

Interview with Joe Rosenberg, Chief Investment Strategist, Loews
By ANDREW BARY

JOE ROSENBERG IS ONE OF THE MOST KNOWLEDGEABLE and outspoken investors around. He has worked on Wall Street for 45 years, and most of that time has been spent at Loews (ticker: LTR), the conglomerate controlled by the Tisch family.

Alan Abelson has aptly called Rosenberg a consigliere to the Tisches. Originally an airline analyst in the 1960s, Rosenberg was hired by Larry Tisch in 1973 and acted as Loews' chief investment officer until 1995. Since then, he's been chief investment strategist and has played a key role as an adviser to Loews' current CEO, Jim Tisch, Larry's son. Rosenberg is a director of CNA Financial, the insurer that is 91%-owned by Loews.

Rosenberg has been interviewed numerous times by Barron's. The last time was 1997. He then presciently railed against Wall Street research practices, criticizing analysts who "simply don't publish what they know for fear of retribution from corporations" and lamenting that "there used to be something called a Sell recommendation on Wall Street." He also decried excessive option grants.

Rosenberg hasn't always been right. He was prematurely bearish in the late 1990s, but eventually vindicated.

Rosenberg: The most rampant speculation today is taking place in commodities.

Speaking to us last Monday in the den of his New Jersey home, Rosenberg expressed strong opinions on many front-burner topics, including the commodity boom, the Federal Reserve, Russian and Chinese stocks, and hedge funds. He also has some pointed advice for the managements of Microsoft (ticker: MSFT) and Pfizer (PFE).

Barron's: There's a lot of controversy about whether the Federal Reserve should stop raising short-term rates. If you were in Fed Chairman Ben Bernanke's shoes, what would you do?

Rosenberg: If the Fed were to merely raise short-term interest rates significantly right now, we actually would lower long-term interest rates. Let me back up a little bit. One of the problems that the Fed and the central banks around the world have is that they are trying a new experiment of transparency. And I think that this explosion of transparency forestalls where the real rate of interest ought to be today. If we had less transparent central banks both here and overseas, people who trade interest-rate securities and other things would have more of a fear factor. They couldn't prepare for each interest-rate move. That would thwart people's ability to speculate.

What kind of speculation do you see?

We have significant speculation. We've gone from equities in the late 'Nineties to housing and now, of course, the most rampant speculation is taking place in commodities: There's an estimated \$120 billion to \$140 billion invested in commodity funds by institutions, including \$40 billion at hedge funds. This compares to \$6 billion in 1999. One of the Street firms did a study that showed a record 35% price spread between commodities that had a listed futures contract and therefore were investable by hedge funds and commodities that didn't have a readily investable product. So in other words, much of the rise in the commodities that you see around the world today is a result of speculation on paper.

The metals have been focus of the commodity bull run. Do you think the move is overdone?

It's way overdone. I have all kinds of people telling me why this time is different. After all, we have to build up the infrastructure of India and China. Maybe copper will be at a significantly higher price five or 10 years from now. I don't know. But I do know that the sudden shift in the demand side is not a consequence of a sudden boom in China and India. More likely, it's caused by a bunch of hedge funds just piling in.

How about the bond market? You've been bearish on Treasuries since the market peaked in June 2003. Are you more constructive now that the 10-year Treasury yield has risen to over 5% from 3%?

I've been bearish until literally the last few days. I now take the position that there is a possibility of a meaningful rally in the bond market.

Are interest rates and commodities linked?

There is an interaction between the commodity market and the bond market. The best commodity to focus on is copper. That's why it has been called Dr. Copper, the best economist in the world. [Copper prices are up more than 50% this year, to \$3.75 a pound.] If in fact copper has put in a top, which I think it has, it would confirm that the bond market is looking attractive.

But is a 10-year Treasury yield of 5.15% enough to thwart a commodity rally or inflation?

It's certainly not a high yield, but it's a percentage point higher than it was as recently as last September. It's not just the Fed raising rates. Some of the most important central banks in the world are reducing liquidity in the market.

What about corporate bonds and emerging-market debt? Those markets have benefited as yield spreads have tightened relative to U.S. Treasuries?

Those two markets are incredibly overpriced. The narrowness of the spreads is another indication of the excess liquidity created by central banks around the world. Money is just reaching for home and it's reaching for yield. Somebody once said that more money has been lost reaching for yield than at the point of a gun. People have very short memories. They forget that in 2002, the corporate bond market was falling apart and spreads were much wider.

Emerging-market bonds yield -- what? -- two to three percentage points above U.S. Treasuries.

It depends on the country. But the idea that a country like Iraq could even float a bond at all is just an example of how insane the emerging-debt market has become. [Iraqi dollar-denominated bonds yield about 9%.

What about emerging-market equities?

Russia and China are doing very well, but I wouldn't go near any of their debt or equity securities. It's important to look beyond the quality of a balance sheet to the political progress in a country. Russia doesn't have a rule of law for the investor. The rule of law in Russia today is [Vladimir] Putin. Whatever he decides, that's the law. People come to my office trying to sell me Russian securities or telling me stories about real estate in St. Petersburg -- wonderful stories. But it's absurd, because Putin is the law. I'd rather have my money at risk in a court of law in this country, as much as I don't like the courts in this country.

How about China?

China has a wonderful economy that I think will keep growing. But there's no real transparency or corporate-governance rules there. I think the best way to invest in China is selling to the Chinese or purchasing cheap goods in China like Wal-Mart [WMT] does. A lot of people say that China will float its currency, which will raise the cost of goods produced there.

You don't think the Chinese currency will be revalued upward much against the dollar?

That's not going to happen for a long time, in my judgment. China will keep the cost of goods low, because they've got a great money machine going and they have a need to employ people. As long as they have to employ people, they are not going to worry about how they are losing money by owning U.S. government securities. China and Hong Kong together own almost a \$1 trillion of U.S. government securities and people keep telling me, "Aren't the Chinese worried that they are going to lose money in their holdings of Treasuries?" My answer is that they are worried, but there is nothing they are going to do about it because they have a much more important problem, which is to keep people in China employed.

What do you think about the U.S. stock market?

If you had asked me the same question in the year 2000, I would have said the Nasdaq and Standard & Poor's 500 are insane. However, we were finding good values, and we did invest a great deal in small- and mid-cap companies. Two areas that we invested in early in this decade, which today are the darlings of Wall Street, are fertilizer and coal stocks. I wouldn't go near them now. If anything they are a major Sell.

That was then. What about now?

We now have a situation where some of the largest companies, that were overvalued six years ago but have continued to grow earnings at 10% to 15% a year, are completely unloved on Wall Street. These companies are all household names. I never in a million years thought that I would be recommending stocks like Microsoft, Pfizer, Johnson & Johnson [JNJ] or Wal-Mart. These are some of the best values anywhere in the world.

If, for example, the U.S. is ever going to try to resolve its pension-liability problems, it's not going to happen by buying bonds at a 5% yield, even though I hear so much talk about this is where an impetus for buying bonds is going to come from. There is a much better chance that companies can meet unfunded liabilities by owning some of the best-quality growth stocks in the world today.

People have been saying for a while that these big stocks would outperform their smaller brethren, but they haven't.

I manage absolute-performance money. But if I were a relative-performance manager today, this would be a no-brainer for me. I'd love to run a large-cap portfolio, because these growth stocks are cheaper relative to the overall market than at any time in my experience on Wall Street.

Microsoft has been a disappointment to investors for many years. Will anything change that?

Let me say that there are numerous stocks that are similar to Microsoft, where the opportunities within the companies are immense. The managements are still living in some sort of a past world that doesn't reflect today's reality. However, we live in an era of activism. Managements who in prior periods might have gotten away with things aren't going to get away with it today.

What about Microsoft?

A few weeks ago, Microsoft announced that it was going to increase spending in its next fiscal year by \$2.4 billion above what analysts thought. The stock fell 15%, and I think a lot of the decline resulted from frustration among analysts who have lived through so many years of sideways movement. That \$2.4 billion is equal to about two months of free cash flow, and the market knocked \$40 billion off the value of the company. Now that's insane, and it offers a wonderful opportunity for people who want to buy the stock.

What should Bill Gates and CEO Ballmer be doing?

Management's response should have been: "Great! Wall Street is insane. Since we have \$35 billion of cash on our balance sheet and no debt, why don't we announce an immediate tender offer for two billion shares of stock." That would cost about \$50 billion

That's almost 20% of the stock.

If Microsoft believes that the extra spending will result in better earnings down the road, they should be buying back a lot of stock. I think Steve Ballmer spends too much of his time on the operational side and not enough time on the financial side. He unfortunately shuts himself off from the financial community. He only meets with the financial community once a year. Since I can't tell him in a private forum, I might as well tell him in a public forum. If Microsoft reduced its share count by 20%, it still wouldn't be a terribly leveraged company. Now having said that, even if Microsoft doesn't buy back a lot of stock, the shares are still attractive because if you project forward, Microsoft probably sells at 10 times its free cash flow in 2011.

At 23, Microsoft is at 16 times earnings.

That's about right. Microsoft is expected to earn about \$1.40 per share for the fiscal year ending in June of '07. When you look at that multiple, you should really take out the \$3 to \$4 a share of cash. However, if do that, you should subtract from earnings the 5% interest rate on that cash.

Microsoft also owns a hundred million shares of Comcast [CMCSA]. It's a wonderful company, and we own it. But the Comcast investment isn't serving any corporate purpose I'm aware of.

I just read on Bloomberg that Microsoft is adding employee perks like a free towel service and increasing its employee stock awards by 15% to help raise morale that has been depressed by the weak share price. This is another example of how Ballmer doesn't understand the financial markets. What he should do is announce an immediate tender for the stock, which would help both employee shareholders and outside investors. Ballmer is hurting employees because the added dilution caused by these awards is depressing the stock. If this continues, the employees are going to need those towels to cry into.

Let's talk about Pfizer.

Pfizer is another example of a company with loads of cash flow and loads of low-hanging fruit but a very obstinate CEO, Hank McKinnell.

I've yet to meet anybody [inside or outside] the analytic community that has dealt with him that doesn't describe him as being incredibly arrogant and unwilling to listen. He

certainly hasn't listened to the Wall Street community, and I'm not talking about just listening to a bunch of analysts. I'm talking about listening to people who are not short-term holders on the buy side of the business. I have spoken to some of the largest shareholders of Pfizer.

Pfizer stock is around 24, with about \$2 a share in annual profits. It has a price-earnings multiple of just 12. What ought management be doing?

Several things. Number one: Pfizer has a cost-reduction program that aims to save \$4 billion annually by 2008. Pfizer could do much more. They have 35,000 salespeople calling on doctors. That probably costs them \$7 billion a year. Now I don't know where they came up with the idea of 35,000 as the right number, because if in fact every one of those salespeople is effective, then why not have a 100,000 salespeople? Pfizer ought to cut its sales force. What's wrong with 25,000 salespeople?

Look at Pfizer's annual research spending, which is \$7.8 billion a year. I don't think Pfizer is earning an adequate return on that investment.

Should Pfizer cut R&D spending?

Yes. Pfizer has a great balance sheet. It ought to announce a tender offer for \$10 billion of stock. My message to CEOs of companies like Pfizer and Microsoft is that you have to be cognizant not only of what you are doing operationally, but also financially. The market very often affords opportunities to buy back stock and to sell stock. I'm speaking from the vantage point of someone who works for a public company. I see how a public corporation functions internally and at different points in the life cycle of a company, you have to do different things.

One of the best managers in the drug industry, Fred Hassan of Schering-Plough [SGP], works for a company with operational problems. Hassan has had to deal with difficult times. One of the problems with McKinnell is he's never had to deal with a difficult time.

One way to participate in the depressed drug industry is to own the Pharmaceutical Holdrs. The ticker is PPH.

PPH is a basket of drug stocks.

About 40% of PPH is in two stocks: Pfizer and Johnson & Johnson. Now Johnson & Johnson is an extremely well-run company, both operationally and financially.

It's also out of favor right now.

I think J&J is a very attractive company. It's having some problems now with its pharmaceutical business. But I think that the management there is much more competent than Pfizer's, and I think J&J will get it right eventually.

There's \$1 trillion in hedge-fund assets. Are returns destined to fall?

We started investing in hedge funds in 1991 at Loews and also at CNA, long before hedge funds became a very popular vehicle. I would say to you today it's very difficult to find any hedge fund that's worth investing in, and if you do find one, they're probably not going to take your money.

They are closed to new investors?

Right. We've invested with some outstanding managers. But many of them aren't taking money. There are two categories of hedge funds today, those where the managers' interests are closely aligned with those of the limited partners and those hedge funds where their interests are not aligned with investors. There are hedge funds that are essentially just trying to pile on assets. And who can blame them? If they are going to get a 2% base fee annually even if they don't outperform, it's a terrific business. I don't know of any other business in the world that is so remunerative. So if you have a \$10 billion hedge fund and you are getting 2%, forgetting performance, you are collecting \$200 million a year. That's a terrific business even if you have to spend \$50 million or \$100 million a year on support staff. That still leaves \$100 million for the general partner, not to mention a percentage of the profits, if they do even marginally well.

Building assets is not in the interests of the investor because the more assets under management, the poorer will be the performance. On the other hand, there are hedge funds that constantly try to shrink their size and don't want to take new money. In these situations, the general partner may already own a major percentage of the hedge fund and simply wants to keep performing well because his own capital is at risk along with the investors.

Can you give us an example of that?

One that we've held for the last 11 years and is outstanding is Appaloosa, but it's not taking any new money.

That's David Tepper's fund.

Tepper is an example of a hedge-fund manager whose interest is certainly aligned with his investors. He represents very probably a significant portion of all the invested capital in the fund. Eddie Lampert's hedge fund is another example where the investors' interests are aligned with the manager's. Loews is not invested with him, but I have tremendous admiration for what he's done and continues to do. When he gets involved in a business, it usually does very well. Just look at the Kmart's resurgence and Sears.

How much longer do you intend to work for Loews?

Until they throw me out.

You've liked working for Jim Tisch?

I've been very happy working for him. I've been in the business for 45 years, of which the last 33 were at Loews. As long as Loews wants me around, I'll hang around.

Thanks. Joe.