Interview with Mr. John Mauldin

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About John Mauldin: John Mauldin is the author of the NY Times top ten best-selling investment book, "Bull's Eye Investing" and the President of Millennium Wave Investments, an investment advisory firm based in Fort Worth Texas but which is registered in many states. John Mauldin is regarded as a leading thinker of the most complex financial and economic issues of our day – and regularly appears on many television and radio shows, including CNBC. In addition, he is the author of the popular financial e-letter "Thoughts from the Front Line" (which has an audience of over one million subscribers) and regularly speaks to or hosts seminars for pension funds, high net worth individuals and large groups of average investors. Readers can subscribe to his weekly e-letter for free at www.frontlinethoughts.com.

In his best-selling book, "Bulls Eye Investing," John Mauldin makes a case (and presents a significant amount of evidence and stock market history) for why we are currently still in a secular bear market, what we can expect, and what the average investor can do to successfully navigate the volatile times ahead of us. He candidly challenges the notion of buy-and-hold and presents a very compelling case for how average and accredited investors alike can outperform the market (and preserve their capital) during these years. The purpose of this interview was to seek some clarifications on the various topics covered in his book and to try to get to know more about John's personal and investment background. This interview was conducted with John Mauldin on Friday, October 8, 2004 at the Westin Oaks Hotel at the Galleria in Houston.

Your detailed and breadth of knowledge about economic trends and financial history is simply amazing. Did you always have an interest in studying the financial markets and economic trends? What first peaked your interest in the field of investments?

I took economics when I was an undergraduate student at Rice University but what really triggered my interest was when I started working with an investment publisher in 1982. While doing marketing for them I became a part-owner of the business and started really reading once again economic history and investment newsletters. I have always been a big reader and obsessed with learning things. Sometime in the mid 1980s, I realized that there was more money in managing money than writing about it. So I went to the investment business and formed a firm with another friend.

Why did you decide to focus on studying economic trends and writing about the financial markets as opposed to trading the markets? It seems that you will be very successful no matter what you choose to do in the investment field.

Early on I realized that I am really a better judge of money managers than I am a trader. It is similar to our college experience at Rice when we both found out the other guys were smarter and doing better than we were.

[Editor's note: Prior to our interview, John Mauldin found out that I also attended Rice University and studied economics (I double-majored in economics and pure mathematics) during the time that I was an undergraduate student there. We subsequently had a conversation where we joked about how we had to change our major to economics once we found out that most of our peers were smarter than us in the pure science fields. John initially wanted to study one of the pure sciences while I had bigger ambitions in the field of pure mathematics.]

There are better traders out there than I am and both my clients and I are better off trying to access these traders instead. This enables my clients to make more money – and the way our business model works, those other traders and managers will pay me a portion of their fees. This model has worked out well for me.

So you get to do what you like to do instead of trading?

Yes, I much prefer reading and doing research and meeting managers and talking. I much prefer doing that than actually sitting in front of the computer screen and doing the actual trading.

My impression is that a lot of people who trade – individual or daytraders – they don't really take the time to learn about themselves or their own psychology to see if they really make good traders or not.

Yes, you are absolutely right.

[Editor's note: At this point, I am reminded of the interview by Jack Schwager with Ed Seykota in his original "Market Wizards" book. During that interview, Ed Seykota mentioned that "Win or lose, everybody gets what they want out of the stock market. Some people seem to like to lose, so they win by losing money." I believe that some traders trade because of the excitement. Some traders always want to be proven right – especially if they are into fundamental analysis – which could be a devastating hindrance on one's performance. Ed Seykota further mentioned that he has "worked with a number of traders in order to examine their priorities and align their goals … The traders usually either (1) get much more successful, or (2) realize they didn't really want to be traders in the first place." I think Ed Seykota has a very important point – and that every trader should study his/her own psychology and priorities before he/she starts committing time and money into trading.]

No doubt the investment industry is one of the toughest industries to succeed in – could you tell me some of the specific obstacles (physical and psychological) that you had to overcome before you succeeded in this industry?

I cannot really pinpoint what it is that makes one successful in this industry – part of it is that you just need to be tenacious and keep at it. Part of it is the style of management that I tend to do. I am not committed to one style of management. I am flexible to change – this gives me the flexibility to move and it gives me a lot of room to take my clients along with me. For example, if you are only focused on long-only mutual funds, when they go out of favor you are in trouble. On the contrary, I am flexible. I get to fire managers if they or their style goes out of favor and this gives me an advantage. And this style of management is easier on me as well.

How much of that is being able to predict longer-term trends? Most people don't have that gift, even though they may like to do what you have been doing.

I am not certain that I have the gift. I have been lucky over the last four years in that most of my calls have been right on the long-term trends. A lot of what I do is to read and try to take a lot of opinions in. There is really a couple of different ways to come to a conclusion. One is data driven. You get a lot of data and extrapolate that data – your research becomes data-driven and thus your conclusions are also data-driven. But then you are limited to the data you have. Or you can take the same research and pull inferences – and I probably pull more inferences than I do rely on data alone. At the end of the day, when you are beginning to pull inferences out – your jobs is to say what it feels like – what patterns can we see that the data is talking to us about that may not be a logical extension of that data? Why is it, for instance, that the data is telling us that the dollar should be falling out of bed but it is not? There are other things obviously happening – what can we infer? A lot of it is just reading a lot of materials and letting it bubble up – what comes to your mind?

Given your hectic travel schedule and your many responsibilities, how have you been able to juggle between your family, your work, and your charitable activities?

Very poorly. It is always a struggle.

I bet. You have seven children?

Yes, five of them are basically out of the house now. There is less demand and we get together a lot. As for travel schedule, it varies – some years it is not hectic, some years it is crazy. It runs in circles. This year it has been crazy. As for next year, I am sure things will come along but as of right now, I actually don't have one trip or one conference scheduled. This will change as things come closer but I currently have one speaking engagement in December and then nothing after that. That may be the universe telling me to go back and start writing my next book – well, I do have to go to Europe a few times but I am actually hoping that my travel schedule will be less hectic.

I am now going to ask you for some clarifications about various things that you mentioned in your book, "Bull's Eye Investing." In the chapter "Pension Fund Problems in Your Background," you informed us that pension funding problems are very widespread – across both the private and public sectors – and that ultimately more traditional defined benefits plans may be replaced by defined contributions plans (e.g. 401(k) plans). I am a pension consultant and I can tell you that I don't know of anyone who has a clear vision of where DB plans are heading. The "pendulum" has certainly been swinging in the favor of DC plans, but if the stock market continues to underperform in the next ten years (as outlined in your book), do you see employees demanding a return of traditional DB plans at certain companies (which would promise them a "defined" amount at retirement) – especially at newer companies that have been doing well in our current economy?

No, I don't see it. They may want it but it ain't going to happen. Because what happened over the last few years is that companies have seen how much of a hole they can end up digging themselves into.

[Editor's note: The severe underfunding situation in the defined benefits pension plans of General Motors, Ford, and the airlines over the last few years are prime examples.]

I think you will get a continuation of the trend we are seeing now. Companies will continue to convert their defined benefits plan to defined contribution plans – especially with people living longer and the continued rise in medical benefits. And this trend will only continue, because there is always more potential medicine that we could buy – so people will buy more. That is why healthcare costs will continue to grow – not because current medicine or procedures will cost more but because there will be more procedures and stuff we can do to improve our standards of living.

In the chapter "King Dollar and the Guillotine," you mentioned that the dollar is artificially high and that a drop of 20% to 30% is in order over the coming years. You also mentioned that "the dollar dropping 20% to 30% is not the end of the word" and brought up the fact that the American economy had real growth even as the dollar also dropped by more than one-third during the 1980s to early 1990s. If there is ever a wildcard, however, it is (I believe) the current account deficit of over 6% – this huge imbalance – at the end of the day, do you see a possibility of a swift decline in the dollar as foreigners scramble to get out of dollar assets once the dollar starts declining (similar to what happened to certain countries during the 1997 Asian Crisis)?

Sure there could be the possibility of a swift decline. If by swift you mean six months to one year? Currency declines typically happen in spits and spurts. We have seen significant drops compared to the euro, etc. And it will drop again. The lynch pin here is really China.

[Editor's note: As of August 2004, the Bank of Japan and Bank of China has accumulated holdings of U.S. Treasuries of $722 billion and $172 billion, respectively – in an obvious attempt to put a lid on the value of the Japanese yen and the Chinese renminbi. Foreigners now hold $1.839 trillion of the US$3.84 trillion in marketable US Treasury securities.]

How about a decline similar to the decline of the Thai Baht during the 1997 Asia Crisis? Given that the U.S. dollar is the world's reserve currency, this is probably not a huge

possibility but do you see this potentially happening here – especially if the Chinese and the Japanese start selling their bond holdings in the bond markets?

The Chinese and the Japanese do not want to create a major problem for the U.S. That is not good for their own economies. I believe we are going to transition from a U.S.-centric economy to a world economy where it is more balanced – where the Asian countries have more consumers in their own countries and where they will import less foodstuffs from the rest of the world, if you will.

In the same chapter, you mentioned that Japan would have a very difficult time trying to achieve sustainable growth going forward (e.g. page 172), despite its high savings rate. The Japanese people have also resisted reforms for over a decade. In your opinion, what can the Japanese do to rectify this situation? Can the Japanese again become the world economic power that they once were?

Changing a national culture is something that I do not have any idea about. What will happen is that change will be forced on them. That's how most human beings deal with change – in that they let themselves be forced into change as opposed to willingly say "Me! I will take change."

Similar to what we are witnessing in demographic trends across the world?

Yes, that is going to force things to change – it will force us to do things that we would not be happy about, but that is just the way how things are going to be.

[Editor's note: Please read my August 29, 2004 "Special Report: Economic Survival in the 21st Century" in order to get a basic understanding of the demographic issues that we will have to deal with over the next few decades.]

Throughout your book, you mentioned that the average investor has historically underperformed the average mutual fund, which in turn has historically underperformed the market. You stated that there is a variety of reasons for this, but most of these reasons are due to character traits that are inherent in our genes – traits such as overconfidence, overoptimism, and the illusion of knowledge. If you were allowed to give an individual investor only one piece of advice for successfully navigating this secular bear market (or markets in general), what one piece of advice would that be?

During a secular bear market, the person who loses the least wins. Stay out of the market. Go do something else.

A Richard Russell quote?

Yes. Actually, I think he may have gotten the quote from someone else. I think it may have been a quote originally from Gary North.

Obviously, you have consulted with quite a number of hedge fund managers and fund of funds managers during your career. The growth in the hedge fund universe has just been astounding. In the chapter "Hedge Funds 101: The Basics," you mentioned that today, there are approximately 8,000 hedge funds managing over $700 billion, and that number is "growing rapidly." I have heard various people state that the hedge fund world has grown "too big" and because of this, most hedge fund managers will underperform the market going forward. What is your opinion on this? Is it just matter of the belief that there are not enough smart investors or traders in this world or will hedge funds continue to grow simply because of the variety of strategies available to them that are not available to traditional mutual funds?

I think mutual funds have a place but they are not the growth sector that hedge funds are. In the

1980s there were all these Cassandras running around talking about the end of the world because that there were too many mutual funds – more mutual funds than stocks. They cited this as clear evidence of a bubble and a problem – which is the same argument of a bubble in hedge funds today – that there are too many of them and this can't be good. Well, we now have more mutual funds than we have back then and this hasn't seemed to bother anybody.

You can have too many hedge fund managers chasing too small an amount of alpha – and certainly some people are suggesting this today and there is some reasonableness in that. But also another reason of the flat or sideways return in the hedge fund world this year is that the bond market, stock market, the dollar – everything has gone sideways. Everybody is getting whipsawed. It is a tough environment. Where are the opportunities? Will all this stop and will there be opportunities in the end? Yes. Each of these markets that I just mentioned has all had these flat periods before. It is just these are all happening at once right now and they are happening to everybody. There are no trends anywhere, other than the recent trend in crude oil.

This is just a general question but quite a number of experts in recent years have stated that the United States is already past her era of supremacy (including none other than George Soros) and that other countries are set to take over the world leadership role in the 21st century. Two countries that immediately come to mind are China and India. What is your opinion on this? Do you see these claims as valid (similar to the British experience in the 20th century) or do you see these claims as unfounded – similar to the claims of the inevitability of Japanese supremacy in the late 1980s?

China and India will not take over world supremacy or leadership until they have fundamentally changed their nature of their national economic organization. To overtake the United States, you have to have a true free market economy. One of the reasons that we have outperformed the rest of the world over time is that we have been willing to change. We certainly don't know what the next new thing is right now, but my answer to that is that there will be one. Somebody in his garage; somewhere is creating the next new thing. And it will ripple through the country, become a tidal wave and it will spur new growth in the economy. The next new thing may be something developed in China or India. If there was a change from when I was young to today, it is that I am less nationalistic than I was. Part of me is encouraging China and India to become more free market and unleash their entrepreneurs. I want them to develop new products and services. I want them to develop new drugs. I want them to figure out ways to make my life better. If their lives get better relative to mine, then so what? They have made my life better and they should profit from it. We don't sit here and fight because Alabama is getting jobs that should have been California's. Anybody in America will think this is silly. But all of a sudden if the jobs go to Mexico, then it creates an uproar – as if we have a divine right to our existing jobs. A free market economy dictates that you have a right to something if you produce, and only if you can do it better than the next guy at a good price.

I agree. I believe a classic example is the most recent issue of outsourcing or "offshoring" – which is basically just a logical extension of this 100 year-old trend of shifting obsolete industries or jobs overseas.

The data clearly shows that more people outsource to America than we outsource out. If the world stops outsourcing today, then America would be the net loser. More of our jobs are dependent on people outsourcing to us – to our specialties. I would highly recommend reading Andy Kessler's book "Running Money" if you want to gain a good insight on the historical trend of "off-shoring" and on the modern American economy – it is also a very important book to read if you are managing money.

In one of the chapters in your book, you mentioned that none of the popular technical analysis tools have consistently outperformed the stock market over the years – and that the only proven methods to outperform the market have been buying values or trend-following. My own impression (although I have not done any exhaustive research) is that some methods out there do work, such as the Dow Theory, IBD's CANSLIM method, and the intermediate buy or sell signals from Lowry's reports. Have you seen any research on these

methods and if so, do you regard them as a subgroup of trend-following systems?

What makes a technical trading system work is that it has risk-management. All technical trading systems will work if they have good risk management and if you have the discipline to sell your losers and let your winners ride. So if you manage to catch the trend, it works. There are people that can look at different signals in different markets and they can read it – and they are drawing inferences and it makes sense to them. But most people looking at the same data can't do it.

So a lot of it is an art form?

Yes, if some technical trading system was proven to work and everybody realizes it, then the next day it would stop working.

Finally, a lot of my readers are very interested in investing in precious metals such as gold or platinum. Given the loose monetary policies of the United States in the late 1990s and today (and the fact you think the dollar will continue to decline) do you see gold following an upward path similar to the experience of the 1970s after the Breton Woods System collapsed? Is there a chance that we will swing back to the era of a fixed exchange rate system at some point in time?

I am bullish on gold over time but I don't know if we will experience something similar to the 1970s blow-off in gold to over $800 an ounce. But as long as I am bearish on the dollar *[John is still long-term bearish on the U.S. dollar as we are publishing this interview]*, I will be bullish on gold. However, gold won't be in a real bull market until the gold starts breaking out against all the paper currencies. If you are in Europe, you are not seeing a gold run – maybe a little bit of it recently but not much.

Thank you for your time, John.

Sure. These have all been very good questions.