

MARKET SNAPSHOT

	U.S.	EUROPE	ASIA
DOW	12,330.60	-87.83	-0.71%
S&P 500	1,266.59	-10.71	-0.84%
NASDAQ	2,642.86	-5.50	-0.21%

%	Nasdaq	2,642.86	-0.21%	Dow	12,330.60	-0.71%	S&P 500	1,266.59	-0.84%	FTSE 100	5,622.28	-0.81%	STOXX 50	2,313.33	-1.56%	DAX	6,088.27
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# 5 Questions for Ian Smith on 2012 Predictions

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By Ben Steverman - Dec 30, 2011 5:33 PM ET

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It was a year prognosticators would sooner forget.

Pimco's [Bill Gross](#) got the direction of [interest rates](#) wrong, while hedge fund billionaire [John Paulson](#) had the worst year of his career. Mutual fund investing stars of past years, such as Fairholme's [Bruce Berkowitz](#) and CGM's Ken Heebner, saw their portfolios fall to the bottom of the pack. Economists did no better. According to [Goldman Sachs](#), the consensus growth forecast for U.S. gross domestic product in the first three-quarters of 2011 was too optimistic by 1.6 percentage points, the widest miss in 14 years.

Ian W. Smith helps manage \$10 billion in assets for wealthy families at Silvercrest Asset Management Group, where he's a managing director. Bloomberg.com's Ben Steverman asked Smith how investors can put their money to work in a world that seems increasingly unpredictable. Edited excerpts of their conversation follow: 1. How much value do you place on predictions and forecasts?

We treat forecasts with a great deal of humility, given the level of volatility we've experienced over the past decade. The vast majority of managers have a very poor ability to call the market accurately over the short term. Very few people predicted the severity of 2008's downturn. Very few people predicted the trough in March 2009.

Even hedge fund managers, who are paid to be more tactical in nature, have not done a very good job this year. This summer, the market sold off sharply: 17 percent in about two weeks. Managers then became more defensive. Therefore, they locked in losses and have not participated in the subsequent recovery.

My belief is that trying to get in and out of the market over short periods of time is detrimental to long-term investors' returns. You need to get the timing of the sale correct. Then you have to



Enlarge image  
A trader works on the floor of the New York Stock on Dec. 30, 2011. Photographer: Jin Lee/Bloomberg



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Photograph courtesy of Ian Smith

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make a second decision correctly, which is when to get back in the market. In our experience, most investors get one or both of those decisions wrong.

2. What was it about 2011 that made it so tough, even for experienced managers?

Volatility, and the uncertainty that caused it. There is global liquidity risk, à la 2008, with many banks in the euro zone owning bonds of the distressed countries, such as Spain, Portugal, Ireland and Italy. There is the potential -- albeit a small one -- for a very bad outcome in both the equity and fixed-income markets. So investors are trying to price in that probability, along with the risk of the monetary authorities releasing a torrent of liquidity, causing a very sharp upward move in the market. If you're a hedge fund manager, you're trying to manage both of these very distinct outcomes.

3. Do you rely on forecasts or predictions when deciding how to invest clients' portfolios?

Let me concede that we do make predictions; however, we're not making any grand predictions. We're forecasting that GDP will grow at a modest pace, which we believe will help support stock prices. We are not making any tactical bets as a result of our forecast. We could have recession, and we could have even faster growth.

4. So how do you make investment decisions if you can't rely on forecasts?

We construct an asset allocation we believe is aligned with our investors' interests. A moderate risk investor might have 60 percent of his portfolio allocated to stocks or equivalents and 40 percent allocated to bond and equivalents.

We try to maintain those allocations through good periods as well as bad. In March 2009, at the trough of the market, it was a wonderful opportunity for investors to rebalance portfolios, because stocks had fallen so much in value. To reduce fixed-income exposure at that time was a very difficult thing to do, but investors who did it were richly rewarded.

We make a concerted effort to harvest gains from an asset class that has done exceedingly well and reinvest in an underperforming asset class. I think many investors have reacted to this volatility by selling equities and buying bonds. That is reflected in the mutual fund flows. We completely appreciate the discomfort, and we understand it. Retail mutual fund investors, however, have been selling an undervalued asset and buying an overvalued asset.

5. Why do you think bonds are overvalued, and what's your fixed-income strategy?

The statement that 'bonds are overvalued' is just factual. Yields are at 50-year lows. We don't see much value in 10-year Treasuries. With the 10-year bond yield at 2 percent and inflation running in excess of 3.5 percent, your return after inflation is negative.

There are other segments within fixed income and equivalents that do look appealing. There is some value in high-quality noninvestment-grade bonds. They provide yields well in excess of inflation, and we think investors are adequately compensated for the risk. Also, we can earn between 5 percent and 8 percent on higher-yielding municipal bonds, some of which are not investment grade.

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3/1 Year ARM	2.79%
1-Year ARM	2.78%
30 Year Jumbo	4.54%
15-Year Fixed Jumbo	3.83%
5/1-Year ARM Jumbo	3.16%

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