Interview: Jeff Mortimer, CIO of Charles Schwab Investment Management

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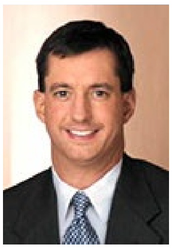
by Robert Huebscher



Jeff Mortimer is Senior Vice President and Chief Investment Officer—Charles Schwab Investment Management, Inc. (CSIM). Mortimer has overall responsibility for approximately $240 billion in Schwab Funds and managed accounts. He joined CSIM in October 1997. Jeff earned an MBA degree, with an emphasis in finance, from the University of Chicago Graduate School of Business, in 1992; and a BS degree from Babson College, in 1986. He is a Chartered Financial Analyst (CFA) and a member of the Security Analyst Society of San Francisco.

We spoke with Mortimer on September 14 at the Schwab Impact conference.

What is your assessment of valuations in the US equity markets?

I think the bottom made on March 9 is still not understood in its significance. The modeling that our group has done shows that it was as significant as the lows made in 1973-1974 and 1982.

During market cycles like 1973-1974 and 1982, investors were very slow to buy into the strength of the economy or the argument that things were not as bad as they thought. Now investors continue to sit on the sidelines. Flows in mutual funds are still going into fixed income investments. People are fighting the last war instead of the next one, and that is the unfortunate nature of investor behavior.

Markets have to typically double for investors to become emotionally engaged again. We all unfortunately chase performance.

Although I am not a raging bull, I am here to provide an understanding of the markets – that they are a discounting mechanism. People forget that the Dow is at 9,500 and not 14,000 any more. Yes, the economy is growing more slowly and we still have issues, but the market reflects that.

What are the key metrics you look at to assess whether the market is fairly valued?

PE numbers are one of them. Looking back historically, it would be very easy to buy when PEs were below a certain level or not buy too much when they were above a certain level, especially when they were at their frothy levels of the late 1990s. People look back and ask “how could they not have seen that coming?” But we don’t see extreme under- or overvaluation at today’s levels.

We look at cycles to see what types of stocks do best at market bottoms. We look to see what rallies best off market bottoms, and it’s always the junk. That has been the case with this rally.

In 2003 we were up 50% off the low and stocks like Intel doubled. You don’t have to look beyond the large caps or ex-large caps to find stocks that will perform well at this stage of the cycle.

What about the health of the US consumer? Can it still drive the economy or will a “new frugality” dampen consumer spending?

Our consumer is two-thirds of the economy with an amazing ability to spend. The deleveraging that has taken place across the American financial system is now taking place on our personal balance sheets. There will be a new frugality that comes out of this. People have changed.

The path of economic growth may have been steep in the past and maybe it will slow to around 2%. So perhaps you should look to incorporate faster growing asset classes like emerging markets into your asset allocation. It doesn’t overly concern me that consumer slows down and spends less. The market has already discounted that.

Maybe we are not going out to eat as often and businesses will compete for fewer dollars, but this is already reflected in prices and companies are adjusting to reduced levels of demand.

Do you anticipate difficulties for some industries – automobiles, financial services, and retail – digesting overcapacity?

It is not a focus of our research and perhaps going forward some industries will continue to struggle more than others.

I speak at a lot of client events. Often, a client will stand up and list an inventory of fears: deficits, taxation, overcapacity, lack of competitiveness, etc. I look at the other 250 people in the room and ask how many are not aware of those fears that this person very intelligently expressed? Any hands? Any surprises?

If those in the room understand these fears, then I have to believe they have already been priced into the market.

I believe markets are efficient, but I also believe that at market bottoms markets can be more emotional than rational.

I've heard this story before - you give up hope and sit on the sidelines. At this point in the cycle I believe the market is a glass that is more than half full and less than half empty.

What is your position in the inflation versus deflation debate?

Most investors are more fearful of inflation because they have never seen deflation and don't realize how close we are – or continue to be, in my opinion – to it. The government stepped in to avert deflation, which was a major force in the Great Depression. You have to fight the deflationary battle, and the Fed has done a good job at that by keeping interest rates near zero.

Have we averted deflation?

No, not at all. Perhaps we will have mild inflation, but it will not be the problem and could be controlled by appropriate policy.

The big issue to me is that the markets are functioning again. In addition to equities, I oversee our investing in money markets, indexed funds, and fixed income. These markets are all functioning more normally.

What is your assessment of the equity risk premium right now? Investment grade bonds are still trading at historically wide spreads. Do you see them as a better value than equities?

We see value now in both asset classes -- but there is also risk here. There has certainly been reward on the equity side, and there has been huge reward in high-yield bonds this year.

There is some relative value in the investment grade market and in our bond funds we are going after that.

But you are sitting on top of both these markets.

Yes and I worry that investors are playing it too safe. The opportunity cost has been and will continue to be substantial.

What are your greatest fears about equity valuations and the overall direction of the market?

If you're talking the US equity markets, I have the utmost faith the vibrancy and resilience of American industry. Don't sell it short. My greatest fear is that investors are not on board as this market moves higher.

What are the key variables that you will look at to see if the economy has turned the corner and the fundamentals are in place to really drive valuations?

Unemployment is the key variable. The most critical report is the labor report on the first Friday of every month. That is the one that can change the direction of the market.

It is a lagging indicator. Stock markets, on average, bottom 12 months before unemployment peaks.

But isn't this cycle a little unique? We are in a deleveraging-based recession and foreclosures and unemployment are feeding off of one another – hopefully not in an endless cycle – and it may be some time before both housing and unemployment stabilize. There is another wave of ARM resets about to come through.

Now it's prime borrowers that are facing the most severe resets. But many ARM loans will reset to very low levels, because short-term rates are so low. As resets happen at zero interest rates, it might be a minor issue but hopefully not a major issue.

It is different this time. Our economy has gone from a 25-year leverage binge and is now in a deleveraging stage, and we don't know what the ultimate effect will be on economic growth.

I don't rule out a jobless recovery. Unemployment could remain "stubbornly high" for quite some time as Geithner said in a recent town hall meeting. But that doesn't rule out a strong equity market. Unemployment will not fully recover until we get another industry that truly generates jobs.

What are the other variables you look at?

Inflation is the most important variable. Tell me what inflation will be and I will tell you what asset classes to be in.

The dollar has an amazing amount of information in it, and we have begun to see some weakness. Our group continues to monitor the strength of the dollar but at these levels we are not overly concerned.

All these things are a puzzle and the job of our team is to allocate dollars in this risk environment.