean-Marie was portfolio manager of the Global Value Strategy for many years and is now a Senior Advisor. We sat down with the legendary investor to discuss his experience and outlook.

Q

JEAN-MARIE, THANK YOU FOR JOINING US TODAY. HOW DID YOU DISCOVER THE WORLD OF VALUE INVESTING?

It happened in two steps.

First step: I began working for a French bank in 1962, and after five years I was getting a bit restless. The bank sent me to New York for a year or two, and after a few months I met two Frenchmen who were studying at Columbia Business School. They told me about Ben Graham, the father of value investing, who had retired from teaching at Columbia three years earlier. So, I went into a bookstore and bought *The Intelligent Investor* and *Security Analysis*.

There was a famous French writer, Paul Claudel, who was agnostic, and for aesthetic purposes, he set foot in Notre Dame cathedral. He said he was standing by a pillar and he was illuminated by grace. He was a devout Catholic for the rest of his life. In a very modest way, I was sort of illuminated by reading Ben Graham. The approach set out by Graham made sense to me—absolute sense. And 50 years after I first encountered it, I can confirm that it also works. Graham's premise was that the intelligent investor buys shares of a company when it is trading at a price that reflects a discount to the company's estimated intrinsic value. In other words, he believed it was best to invest with a margin of safety.

Back in Paris, I tried to convince the bank to let me invest on a Ben Graham basis, but the bank had never heard of him and wouldn't let me run even a modest amount of money. It wasn't until 1978 that the bank finally said, "We have a small fund that's being managed by a sub-advisor whom you could replace. We'll send you back to New York." And the fund was only $15 million dollars in size.

Second step: When I got back to New York, I read a very positive little piece about Warren Buffett, and that led me to get copies of the Berkshire Hathaway annual reports. That was the second step in my discovery of value investing. Buffett had studied with Graham, but he took Graham's principles in a new direction. Unlike Graham, Buffett says there are some lines of business that are better than others. Indeed, in some instances, companies can have what Buffett called a "moat"—a competitive advantage that may protect them not just for the next year or two, but for the next 10 or 15 years. Buffett's additions to the teachings of Ben Graham were considerable as well as successful.

Of course, there were alternatives to the value investment philosophy. What the French bank did was to trade in and out of the big stocks in the index based on market psychology. I didn't think this was particularly appealing. At the time, some other investors practiced technical analysis, using charts to predict short-term market trends. I could see that if enough people believed in this system, it might have an impact, but when you stop to think about technical analysis, it's meaningless. How can you take a chart and figure out whether the shape of the line is a short-term bullish indicator?

Value investing made much better sense to me. I decided to use both the deep-value Graham approach and the moat-based Buffett approach.

Q

IN THOSE DAYS, US INVESTORS SHOWED A STRONG HOME-MARKET BIAS. HOW DID YOU INTEREST THEM IN GLOBAL STOCKS?

Luck plays a major role in life, and I simply got lucky. I started on January 1, 1979, and Continental Europe was making some progress toward greater economic union. In the past, there had been a French equity index, a German index, an Italian index, et cetera. What was relatively new at that time was a pan-European index. All of a sudden, funds began to compete on the basis of that index.

If you're a value investor, you are by definition a long-term investor.

The small cap stocks that had been part of the French index were not included in the European index because they were too small, and some investors who were focusing on the European index dumped those small caps. To me, those stocks looked like interesting opportunities. Because accounting methods tended to understate the profitability of companies in Europe, some of the shares were even cheaper than they appeared. I was willing to stray from the index and look for more obscure local companies that I felt were good value buys and would generate nice returns over time. I thought there might be more to this story, so I called somebody I knew in money management in Paris and I said, "Am I missing something?"

And he said "Sure, you're missing something. You're missing the fact that if we, the locals, don't buy those small French stocks, they will never go up."

But that was not true. What he should have said was, "You may make three, four or five times your money over time, but you will have to be even more patient than usual because today there are no buyers for those stocks. So maybe you will have to wait two or three years."

If you're a value investor, you are by definition a long-term investor. It goes back to what Ben Graham believed: In the short-term, the stock market is a voting machine, where investors vote with their purchases and sales; and in the long term, the market is a weighing machine that weighs the realities of the businesses, in either a positive or a negative way. As a value investor, you try to make investments that, over time, will align with the weighing machine. Patience is essential.

Q

WHAT CHALLENGES HAVE YOU FACED THROUGHOUT YOUR CAREER?

We started with $15 million in 1979 and we were at $100 million in 1987. But Japan in the late 1980s was a big challenge. Most of the time, after several years of a bull market, there are few investment opportunities, and after several years of a bear market, there are plenty of opportunities. In other words, there are always at least some opportunities. In my career, the only exception was Japan in the late 1980s. I thought, "Even if I study 75 stocks there, I will not buy a single one of them." There was a gigantic bubble both in real estate and in the stock market. People were buying stocks at any price, but I was buying none.

I'm willing to completely ignore a particular industry or a particular country if I think that there are no opportunities. At the time, Japan was the second largest equity market in the world after the United States, and I owned nothing. I got phone calls from financial planners saying, "Well, if you owned relatively few, we would understand. But nothing?"

I said, "Sorry, but everything has ballooned."

We faced a similar kind of challenge in the late 1990s when I did not participate in what I thought was a technology media and telecom mania—the dot-com era. I lagged very badly for three years in a row in the late 1990s. We had assets under management of $6 billion in the fall of 1997, but by late 1999, we were down to about $2.25 billion. Even in the Global Value Strategy, where I already had a twenty-year track record, seven out of 10 shareholders disappeared.

If you're a long-term investor, you don't try to keep up with your peers or with a benchmark on a short-term basis—which means that, every now and then, you will lag.

As value investors, we know that we will sometimes lag. This goes back to Ben Graham. If you're a long-term investor, you don't try to keep up with your peers or with a benchmark on a short-term basis—which means that, every now and then, you will lag.

If you don't lag for too long or you lag in a moderate way, it's not the end of the world. But, in the late 1990s, although we were up a bit, it was not nearly as much as many of the more-aggressive funds. We lagged badly then, and when this goes on long enough and is sharp enough, it's very painful. Our fund was added to a lemon list. That's not very encouraging. There were moments of self-doubt. Sometimes I would go home at the end of the day and say, "What am I missing that everybody seems to be very positive about."

What kept me going was my conviction that, over the long term, value investing would deliver good results. Genuine value investors have to be willing to take some pain. And when the dot-com bubble burst, our patience was rewarded.

I have always said that I would rather lose half of our shareholders (which we did in that period) than lose half of their money (which we did not do, once the tide had turned and the technology, media telecom bubble had burst).

During those years of shrinking assets under management, I believe that the French bank hesitated between firing me and selling the operation. I was lucky there, too, because the bank decided to sell the operation. I felt a bit like a horse at an auction, but the sale to Arnhold and S. Bleichroeder (later First Eagle Investment Management) was a great outcome both for the funds and for me, personally.

Q

YOU ARE KNOWN IN THE WORLD OF INVESTING AS A BELIEVER IN THE ENDURING VALUE OF GOLD. WHY DO YOU FEEL STRONGLY ABOUT ALLOCATING TO GOLD?

It could be because I am French that I am particularly concerned about the risk of hyperinflation. France experienced very high inflation, ruinous inflation, on two different occasions in the eighteenth century—once in the Regency period after the death of Louis XIV and later during the French Revolution. I think that knowledge of these events has heightened my awareness of this risk.

My own background was in the Austrian school of economics, which taught that credit booms are followed by credit busts, and that the proper way to handle a bust was to purge some of the excesses—not all of them, which would be too painful, but some of them. It's the idea of accepting some short-term pain now in order to have long-term gain later. But I could see that there was zero appetite on the part of the politicians or the public for the purging of even a few excesses. I thought that this was not a good path, and at the time the price of gold was depressed, so I started investing in gold as a potential hedge against disruptions to the monetary system.

A few years later, we had nothing to show but moderate losses, and I thought maybe we should move on. But then, in 1998, Long-Term Capital Management, a very large hedge fund, ran into considerable trouble. I could understand the Federal Reserve bailing out a bank that has depositors, but bailing out a hedge fund struck me as the last thing that should happen. The firm made a huge bet, it lost, and it should pay for it. When I saw that Long-Term Capital Management was being bailed out, it was clear that the world's monetary architecture could be vulnerable. So we kept investing in gold, and we have maintained an allocation to gold-related investments ever since.

Q

YOU ARE WELL-KNOWN FOR AVOIDING BOTH THE JAPANESE BUBBLE IN THE LATE 1980S AND THE TECH BUBBLE IN THE LATE 1990S. LOOKING AT THE CURRENT STATE OF THE ECONOMY, ARE THERE ANY AREAS OF HESITATION? WHAT KEEPS YOU UP AT NIGHT?

One thing that worries me is the expansion of government debt around the world. In the last 45 years, the French economy, for one, has had some difficult years and a few good years, but since 1974, France has never reported a budget surplus. Neo-Keynesian ideas seem to prevail around the world, and I think these ideas are dangerous. John Maynard Keynes believed that sometimes private sector demand is insufficient and has to be supplemented with public sector demand, which means some budget deficits. But he also said that in a good year there has to be a budget surplus so that government debt does not balloon every year. The neo-Keynesians omit this part of his mantra.

> Throughout my career, I have experienced self-doubt not just when a fund was lagging the market, but also when I tried to figure out what was going to happen in the future. In the face of future uncertainty, we have to remain humble.

Today, in the United States and elsewhere, there is gigantic government debt—not just at the federal level, but in the states and cities, too. There is also gigantic corporate debt and consumer debt. There has been no deleveraging whatsoever since the global financial crisis a decade ago, and this applies to Europe and Japan, and some people are beginning to say that it applies to China, too.

Quantitative easing is completely unprecedented in the history of the world. Nobody knows what interest rates were like 5,000 years ago, but historically—except for a brief period in the Middle Ages when the Catholic Church forbade the charging of interest—there has been no quantitative easing. Since there is no historical comparison possible, nobody knows what the consequences of quantitative easing—and now the unwinding of quantitative easing—will be.

But I always mention that my analysis of the situation today may be wrong. Maybe in the United States and elsewhere, the prosperity will continue for another five or 10 years. Who knows? Throughout my career, I have experienced self-doubt not just when a fund was lagging the market, but also when I tried to figure out what was going to happen in the future. In the face of future uncertainty, we have to remain humble.

Q

DO YOU STILL SEE A PLACE FOR ACTIVE VALUE INVESTING IN TODAY'S INCREASINGLY PASSIVE ENVIRONMENT?

Yes, I do. It's easy to understand the preference for passive investments after a 10-year bull market. Some individuals extrapolate. They say, "The market has been good for 10 years, and maybe it will be good for the next 10 years, too. Why should I bother to buy into an active fund? So many of them over a long period of time have done worse than their index. Why should I take that risk?" So they buy into an index fund or an ETF. And ETFs, I think, are an accident waiting to happen because they give the illusion of liquidity.

> And ETFs, I think, are an accident waiting to happen because they give the illusion of liquidity.

I think there is still room for active funds, but they have to show, over time, that they do better than the index. When I started out in 1979, I said I should have two objectives. One was that, in absolute terms, I had to do better, over time, than a money market fund because I was exposing shareholders in my fund to the risks of equities. And two, over time I had to do better than the index because otherwise investors could say, "I don't need you guys. I might as well buy into an index fund." And I think those were the two appropriate objectives.

People talk now about investing with algorithms and artificial intelligence, but these approaches seem to be based on taking a company's accounting numbers as revealed truth. This is inherently risky. Accounting numbers are often distorted, whether deliberately or not, and we think they should be received with a measure of skepticism. Active research analysts and portfolio managers have an advantage when it comes to detecting this kind of abuse.

Q

YOU HAD A REMARKABLE LONG-TERM TRACK RECORD AS AN INVESTOR, WHICH MORNINGSTAR ACKNOWLEDGED WITH ITS LIFETIME ACHIEVEMENT AWARD. TO WHAT DO YOU ATTRIBUTE YOUR SUCCESS?

Patience.

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