FIRST EAGLE
INVESTMENT MANAGEMENT

Active Investing for Today's Markets

Viewpoints: *Thoughts from a Value Perspective*

Investor capital continues to pour out of active vehicles and into passive ones. Investors evidently believe that passive funds are attractive because their fees have been low and their returns have generally been good. In our view, this is an overly simplistic way to think about today's market environment. Whether in equities or in fixed income, passive strategies attempt to replicate the returns of the broader markets. If the broader markets themselves are priced for low returns, investors who choose passive vehicles face the prospect of singularly disappointing returns over the long term.

Substantial economic risks

In our view, we are living in a time of heightened economic risk. The first concern is leverage. Overall leverage in the world today is greater than it was in 2007; indeed, the sum of household plus corporate plus sovereign debt is at a generational high. This is not necessarily a prescription for near-term crisis, but it does represent a potential vulnerability in a complex system.

The second level of risk is geopolitical: The world order is increasingly fragmented, and populism is a growing trend. The forces of fragmentation and populism have been fueled by a combination of factors: globalization itself has contributed to wealth inequality around the world; easy monetary policy and the resulting asset price inflation have exacerbated inequality; and automation is reducing demand for human workers in the world's factories. In many places, this powerful trio of factors is spurring the rise of populism. Competing cultural systems only add to the complexity. The US agenda is very different from the European, which in turn differs from the Chinese and the Russian and the agendas of the many factions in the Middle East.

Ordinarily, in an environment with this much risk, one might expect assets to be priced at a discount so that investors could be compensated with higher rates of return. Instead, what we see today is exactly the opposite: Asset prices are generally high, not low. In the bond market, there are trillions of dollars of sovereign bonds that bear negative interest rates. In the equity markets, price/earnings ratios are at above-average levels.

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Muted outlook for index returns

We don't have a crystal ball at First Eagle, but we do have a sense of current valuations and of the underlying vulnerabilities in the system. Over the next five to 10 years, we see the prospects for financial markets as muted. This is quite different from what prior generations experienced. In the early 1980s, for example, interest rates were in double digits and PE multiples were in single digits. In that kind of setting, the mere act of passively taking beta risk or duration risk was sufficient to produce a satisfactory real return. In our view, that is no longer the case. In the environment we anticipate, cheap beta and cheap duration through passive strategies are not likely to produce satisfactory returns.

When investors choose passive vehicles, what kind of exposure are they accepting? Many of the benchmarks used by index funds and ETFs—including the MSCI EAFE, Russell 2000 and S&P 500—are either capitalization-weighted or float-weighted. A company with a rising stock price occupies a larger and larger position within this kind of index. As a result, investors in passive funds expose themselves to large segments of the benchmark that have higher-than-average valuations and to companies that are larger-than-average issuers of securities. Is this a sensible way to invest? In today's environment, investors might actually prefer to own companies that do not need to issue securities and that are buying back their shares. They might also prefer to invest in companies that do not feature very heavily in benchmarks and have yet to reach their valuation premiums.

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Passive investing requires active

It is important to keep in mind that passive funds cannot exist without active ones. Investors in passive strategies are willing to commit capital with willful ignorance of the underlying valuation, business risk, capital-structure risk, management risk and regulatory risk of the companies in which they are investing. This strategy of willful ignorance, albeit low in cost, works well only if there is a vibrant active management industry that is pricing the underlying securities relatively efficiently through competitive processes. The passive strategy is, in its essence, a parasitic strategy that requires a vibrant active host.

The advantages of active management

We think active management can address the major shortcomings of passive approaches in the current environment. If valuations are generally high, investors can search, bottom up, for securities with valuations they consider more conservative. If experimental monetary and fiscal policies are exposing investors to risks, investors can search, bottom up, for management practices they believe are more prudent. If excessive money supply is impeding real returns, investors can search, bottom up, for companies that may deliver returns because they embody scarcity in the form of strong and persistent market positions.

At First Eagle, we pursue real returns through four basic strategies. The first is stock selection. Equity markets as a whole may be priced for low real rates of return, but not every stock is at a new high. In fact, around the globe and across industries, there are many individual companies that, for one reason or another, have gone through their own bear markets. We focus on those that are likely to prove resilient when challenges arise. Having identified such companies, we commit capital only to those where we see a "margin of safety" in price. A margin of safety is the difference between our estimate of the intrinsic value of a security and the price at which it is selling.

Our second strategy is to hold cash[1] when we cannot find shares that are trading with what we believe to be a margin of safety. Waiting patiently in cash is quite unusual in the industry; most investment managers feel the need to be fully invested at all times. But if we are going to commit capital only when we can buy what we believe to be the right kind of company at the right kind of price, there will be times when such opportunities are scarce. For us, cash is a residual of a disciplined, bottom-up investment approach. It's deferred purchasing power. Our cash tends to get invested in windows of market distress, and it tends to build when markets are frothy or more fully valued.

Our third important strategy is investing globally. In a world where interest rates have fallen towards zero or below zero in many places, it's increasingly important to be mindful of risks that can emerge in the currency markets. Many policymakers attempt to depress the value of their currencies as a way to spur exports and stimulate economic growth. Around the globe, there are areas where currencies are currently overvalued in real terms relative to their long-term historical norms. In cases where that overvaluation does not seem to be due to a country's trade position or the aggregate level of debt in its economy, we may hedge our currency position. On the other hand, in parts of the world where currencies are materially undervalued relative to the historical patterns, we may be willing to hold those currencies or securities denominated in those currencies on an unhedged basis because of

1 References to "cash" encompass both cash and cash equivalents, such as commercial paper.

the potential compensation and the opportunity to diversify our cash. We think intelligent currency management can help both to preserve wealth and to enhance the potential for real returns.

Our fourth and final strategy is maintaining a structural allocation to gold[2] as a potential hedge against extreme market outcomes. The global supply of gold is constrained, and on a per capita basis it has been fairly stable for several generations. As money supply and

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debt levels and nominal economic activity have all grown, the gold price, although volatile, has risen in real terms over a 50-year period.[3] Because gold is chemically inert, it tends to be resilient in times of crisis when the prices of more useful commodities react more strongly to erosion in business conditions. For us, gold offers elements of scarcity and resilience—the same attributes we like to see in the businesses we select for investment.

2 References to gold include both bullion and gold-related investments, such as shares in gold mining companies.

3 Bloomberg.

Choosing a strategy

Given the prospect for low real returns over the next five to 10 years, we think investors should look for strategies that embody resilience in times of crisis and that have demonstrated through-the-cycle outperformance. These features are typically measured in decades rather than months. Resilience in times of crisis is evidence of prudent investment underwriting. Through-the-cycle outperformance is evidence of an active manager's sensitivity to valuation considerations. It is our belief that the best feature of active management is the ability to help mitigate risk. Rather than trying to create wealth quickly, we favor creating wealth more slowly, but potentially with a modicum of greater certainty.

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