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Q&A

A Top Fund Manager Is Worried About Speculative Excess. 2 Stocks He's Willing to Bet On.

By William Green

While many investors are rejoicing in the market's sumptuous returns over the last year, Matthew McLennan is wary.

Deviating from the crowd is nothing new for McLennan, who oversees the $89 billion global value team at First Eagle Investment Management, including the First Eagle Overseas (ticker: SGOVX) and First Eagle Global (SGENX) funds. An Australian now based in New York, he spent the first part of his life in Papua New Guinea and later grew up in a home filled with books but lacking hot water and electricity. After a stint at Goldman Sachs, McLennan took over from legendary value investor Jean-Marie Eveillard a week before the Lehman Brothers collapse, and has become one of the most influential investors today.

I profiled McLennan in my new book, Richer, Wiser, Happier: How the World's Greatest Investors Win in Markets and Life. I spoke with him again last week for Barron's. McLennan warns of his concern over extreme economic uncertainty, speculative excess, and heady expectations for assets like tech stocks and Bitcoin. An edited version of our conversation follows.

Matt McLennan, First Eagle Investment Management
Photograph by Guerin Blask

Barron's: What about the U.S. stock market concerns you most?

Matthew McLennan: I'm torn at the moment. On the one hand, we're recovering from a deep cyclical trough, and that's usually a good time to be an investor. On the other hand, prices aren't that attractive, and we have all these secular issues. The flashing warning light is the scale of our fiscal deficit—it's 15%. [Meaning the federal government is spending 15% more than it's bringing in.] The market has been a beneficiary of enormous stimulus that's of a wartime scale. The challenge is, by the mid part of this year, at the Fed's current run rate of balance sheet expansion—what has been a 25% increase in money supply over the last year—will start to moderate to about a 10% percent rate of increase. So we'll see a deceleration of the rate of money supply growth.

Markets will also have to move beyond the focus on fiscal stimulus to 'How are we going to pay for all this?' And we're going to see the emergence of a new regulatory architecture, which isn't likely to be any more business-friendly. Inflation expectations have also moved up quite a bit, and what happens if inflation rises more than people expect? These are all issues that can weigh on the market as we roll forward.

Are there signs that investors aren't taking these risks seriously?

There are periods where the market pays a premium for growth, and then there are market environments where it's not even about growth—it's about optionality and acceleration. You see that in multiple dimensions now: Witness the dramatic rise of Bitcoin or the eye-popping valuations of some of the larger companies in technology or alternative energy. Or the whole creation of the SPAC [special purpose acquisition

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companies] market where, again, people are paying for optionality—they're paying for the potential to own a business. They don't even know what it is yet. Things like that make one a little wary.

I've also received calls from friends of my children and older people—all wondering how they can make money quickly in some of these emergent fields. I haven't received such a frequency of calls since the late 1990s. It feels like one of those moments where it's worth reminding people that the whole point of investing is to preserve purchasing power. If you're prudent, you hopefully grow your purchasing power in a way that's resilient.

How does today compare to the excesses of the dot-com bubble?

I think 1999 was more extreme. A host of concept stocks didn't even have businesses, and some things traded at 25 times projected revenues. The Facebooks of the world are very real, cash-flow generative businesses. To me, what's more disturbing today is that the policy backdrop is more extreme. The private sector is healthier, but maybe that's because it's subsidized by these massive fiscal deficits. The whole environment feels more artificial to me because we've never seen stimulus like this in our lifetimes.

Gold is the biggest position in your two largest mutual funds. Why?

We've held gold as a potential hedge for a decade-plus. During that period, the imbalances we worried about at a macro level have only grown worse. Mid-cycle fiscal deficits are worse today than 20 years ago. Structural real interest rates today are negative, whereas they were positive 20 years ago. The geopolitics of the world have only become more complicated. Even domestically, based upon the heated last election, it's fair to say that the internal political dynamic is more fraught and less stable than it's been for some time. And the stock market today trades at above 25 times the trailing peak level of earnings in 2019. So it's already pricing not only a recovery of earnings, but the market setting a new high water mark in earnings. There are all of these risks out there, and the market's not pricing a lot of risk right now.

We own gold as a hedge against the unknowable. It's almost a recognition of one's own humility in the face of that uncertainty.

Bitcoin is often described as "digital gold." You're skeptical. Why?

Bitcoin was an amazing innovation. As a concept, as a mathematical construct, it's quite the invention. But I refer to Bitcoin as a call option on digital gold rather than being digital gold. It's not even 13 years old. It's emergent in a new field of cryptocurrencies, and it doesn't have a monopoly on that field, so it faces substitution risk. And even though it might be a valid option on being digital gold, it's being priced as if it were digital gold. I don't see central banks buying Bitcoin anytime soon, so it's not really a substitute for central bank reserves. Nor is it a substitute for what people might use gold for, which is for eternity and adornment.


First Eagle's McLennan
Photograph by Guerin Blask

If Bitcoin were to be a digital substitute for gold, it would have to be for the private hoarding demand of gold. Yet it doesn't behave like gold. It has much greater volatility; it doesn't have the same tight negative correlation with real interest rates and with the value of the dollar. In fact, it tends to trade more on tweets, whether from Elon Musk or people speculating about a Coinbase IPO valuation. So it trades more like a growth equity, based on perceptions of its adoption, rather than as a more traditional store of value. If Bitcoin takes root more deeply, it can go up in value. But it's hard to say that this is a value entry point.

The last few years have been frustrating for investors in foreign markets. Are you finding attractive opportunities there?

The international universe has been out of favor for a confluence of reasons. One is that the U.S. has been the epicenter of growth stock enthusiasm. Another reason why markets outside the U.S. have been at lower valuations, whether it's Japan or the Eurozone, is persistent concern around deflation. But the U.S. doesn't have a monopoly on good businesses. It pays to diversify, and you're being paid to do so because valuations are lower internationally, and currencies are somewhat depressed relative to the dollar.

Our largest European holding is Danone (BN.France). It's underperformed the consumer staples universe. It's gone through a series of management and other business-related issues over the last couple of years. The CEO has essentially been forced out. But the underlying businesses are sound. So it's an interesting example of buying a sound business at a time when it's been out of favor.

Danone has three businesses. The infant nutrition business is attractive. They have their traditional dairy products business, with a very strong market share position in yogurt. And they're a leader in the bottled water business, with brands like Evian and Badoit. The bottled water business has been out of favor during Covid because of restaurant lockdowns, and by virtue of ESG concerns. But the company has been at the forefront of transitioning to recyclables. The yogurt business is recovering from a period of sluggish growth. Meanwhile, the company has a free cash-flow yield of 5% to 6%, it's committed to improving margins, and it's in a transition to a management structure that's likely to be more shareholder friendly.

Is there an undervalued U.S. stock that embodies the durability you look for?

Oracle (ORCL) is the dominant leader in the relational database business. They have a very strong market share position, and it's improving. Now they're launching their autonomous database, which requires far less human intervention, and that's a growing part of their business. They're also a leader in the ERP [Enterprise Resource Planning] business, and they're taking share in that space. Those are the last pieces of software you want to change because it's like open heart surgery. It's software that's connected to your entire business fabric. So their customer retention rates are very high.

In the rear-vision mirror, you have a business that's only generated modest revenue growth. But they're close to an inflection point where they've seen the worst of the headwinds of the transition from the traditional software license business to the cloud. You're getting a 5% to 6% free cash-flow yield that's growing in real terms. The founder, Larry Ellison, owns nearly 40% of the company, so you're aligned with someone who acts like an owner. They bought back approximately 40% of their share count in the past decade. We're looking for companies where there's a line of sight to a sound return in a very low-yield world. And Oracle's combination of free cash-flow yield and measured growth is what we look at to feel that we can get a sound real return.

Thanks, Matthew.

Average Annual Returns as of 3/31/21:	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge) (SGENX)	4.05%	39.97%	8.49%	7.12%	1.11%
First Eagle Global Fund - Class A(w/sales charge) (SGENX)	-1.15%	32.96%	7.39%	6.57%	
First Eagle Overseas Fund – Class A (w/o sales charge) (SGOVX)	1.10%	31.38%	5.92%	5.05%	1.15%
First Eagle Overseas Fund – Class A (w/ sales charge) (SGOVX)	-3.98%	24.79%	4.84%	4.51%	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short-term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Past performance data through the most recent month end is available at feim.com or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global Fund and Overseas Fund gives effect to the deduction of the maximum sales charge of 5.00%.

The average annual returns shown above are historical and reflect changes in share price, reinvested dividends and are net of expenses. Investment results and the principal value of an investment will vary.

The annual expense ratio is based on expenses incurred by the fund, as stated in the most recent prospectus.

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The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Funds as of March 31, 2021: First Eagle Global Fund: Oracle 2.81%, Danone 1.49%, Facebook 1.49%.

The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Funds as of March 31, 2021: First Eagle Overseas Fund: Oracle 0.00%, Danone 2.39%, Facebook 0.00%.

Risk Disclosures

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates.

Investment in gold and gold-related investments present certain risks, and returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

The Global and Overseas Funds may invest in gold and precious metals through investment in a wholly-owned subsidiary of the Funds organized under the laws of the Cayman Islands ("the Subsidiary"). Gold bullion and commodities include the Funds' investment in the Subsidiary.

All investments involve the risk of loss of principal.

Investors should consider investment objectives, risks, charges and expenses carefully before investing. The prospectus and summary prospectus contain this and other information about the Funds and may be obtained by contacting your financial professional, visiting our website at www.feim.com **or calling us at 800.334.2143. Please read the prospectus carefully before investing.**

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