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On this week's Consuelo Mack WEALTHTRACK: small company stocks roar back! Will the rally last? An exclusive interview with a great small cap investor, Royce Special Equity Fund's Charlie Dreifus.

CHARLIE DREIFUS
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CONSUELO MACK: On this week's WEALTHTRACK, in an exclusive interview great investor Charlie Dreifus explains why he thinks the stock market is priced to perfection, and why we should be de-risking our portfolios. Royce special Equities funds' Charlie Dreifus is next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Are we in the midst of a small cap renaissance? Last year small company stocks had a stellar year and left their large cap brethren in the dust. The small cap benchmark, the Russell 2000 roared ahead more than 21% versus a 12% advance for the large cap S&P 500. As you can see from this chart showing the relative performance of the two, small company stocks had substantially underperformed large ones for a couple of years before racing ahead, a rally that really took off after the presidential election. Wall Street's thinking is that the Trump platform of regulatory roll backs, tax cuts and emphasis on American companies is especially favorable to small business.

This week's guest agrees with that analysis, but is concerned that the strong small cap rally has left the stocks priced to perfection. He is Charlie Dreifus, a noted value investor known for diving deep into the financial statements of the companies he invests in. He has run two mutual funds since their inception. He made his reputation with the Royce Special Equity Fund, a small cap fund for which he was named *Morningstar's* Domestic Stock Fund Manager of the year in 2008 and still carries its highest gold medal rating. Since inception the fund has beaten the market with far less than market risk. The fund was closed to new investors in 2012 because he couldn't find compelling values for new money coming in. He reopened it just last year. He was finding value in large cap stocks however, and at year end 2010 launched the Royce Special Equity Multi-Cap Fund to invest in them. This fund has underperformed its market benchmark with more than market risk. I will definitely ask him why! But first I wanted to know why he decided to reopen his flagship Royce Special Equity Fund after being closed to new investors for four years.

CHARLIE DREIFUS: In its life the fund had been closed six of its 18 years as of then. You close a fund when there's an issue about capacity, being able to find names, because if you don't find new names to invest, the cash builds and dilutes the progress the existing investors would benefit by.

CHARLIE DREIFUS: It's a matter of stewardship. We should always put the client first. Obviously many managers might keep a fund open because it's lucrative to the firm and the managers to do so, but not for the clients, the shareholders. So we opened it because I thought there may be a sell-off in the market, and historically investors have come to me and wanted to buy my fund during those periods of time because they know I'm opportunistic. I'll take advantage. I'll find good names and they'll make money in doing that. Now it's interesting because we opened the fund the very beginning of January of 2016, and the market did decline in January and early February, so I ...

CONSUELO MACK: It was February 16th I think was the low.

CHARLIE DREIFUS: Exactly. So I was able to find a lot of names. Interestingly enough, no one showed up to the party. We didn't get a lot of new investors. I did invest for my grandchildren in the fund then, so I know of two new investors, and then obviously as the year progressed the market went up, and there were fewer opportunities. Now, had I had a huge inflow of money last year, I would have been forced to shut it again because it's very difficult in this elevated market to find opportunities.

CONSUELO MACK: Charlie, as a matter of fact in 2016 your fund outperformed your benchmark by a huge margin. So how do you explain that outperformance?

CHARLIE DREIFUS: Well, fortunately it came about as the historical performance pattern of the fund has been in that the outperformance of the fund occurs because it defends well during adverse times. The 1,100 basis points or 11 percent of outperformance occurred entirely during the times when the market went down, and we went down either less or actually advanced during those periods of time.

CONSUELO MACK: Why is that? Why do you do better in down markets than the benchmark?

CHARLIE DREIFUS: It has to do with the whole methodology. I select securities that have in the parlance of Ben Graham, the granddaddy of security analysis, a margin of safety. I often describe it as margin of safety squared. My colleague, Steve McBoyle, and I look for companies that are absolutely inexpensive.

CONSUELO MACK: What does that mean, absolutely inexpensive?

CHARLIE DREIFUS: Well, as a business person you could buy the company in its entirety using modest earnings numbers, meaning no improvement to the current numbers. So many times when people buy things, they look to the future and they assume better. I don't assume better. I assume at best it's going to be as good as it's been the past 12 months and in fact, if I have a feeling that the next 12 months are worse, I will use a lower number. So if the return the investor earns in that calculation exceeds the financing cost, it has absolute value, and having run funds in this fashion for 37, 38 years, I've noticed that when the market loses its bearing as to what the proper valuation is, the absolute value kicks in, and absolute value translates into ultimately absolute return, particularly if you also stress besides the absolute value an insistence that it's a good company, that it has high return on invested capital. It's productive. In Warren Buffett's addition to Ben Graham's work, the idea of a moat, a niche, something unique to the company, and that coupled with the third ingredient, which is a stress of the company's accounting and governance, how accountable is management?

CONSUELO MACK: Charlie, explain to me what it means to have accountable management. What does that mean?

CHARLIE DREIFUS: Well, it takes various forms, Consuelo. It has to do with not only the veracity of the numbers. The numbers that the company reports should reflect economic reality. They really shouldn't embellish it, nor should they detract from it. It should be the actual results, and one can do a deep dive into the financials and see to what extent companies are taking shortcuts, advantages. And what we found is when companies act shareholder-friendly and honestly and ethically, it's pervasive. Unfortunately, the flip side is also pervasive.

CONSUELO MACK: Charlie, given kind of the high standards that you're setting in accounting alone (Laughs) for the companies that you're looking at, how hard is it to find companies that meet your standards?

CHARLIE DREIFUS: It's a great question, Consuelo. It is very hard to make it into our portfolios, we often use the term, although we haven't actually calculated it, but it appears that roughly one of the 15 companies we look at... now we screen a database for candidates. We decide what we're going to look at. Out of those that we look, perhaps one out of 15 ultimately get into the portfolio, because it has to have the attraction of the absolute value margin of safety. It has to have a high return on invested capital. It has to meet all of these governance and accounting standards, and then some other accounting metrics: free cash flow, low leverage, things like that. So it's very demanding. I like to refer to it as disciplined. Some people have said rigid, and I plead guilty to rigid. It works. I mean I've seen over many periods of time how that contributes to the defense of characteristic of the portfolio.

CONSUELO MACK: Why didn't it work in 2015? That was one of the exceptions in your long track record. It didn't work and you actually underperformed the market in a down market. What happened?

CHARLIE DREIFUS: Great question, and I am actually embarrassed, but I'm glad that you raised it, Consuelo. In 2015 indeed was the worst year of my career, not in the absolute number. I've managed to do worse than I did in 2015 in an absolute manner, but it was the only year in a down market, as you mentioned, that I declined more than the market. Now, 2015 had many factors that were somewhat unique. People were looking for dreams, for revenue growth. The economy and frankly this is what tilted I believe the election. The economy has been underperforming for such a long period of time that GDP growth was so tepid, which didn't allow revenue growth, and so there was a premium for companies that displayed strong revenue growth.

CONSUELO MACK: Absolutely.

CHARLIE DREIFUS: So that was biotech and then...

CONSUELO MACK: You don't buy companies like that.

CHARLIE DREIFUS: I don't buy because they're selling on expectations. Some don't even have any earnings let alone a modest amount of earnings. So 2015 was that on steroids in a sense it became known as the FANG stocks, F-A-N-G, Facebook, Amazon, Netflix and Google, and those four stocks accounted in the large cap indices for more than the entire advance. It was a very narrow market. Now what do those four stocks have in common? Rapid revenue growth, and people were striving, seeking, hungry for those kinds of companies. I don't invest in those kinds of companies, and everything else in the market basically did poorly.

CONSUELO MACK: How do you explain kind of the recovery, the resurgence, and the renaissance that's occurred in small cap stocks? Why is this happening now?

CHARLIE DREIFUS: Well, it has to do in part of the uniqueness, even pre-election, but certainly post-election, having to do with U.S.-centric businesses. There are a lot of concerns about what's going on let alone with our neighbors, but around the world. A lot of the tax talk in terms of the new administration, in terms of tax reform...

CONSUELO MACK: Tax cuts.

CHARLIE DREIFUS: ...tax cuts would benefit companies with high tax rates. The companies that have high tax rates are domestic. They haven't taken advantage of the lower offshore tax rates. Small caps benefit by that.

CONSUELO MACK: Also the rollback in regulations if that occurs, that's going to help the small businesses. All say my number one issue is regulation, over regulation.

CHARLIE DREIFUS: Regulation, Obamacare, all these kinds of things which had been highlighted by small companies as being headwinds become less so. To the extent that the U.S. economy improves, companies that are U.S.-centric, rather than multinational, benefit the most. So there's been a resurgence in small cap, although the entire market in 2016 was very broad and advanced.

CONSUELO MACK: Now what? As a value manger with the Special Equity Fund investing in small cap stocks, how do the values in small caps look at this point?

CHARLIE DREIFUS: Not too inviting.

CONSUELO MACK: They're expensive. Is that right?

CHARLIE DREIFUS: They're expensive. Valuations are high. Valuations were high going into the election already. Post the election the market has advanced. Record highs on the indices, and yet interest rates rose. So if you go back to my buying a company as a business, if I have to pay more for the business, I'm going to earn less as a return, and yet when I finance it, I'm going to have to pay more to borrow the money. So the market is even less attractive now than it was before the election. The market in my opinion is priced to perfection, so this can get resolved in my opinion two ways. Time. The market does nothing for a period of time, whether that's a year or two. If the market goes flat and in fact the economy improves, then earnings catch up to valuation. Valuations decline. Things become much more attractive. The other way that it corrects which is less pleasant is a big decline.

CONSUELO MACK: A big correction.

CHARLIE DREIFUS: A big correction, which could happen for any reason, a black swan reason, God forbid terrorism. All kinds of things can happen.

CONSUELO MACK: Therefore, what are you doing with the Special Equity Fund? How are you positioning it possibly expecting some sort of possible event?

CHARLIE DREIFUS: People give me the money in Special Equity to invest, so I don't market time. The cash is a residual, but having said that, the market influences the residual. If the names available to invest in, if I can't find anything to invest in and the names that I already have populated in the portfolio become more expensive, I sell the ones that are expensive, and I'm not replacing it with anything new. So cash as a percentage of the portfolio rises. So it's not a direct market call. It's not a macro market call, but it's a bottom up market call, which I think is even more important. When you can't find merchandise, if you have a discipline that has worked for many years and there are no new opportunities, don't force it. Don't do something that is not part of the discipline, because the discipline works over time.

CONSUELO MACK: Charlie, let me ask you about the Royce Special Equity Multi-Cap Fund. How do you view the values, opportunities in large cap stocks, in that space at this particular juncture?

CHARLIE DREIFUS: The large caps statistically are less expensive. It doesn't mean there are an enormous number of attractive names there either. That universe is also expensive. Valuations are high. There's no way of cutting it to say that the market is better than fairly-priced, no matter which category of U.S. equities you look at. So we continue to invest in the multi-cap space. The multi-cap fund has been in existence for six years. It has underperformed the index over the six years.

CONSUELO MACK: In that case it's the Russell 1000. It has, which is surprising given your track record. Also, I was reading the profile that Royce puts out about it. It says it's higher than market volatility. Well, what's going on here? (Laughs)

CHARLIE DREIFUS: Yeah. It has been a surprising event.

CONSUELO MACK: With your approach which is the same approach in looking at companies so carefully.

CHARLIE DREIFUS: Well, again because much of that time, particularly in large cap, was biotech and the FANG stocks. I didn't own those. So what I owned compared to the rest of the universe that did well tended to do much poorer and, therefore, had greater volatility. So what any fund, whether it's my fund or anyone else's fund, what you really have to judge a fund over is ideally a very long time period.

CONSUELO MACK: The other thing that you've done in the multi-cap fund is that you've invested in a number of the dividend aristocrats. These are large cap companies with long histories of paying dividends; a very hot area in this low-yield environment when everyone was stretching for yield. I just remember the one investment when you've been on the show the last couple of times. You can't recommend your own funds, so you recommended a couple of ETFs, a SPDR and a Vanguard that were investing in these consistent dividend payers. How does that space look now?

CHARLIE DREIFUS: They've gotten very expensive because these dividend aristocrats not only have paid dividends for very long periods of time, but they've increased.

CONSUELO MACK: Increased dividends every year.

CHARLIE DREIFUS: So in many cases dividend aristocrats generally are those who have done it more than 25 years, but we ones in this multi-cap that have done it for more than 50 years, and then we have the next generation I refer. If the dividend aristocrats are the kings and queens, then we're looking for the princes and princesses.

CONSUELO MACK: Princes and princesses. (Laughs)

CHARLIE DREIFUS: In terms of the next generation.

CONSUELO MACK: There is a next generation that you've identified?

CHARLIE DREIFUS: There is. I mean Apple is one of them. Microsoft, Cisco, all of the old, very expensive at one point in time technology stocks became much more mature. They are now becoming these dividend aristocrats. You buy an amalgamation of those kinds of securities, you don't know what you're going to get in ten years, but over those ten years, you're going to get rising income every year. And it's possible, likely even, that over ten years you'll get more than what you invested.

CONSUELO MACK: Therefore, what would you recommend today that we all own in a long-term diversified portfolio?

CHARLIE DREIFUS: Well, I'm going tilt the question if I may.

CONSUELO MACK: All right. You can try.

CHARLIE DREIFUS: I can try. (Laughter) So I do have a recommendation, but given the elevated level of the market, I think it's time for people to de-risk their portfolios. The first thing is whatever the individual's preferred asset class is, growth stocks, foreign stocks: they should seek out funds, portfolios that have a defensive characteristic that have a good downside capture ratio, a favorable downside where it shows. If you're going to be in this asset class, try to be in something that is less risky, because I think there's a high probability we're going to see a decline of some magnitude at some point. The other thing, when you say to people, "Well, it's time to de-risk a bit," they say, "Well, I don't want to sell anything because I'd have to pay a lot in taxes." Then so I say to them, "Well, do you have a 401(k) or something like that, a retirement plan?" The answer is almost universally yes. Well, there are no taxes there, so one way to de-risk your portfolio is to just sell whatever you wish in your 401(k) but remember to go back at some point.

Now there are ways of sort of getting that, and that's the name that I have in mind, which is called the Vanguard Life Strategy Moderate Growth Fund. The symbol is VSMGX, which that fund is 60 percent equities, 40 percent fixed income divided both domestically and internationally. So basically if the market comes down, historically the economy does less well. Interest rates come down or at least don't advance. So the bond part, which is of concern... if the economy is very strong now, interest rates are going to rise. Bond prices will decline. But in terms of de-risking, to have a diversified portfolio, which is something of course, Consuelo, that you have stressed and makes a lot of sense, but a lot of people don't have that kind of portfolio. There are portfolios that combine this. This Vanguard one is a low-cost provider of course. It's a large fund. It pays over two percent current yield, mixture of the equities and the fixed income, and I would think, I would expect that during a down turn it will go down, but it will go down less. I just think we're approaching an inflection point, and I'd like your viewers to give some thought to it.

CONSUELO MACK: We're going to leave it there. Charlie Dreifus, thank you so much for joining us on WealthTrack. As always, such a pleasure to have you here.

CHARLIE DREIFUS: My pleasure. Thank you, Consuelo.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point follows up on Charlie Dreifus' advice. It is: de-risk your portfolio. We do not believe in market timing on WEALTHTRACK, but we do believe in recognizing when a security, or sector, or asset class, or even entire market appears overvalued, and taking prudent action. Eight years into a bull market with so many indexes trading near record levels it is time to take some money out of the market. There are two market truisms that bear repeating: one, price matters and two, reversion to the mean. When something gets out of whack it will eventually revert back to its normal valuation.

Next week, we are going to focus on a big investment expense you can control: taxes! Tax strategy experts Brian Langstraat and Scott Welch will share their strategies to minimize taxes, and maximize returns. In the meantime to hear more of our interview with Charlie Dreifus, and the importance of having investments that don't keep you awake at night, click on the extra feature on our website Wealthtrack.com. Also thank you for connecting with us on Facebook and Twitter. Have a great weekend and make the week ahead a profitable and a productive one.