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An Interview With Rebecca Patterson, Chief Investment Officer, Bessemer Trust

Still Bullish, After All These Years

by Lawrence C. Strauss

Rebecca Patterson's early career path was atypical for someone in investment management. A journalism major in college, Patterson worked as a reporter for several Florida newspapers. By the mid-1990s, having earned a master's degree in international relations from Johns Hopkins University, she was writing for Dow Jones Newswires in Europe. "Processing things quickly, separating news from noise, and understanding the context" were some of the skills she developed, recalls Patterson, who covered politics, economics, and markets. She left journalism in the late 1990s to join JPMorgan as a currency analyst. She eventually became chief markets strategist at JPMorgan Asset Management.

Three years ago, Patterson, now 47, became chief investment officer at Bessemer Trust, a wealth manager founded in 1907 that manages $57 billion in assets and focuses on ultrawealthy clients. From August 2012 through June 30, the firm's balanced growth allocation model, which puts 70% into stocks and 30% into bonds, had an annualized return of 9.4%, versus 8% for its benchmark, a blend of the S&P Global Broad Market Index (65%), the BofA Merrill Lynch 1-10 Year AAA-A U.S. Corporate & Government Index (32%), and the Bloomberg Commodity Index (3%).

Barron's spoke with Patterson recently at her office in Rockefeller Center in New York.

Barron's: **How healthy is the U.S. economy?**

Patterson: We are in the later stages of the expansion, but we are still clearly in the expansion. In an expansion, especially when we get to the later stages and the Federal Reserve starts to tighten, certain things are more likely than not to work, and that's where you want to focus. We've been long the U.S. dollar for a couple of years, a theme that plays into expected tightening by the Fed versus other central banks. We have recently gone overweight U.S. banks, which would benefit from higher interest rates. That's also a play on the improving consumer and lending backdrop. And we are underweight fixed income, where we don't see much value.

How long do you expect this expansion to last?

Patterson: In modern times, the longest U.S. expansion lasted 10 years; the average is somewhere between six and eight years. We're in year six now, so statistically we are getting closer to the next recession. History tells us that either heading into a recession, or during the recession, is when you are most likely to get a sustained equity downturn. But we're not there yet. How long can this expansion last? It's likely to be a longer expansion. It's not going to be a typical one, partly as a result of the very deep 2008-09 crisis and the slow recovery, and partly due to a lack of inflation pressure. We pay very close attention to wages, which inform us a lot about broader inflation trends, which in turn will impact the Fed. These trends are also going to tell us a lot about corporate profit margins, and both of those factors -- wages and corporate profit margins – will influence our view on when to start paring back equities.

What does the trucking industry, which you wrote about in a recent letter to clients, tell you about the economy?

Patterson: Trucking is one of the best leading indicators on the consumer. Trucking volumes for retail-related trucks, also known as truckload carriers, tend to lead retail sales in the U.S. by a couple of months. Everything we buy at some point touches a truck. People talk about the Dow transports and how rail isn't doing well right now. Well, that's one piece of the economy – that's industrial and manufacturing, and a lot of it is tied to the oil selloff last year and the ripple effects we're still feeling from that. But consumption is a much bigger part of the U.S. economy. When you look at the appropriate part of the Dow transports, it tells you that

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the sector of trucking tied to retail goods is actually doing pretty well.

Why are you overweighting stocks, considering the walls of worry out there?

Patterson: Walls of worry are one of the reasons I still like stocks. People are so worried that they don't own them. It is not a crowded market. That doesn't mean you can't have a sustained selloff, but it is harder to get a sustained selloff when not everyone is in the trade to begin with. Since the end of the financial crisis in 2009, roughly two-thirds of mutual fund flows has gone into fixed income and only a third into equities. Since the beginning of this year, U.S. equity mutual funds have had net outflows approaching $40 billion. In addition, the world is still awash in money. Even if the Fed starts to hike rates, it is going to be very slow and gradual, and at the same time the European Central Bank will grow its balance sheet to over three trillion euros [$3.3 trillion] by late next year. Similarly, the Bank of Japan is aggressively doing quantitative easing, and it's likely to do even more.

What else gives you confidence in stocks?

Patterson: A lot of investors get nervous that we are near all-time highs. But to me, the index level isn't as important as the valuation underneath it. U.S. stocks are slightly above their historical averages. A lot of people are comparing today to 1999 and 2000. In March 2000, if you looked at the five companies with the largest market caps in the Standard & Poor's 500, the average forward price/earnings ratio was around 60, compared with about 15 recently. It's not a top-heavy market. As for the macro economic backdrop, we're still in the expansion mode, and central banks are aggressively adding liquidity. We are getting near the end of the expansion, but if we see another one, two, or three years of positive equity returns, why would I go to cash now? It is a big opportunity cost, and why would I want to have a lot of bonds, especially U.S. bonds, when the Fed is starting to hike? Bonds have been a great source of return for the past 30 to 35 years. People don't remember what it feels like to lose principal in fixed income, though we got a hint of that this spring when rates rose. But I expect there is more of that to come.

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Why are you underweighting emerging markets?

Patterson: You can't paint emerging markets with one brush, because there are a lot of different stories within regions and countries. We expect China to manage its growth slowdown this year, and we aren't worried about an imminent growth implosion there. But because China's growth is moderating, it is a modest head wind for some of the commodity-exporting emerging markets like Brazil or Chile. Also, the stronger dollar and rising interest rates are broad external head winds for emerging markets, especially for those countries with large current-account deficits. The strong dollar, along with the weak local emerging-market currency, fuel inflation. The central bank must tighten to limit inflation, so the country doesn't have strong growth. At the same time, higher rates raise borrowing costs, which weigh on growth expectations even more. That makes people nervous about the corporate outlook. All of which leads to capital outflows, further weighing on growth and weakening the local currency even more. Brazil is fighting to get out of a recession, and yet it continues to raise interest rates, now about 14%, and probably will raise rates again. At a certain point, emerging markets will offer a great opportunity. Valuations are getting more attractive in a lot of them, but you need to see a catalyst for growth, such as developed markets doing so well they boost trade and capital flows, the dollar weakening, or China improving enough to lift commodity prices. I don't see any of this in the short term.

Are your portfolio allocations tilted toward large-caps?

Patterson: Yes. Earlier this year, as we were starting to position ourselves for a Fed tightening cycle, we did two things. We reduced our bond allocation and moved that into specific credit sectors, especially floating-rate credit, such as non-agency mortgage-backed securities. We also reduced our small- and mid-cap exposure and put it in large-cap stocks. In retrospect, with the big dollar move in the first quarter, we were premature, because it hurt large companies more than domestically oriented small-caps. But I'm still happy we made that move. When the Fed tightening cycle starts, we are going to get more market volatility. And because they are more liquid, larger companies tend to manage through volatile periods better than small ones do. Second, as we get later in this economic cycle, we are starting to see profit margins challenged. I wouldn't say they are falling yet, but they are getting more challenged, more so in small- and mid-cap companies than in large-cap names.

Why are you overweighting banks?

Patterson: Some of this is getting priced into the market, but not fully. The Fed tightening cycle is certainly going to help net-interest margins for a range of banks. This is a sweet spot for these banks. Their net-interest margins will improve, but at the same time, interest rates haven't risen far enough to hurt the consumer or businesses in terms of borrowing costs. In fact, at this point in the cycle, with more jobs being created and companies doing a bit better, we expect to see more lending. And when the first rate hike occurs, people who were on the fence about doing a merger or acquisition, or buying a home, will say, "Borrowing costs are going up; I better lock this in." It's been a very robust M&A year so far, helping banks, and I expect that to continue. A Fed hike might even be a catalyst for more M&A. A name one of our portfolio managers likes is KeyCorp [ticker: KEY], a large regional bank, for the reasons I've mentioned and because the company has a very good handle on controlling costs.

What's another example of a promising financial stock?

Patterson: Our portfolio managers like MasterCard [MA]. As consumer confidence and retail sales improve, payment transactions will increase, benefiting MasterCard. In the shorter term, we like MasterCard as a play on the improving U.S. consumer; longer term, we also see some support for the stock from more noncash transactions globally, particularly in emerging economies.

What's your assessment of the energy sector?

Patterson: We've been underweight energy for about a year and a half. Forecasting the price of oil is one of the hardest things to do in the financial markets. To me, it says something that the International Monetary Fund and the Fed, with all of the economists they have, don't try to forecast it. They just use the futures' curve. If they can't forecast it, how can I? The U.S. has cut rigs, but production hasn't rolled over yet, and the Saudi Arabian supply has continued to ratchet higher. We have question marks over new Iranian supply, so the supply overhang made us reluctant to trim our underweighting significantly. At some point, we will increase our weighting. In the meantime, to protect our portfolios, we have exposure to companies that would benefit if oil prices rise faster than we expect. One example is Fluor [FLR], which has exposure to engineering, construction, and other segments.

Finally, how concerned are you about the Greek crisis?

Patterson: I am much more focused on the U.S. and China, the first and second biggest economies in the world, than on Greece. How they fare is much more important to my view on equities, or investing in general. Greece is dramatic and very sad from a humanitarian point of view, but more likely than not, it is just noise. If the U.S. consumer continues to do well, and if China can stabilize its equity market and stabilize its growth, those are much more important positives than Greece could be a negative.

Thanks, Rebecca.