

Executive Suite

Today: Advice from the Top

Investing on what you know

El-Erian says the New Normal is a different economic world

By Adam Shell
USA TODAY

His firm manages more than \$1.1 trillion of other people's money. Eight million people in the USA alone have entrusted their cash to him.

He works closely with bond king and co-chief investment officer Bill Gross. He is the author of a best-selling book, *When Markets Collide*. He helped coin the concept and phrase, "the New Normal," which predicts a post-financial-crisis world of lower investment returns, slower economic growth and higher odds of another out-of-the-blue financial shock. In short, a world where the range of financial outcomes — and risk — is much wider than normal.

His cerebral, analytical and insightful views on the increasingly complex financial markets are closely followed on Wall Street. He is Mohamed El-Erian, CEO and co-chief investment officer of Pimco, the giant investment firm best known for bond investing.

Given his view that financial markets are entering a prolonged period of abnormal behavior, USA TODAY stock market reporter **Adam Shell** caught up with El-Erian recently to get his advice on how to both protect and build wealth in the New Normal world.

Q: What is the New Normal?

A: The basic premise is that we are in the midst of a major national and global realignment. The main catalyst was the financial crisis of 2008, but the underlying factors have been there for a while. The question is: What does the world look like post-realignment? The world is on a bumpy journey to a new destination and the New Normal.

Q: What does it mean for the economy and investors?

A: If you take a national perspective, it

means slower growth. Normally, the economy can grow at 3%, which we consider a safe speed. We are now looking at a slower speed of 2%, and that means persistently high unemployment (currently at 9.5%). We are not going back to 5% unemployment anytime soon. The (economy's) speed limit is also being lowered by government regulations. There will be lower speed limits and more cops on the highway because we can't repeat another major accident (in financial markets). The political angle becomes more important. Investors will have to worry about politics as much as the economy and financial markets.

Q: Why can't the government increase the economy's so-called speed limit?

A: Policymakers are running out of ammunition. They have been trying to minimize a bad outcome or tail event. We already are running a deficit of \$1.5 trillion. Short-term interest rates are around 0%. That means the effectiveness of policy to deliver outcomes diminishes. Second, we are starting from bad initial conditions, such as an over-indebted society. We've had a binge of credit and entitlements, and now we have to deliver.

Q: Your colleague Bill Gross says investors should only expect investment returns of 4% to 5% — what he calls "half-sized returns" — in all sorts of assets for the foreseeable future. Why?

A: Because a world that grows less rapidly generates less return. Ultimately, you get paid for productivity and growth.

Q: Why shouldn't investors just double down and take more risk in search of bigger returns?

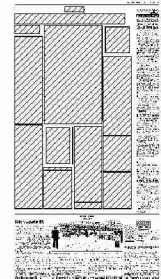
A: If you double down, or lever up, in this bumpy journey, you might not be able to stay in the trade, (which means

About Mohamed El-Erian

Past jobs: CEO of Harvard Management Company from 2005-2007 where he managed Harvard's endowment. Managing director at Salomon Smith Barney/Citigroup in London and before that, he spent 15 years at the International Monetary Fund in Washington, D.C.

Best-selling author: His book, *When Markets Collide*, was a *New York Times* and *Wall Street Journal* best seller.

Education: He holds a master's degree and doctorate in economics from Oxford University and received his undergraduate degree from Cambridge University.



you might sell when prices are low, not high).

Q: Why is deleveraging so painful?

A: Investors have few spare tires left. Think of the image of a car on a bumpy road to an uncertain destination that has already used up its spare tire. The cash reserves of people have been eaten up by the recent market volatility.

Q: Where is the economic power shifting to?

A: The global realignment is accelerating the migration of growth and wealth dynamics from the industrial world to the larger emerging economies.

Q: Will that make markets more volatile?

A: Yes. The talk in the U.S. is of deficits and a debt explosion. In emerging economies, it is about wealth accumulation. Because of that, we will experience tremendous volatility, a lot of triple-digit days for the Dow. Investors will have to manage their money in an upside-down world relative to what they have been used to.

Q: How will that affect the way they think about investing?

A: Investors have to ask themselves two questions: How much can we grow our investments? And, can we afford our mistakes? Right now, there are lots of things we don't know. When you hear Federal Reserve Chairman Ben Bernanke say the outlook for the economy is "unusually uncertain," that is an acknowledgment of how much we don't know.

Q: The economy has been growing since late last year, and the stock market has rebounded. What's the big risk?

A: There are four scenarios for the economy. Scenario A is a V-shaped recovery. Scenario B is up, but in a gradual fashion. Scenario C is the New Normal, which looks like the shape of a square root. And scenario D is a double-dip recession or depression. The market, until recently, was pricing in scenario A. But it is now moving toward B and C. The risk for investors is if the market romances D before settling on C. If that occurs, then even good assets can trade like lemons. Using a car analogy, your stock, which is not a lemon, trades like a lemon. And it is at that point that you want to have cash to buy assets trading like lemons.

Q: The less one knows, the more careful investors have to be?

A: The risk is they make inadvertent

Fun facts about El-Erian

Favorite baseball team: New York Mets.

Best book recommendation: *Too Big to Fail*.

Favorite TV show: *Cheers*.

Best-ever investment: Formal education.

Saver or spender? Saver.

Max out 401(k), yes/no? Yes

Favorite form of relaxation: Spending time with my wife and our daughter.

mistakes. Investors should invest on what they know. The biggest mistake is to invest on what they don't know. Investors should not assume the world is normal again and has just suffered a flesh wound and is going back to normal. Now, we have many possible outcomes and fatter tail risks, so the chance of something nasty happening is higher.

Q: How can an investor protect against disaster?

A: Big institutions do what is called tail hedging. It's no different than when we buy car insurance. You don't buy it because you think you are going to crash. You can cheaply insure against a low-probability event.

Q: How can mom-and-pop investors avoid bad outcomes?

A: First, most people start the day positioned for the Old Normal, not the New Normal. They have too much equity risk. Too much is invested in stocks, investment grade and high-yield bonds, and commodities. Remember, you have to be able to afford your mistakes.

Q: What else is putting them at risk?

A: Second, most people have a lot of home bias (or too much money riding on the U.S.).

Over 50% of S&P 500 profits come from the rest of world. Most people are underexposed to global assets, including foreign stocks, bonds and currencies.

Third, most people have very little optionality, or very little cash, unlike the corporate sector, which has record high cash balances. Corporations have recognized how uncertain the world looks.

The average household has very little cash.

Q: So investors should be more defensive in the New Normal? Are the days of having 80% of one's money parked in stocks for the long haul over?

A: Having an 80% stock allocation signifies a level of confidence that is not warranted by the unusually uncertain outcomes.

Q: Recently you said investors should strike a better balance between fixed income and equities. Why?

A: Because in the New Normal, you are more worried about the return *of* your capital, not return *on* your capital.

(Using a baseball analogy), they should not swing for the fences — yet. Hold off your swing. Check your swing. You are not there to hit a grand slam every time. Hit singles.

Learn about the pitchers. Good hitters take the first two pitches. Recognize that you don't know it all. Recognize that you are not playing in the American League or the National League, that you are playing in a global league, that there are opportunities in areas that you are underexposed to.

Q: What's the bottom line? How should folks divvy up their money?

A: Simply put, investors should own less equities, more bonds, more global investments, more cash and more dry ammunition. There is lots we don't know.



By Brad Swonetz

Mohamed El-Erian: "What does the world look like post-realignment?"