CONSUELO MACK | WEALTHTRACK

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In an exclusive interview, Tocqueville Fund's contrarian investor, Robert Kleinschmidt explains why he is finding the best values where you don't want to be.

Robert Kleinschmidt
Tocqueville Fund

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CONSUELO MACK: This week on WEALTHTRACK, an exclusive interview with contrarian investor Robert Kleinschmidt on why the trump rally has legs, and the bargains to be found in retail and energy stocks. Next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
This bull market which has been chugging along with some fits and starts since 2009 has been called the least believed bull market in memory. The naysayers are out in force again during the current leg, which has been called the Trump rally. There is no disputing the fact that the S&P 500's advance accelerated with the election and took off after the inauguration.

The skeptics cite all sorts of reasons not to get on board: An unconventional president, sluggish economy, elevated stock and bond prices, legislative gridlock and geopolitical upheaval.
This week's guest calls these concerns the proverbial "Wall of Worry" that bull markets are known to scale. He cites changes that are not being well covered that could recharge the economy and corporate earnings and keep the market expanding.

While legislation has been tough to pass there has been a string of Trump administration actions repealing rules affecting a broad range of areas from mining to workplace violations, to teacher standards to internet privacy to family planning and savings plans to name a few.

Under the Obama administration rules and regulations reached record levels. One good measure is the annual page count of the Federal Register, the daily publication of the U.S. Federal government that issues proposed and final administrative regulations of Federal agencies.
The Obama administration leads the top 10 list of most pages or regulations in a given year, starting with 2016 when there were 81,640 pages of rules, followed by 2010 when there were 81,405 pages and so on. The administration captured seven of the top ten records for numbers of rules and regulations in a given year.

According to this week's guest even without legislation, less regulation is bullish for business, the economy and markets. He is Robert Kleinschmidt, President, Chief Executive Officer and Chief Investment Officer of Tocqueville Asset Management, a value oriented wealth management firm devoted to capital appreciation and preservation for its global high net worth clients and institutions. A small portion of its $11 billion in assets are in its Tocqueville mutual fund which Kleinschmidt has managed since 1992. The fund has beaten the market and its peers since then with nearly 10% annualized returns vs. The S&P's just over 9% returns and its category's 7.6% ones, but as many value funds have over the last decade it has lagged the S&P over the last decade.

I began the interview by asking Kleinschmidt, what, if anything, has changed in the economy and markets in the age of Trump.

ROBERT KLEINSCHMIDT: Animal spirits, and that's very important because when you have a bad situation – which we'll talk about later from an economic point of view which we did have during the Obama years – and you expect things to stay bad or get worse, your animal spirits are pretty deflated.

CONSUELO MACK: Which means that you don't invest. You don't ...

ROBERT KLEINSCHMIDT: You don't take risks.

CONSUELO MACK: ... take risks.

ROBERT KLEINSCHMIDT: You don't take risks. People talked about loans not being available during that time period, but the truth was the demand for loans was very, very low. People don't want to go out on a limb when their animal spirits are low. So what happened? So Trump was elected and as importantly I think the Republicans held both houses of Congress, so it became possible to think about big changes in economic policies and regulatory policies.

CONSUELO MACK: And fiscal spending.

ROBERT KLEINSCHMIDT: And tax policies, et cetera, and so that changed the outlook of businessmen and consumers and others, and so the animal spirits got more robust, and so that alone generated a lot of momentum, and it generated a lot of momentum in the markets, and it generated a lot of momentum in the economy. Now it won't forever.

CONSUELO MACK: Well, wait a minute. So in the markets I'll give you that, but have you actually seen it generating activity in the economy in that the capital spending has really not picked up much to the chagrin of economists who say we've seen business confidence go up, but there's nothing to back it up.

ROBERT KLEINSCHMIDT: Well, so business confidence has gone up. Consumer confidence has gone up, and it takes a while for these things to unfold from the drawing board to actually money being spent. So it's early days.

CONSUELO MACK: It is early days.

ROBERT KLEINSCHMIDT: There's a real question as to whether or not Trump can implement his agenda, at least his legislative agenda. So it's not clear that animal spirits can push the markets and the economy forever. You have to have some follow-through, and that's an issue, but for the interim period you've had the animal spirits and you've also had very significant rollback of regulations, and that's where Trump has his greatest leverage because that's the area which was the most suffocating to the economy during the Obama years – it was the lowest eight-year period of growth since World War II.

CONSUELO MACK: Two. So about 1.5 percent GDP growth.

ROBERT KLEINSCHMIDT: Right. Yeah, it went a little bit higher than that maybe but half of the average. Half of the average during that time period and very much below the administrations of Reagan or Clinton for example, even George W. Bush, so it was a significantly poor eight years for economic growth.

CONSUELO MACK: How far can animal spirits take us? They have definitely picked up as you just said. I mean we've certainly seen it in the stock market. We have not seen it in the economy. We've seen it in business confidence, consumer confidence, whatever, but if in fact his legislative agenda is stalled… How troubling is that?

ROBERT KLEINSCHMIDT: It is troubling, and I like to compare this with the Reagan recovery of the '80s. So Ronald Reagan, he inherited an economy that was bound by regulations, but the deregulation process had already started. It started under Carter. Where Reagan had the greatest leverage was in the tax code, but that requires legislative action, and he was able to get it even though he had a Democratic Congress.
What Trump has is he does have I think onerous taxes to repair, but the level of onerousness compared to 1980 is much lower on the tax side and on the fiscal policy side, whereas the level of regulations are much higher…

CONSUELO MACK: I see.

ROBERT KLEINSCHMIDT: So there's a great deal that he can do even if he has trouble getting stuff through the legislature, but one would hope that we will get tax policy. One would hope that we would fix this unitary tax problem that we have with all the overseas money. One would hope that we would get capital gains taxes back to a level that's nowhere near as high as they are now which is 24 percent, maybe back to the 15 percent level, because that tends to lock up a lot of capital.

CONSUELO MACK: Or even 20.

ROBERT KLEINSCHMIDT: Even 20. I think 15 was talked about and certainly lowering corporate taxes to a level that I don't know if the Trump number is the right number, but lowering corporate taxes to the level where they're competitive around the world, and clearly that was one of the reasons and an important reason why companies were moving overseas, not necessarily the only one because I think regulations also played a role in that.

CONSUELO MACK: How sound a footing is the economy on? I mean the Fed is seriously now raising rates in a series, and they're talking about raising rates again this year. I mean if you don't get the legislative agenda through which it looks like it's going to be tough, but you do get the regulatory relief which you're saying we're getting through executive orders, is the economy on sound enough footing to continue – it's now the third longest recovery on record – to continue for another couple of years?

ROBERT KLEINSCHMIDT: I think so, yes. Because the recovery has been tepid, there hasn't been any real buildup of great excesses in the economy. The big excess that you can identify really is sovereign debt and the low cost of interest on sovereign debt.

CONSUELO MACK: So this is government debt.

ROBERT KLEINSCHMIDT: Government debt, but other than that, it's hard to find anything there where you have real ... labor markets aren't really…

CONSUELO MACK: Actually corporate debt too, Robert. I'm sorry. Because of low interest rates, corporations have been leveraging up like crazy.

ROBERT KLEINSCHMIDT: Well, they have recently, and some of the strongest companies have levered up because they have so much cash overseas that they can't bring back. So like a Google or a Microsoft or an Apple will raise funds over here because they can't bring the other stuff back, but it's a wash from that point.

CONSUELO MACK: I see.

ROBERT KLEINSCHMIDT: But the extent of government debt is completely unprecedented, and that's much different. So I'll get back to the Fed for just a second because I don't believe that the Fed actually does lead the interest rate markets. The Fed is a follower. It can get ahead of the markets, and usually when it does, there are bad consequences to that, but generally speaking the markets move first and then the Fed just follows.

CONSUELO MACK: That's the case now.

ROBERT KLEINSCHMIDT: I think it is.

CONSUELO MACK: It's kind of catching up.

ROBERT KLEINSCHMIDT: Right, catching up with the fact that the demand for loans is getting a little better, animal spirits again. So the trick of this recovery will be – and I don't think anybody can give you a number as to what it should be – but the trick of this recovery will be if the growth is enough so that the rise in the interest rates is small enough so that it doesn't overwhelm the governments with huge new expenditures.

CONSUELO MACK: Interest.

ROBERT KLEINSCHMIDT: So let me give you an example. In 2015, ball park number, 2016, the Federal government paid about $250 billion in interest charges. That's what they paid in 1992. So you've had 25 years of deficits, and the interest bill hasn't gone up. Why? Because interest rates have come down that much. But if interest rates were to go back to where they were in 1993, the four or five percent ... I think in 2007 the Fed funds rate was five percent before the markets rolled over. If you were to get that back there, then the interest bill, instead of being $250 billion, would be a trillion 250. Where would that extra trillion dollars come from? So that would screw up everything. So the trick is to have growth but not so fast that rates move too quickly before we can generate enough income to pay for the debt. I don't know how that's going to happen. I don't know how that's going to play out. That's the one thing that really worries me, but in the interim I think that there's no reason that the economy can't continue to grow and grow faster than it has in the past.

CONSUELO MACK: Market valuations. What is your sense of the market?

ROBERT KLEINSCHMIDT: So there I think what's important, and we talked a little about this before the cameras started rolling, but what's important there is that valuations are not egregious, but they're certainly not low, and they're above average. So it's asking a lot for valuations to go higher, and it's particularly asking a lot for valuations to go higher if interest rates are going to start to move up. So you're not going to get the market moving up on the basis of higher valuations. You can only get the market moving up in my view with higher earnings, and higher earnings can drive the market a lot higher for a longer period of time, but there you don't get higher earnings unless you get stronger economic growth, and so it gets back to the need to roll back the regulations, roll back the economy-crushing tax burden, and let the economy go but not so fast as to raise interest rates to the point where it makes governments insolvent in our country and really all over the world.

CONSUELO MACK: How worried are you? You're known as a contrarian investor. You usually kind of are out of step with what the herd is doing in many ways. Everyone's been talking about the fact that the VIX, the Volatility Index, has been unusually low for a long time. There doesn't seem to be a lot of concern among investors that we're going to have a recession anytime soon; that we're going to have a big market correction anytime soon. So there are a lot of animal spirits. How much does that concern you?

ROBERT KLEINSCHMIDT: I'm always concerned about the market, but there are plenty of things to worry about. They say a bull market climbs the "wall of worry".

CONSUELO MACK: Climbs the "wall of worry."

ROBERT KLEINSCHMIDT: So let's start with disarray in Washington. It's a pretty big disarray right now.

CONSUELO MACK: Yes, but it doesn't seem to be affecting the markets.

ROBERT KLEINSCHMIDT: That's my point. The bull market is climbing that particular "wall of worry".

CONSUELO MACK: Right, right. I see.

ROBERT KLEINSCHMIDT: There's also North Korea lobbing nuclear bombs past China, so that's a new development. So there are geopolitical worries, and there are political worries within our own country. So I think those are two areas that should give and probably do give people pause. So I don't think you see universal optimism among players in the market. I think there's a fair amount of caution and, in fact, if you look at the markets so far this year and take out Apple and Amazon and ...

CONSUELO MACK: The FANGs or whatever, Microsoft.

ROBERT KLEINSCHMIDT: The market is really not up that much. It's up a couple of percent, and there are areas where there's been real carnage, and as a value investor and a contrarian investor, that's sort of the areas where we're doing most of our looking right now.

CONSUELO MACK: Talk about where you're doing most of your looking. I think you had a great quote that you told me, something about a value has to look where values are, not where you would like them to be.

ROBERT KLEINSCHMIDT: That's correct.

CONSUELO MACK: So where are the values where I would rather not be?

ROBERT KLEINSCHMIDT: Let me tell you where they are. Where you'd like to be is you'd like to find the next Netflix and Amazon.

CONSUELO MACK: Yes, exactly.

ROBERT KLEINSCHMIDT: I think the two areas that have performed the worst this year and for quite a while is the energy area and the retail area.

CONSUELO MACK: Recently retail shock that Amazon bought Whole Foods. That was the talk of Wall Street.

ROBERT KLEINSCHMIDT: Exactly.

CONSUELO MACK: So tell me about the retail space.

ROBERT KLEINSCHMIDT: The general point of view was it's bricks versus clicks. The general point of view was that clicks was winning and bricks was losing. That has been true in terms of at the margin, but still the overwhelming amount of retail shopping is done in stores, and the fact that Amazon went out and bought stores is a reasonably good imprimatur that they think that stores are still important. All the big retail stocks were down on the day that that was announced, but on the same day that it was announced and Wal-Mart was off five percent, they announced that they acquired yet another online retailer. So Amazon's buying bricks and mortar, and Wal-Mart is going the other way.

CONSUELO MACK: Wal-Mart is buying clicks.

ROBERT KLEINSCHMIDT: But if bricks and mortar are important, I guess you could argue that Wal-Mart has thousands of stores, and Whole Foods has hundreds. So who's really better positioned? My point is that it's so obvious to everybody that it's all about e-trade that there has to be values and there are values I think in the more traditional retail space.

CONSUELO MACK: Tell me about the bricks and mortars. Where do you see value in stores?

ROBERT KLEINSCHMIDT: One name that we're looking at and we've started to fool around with is actually an REIT that invests in ...

CONSUELO MACK: A REIT.

ROBERT KLEINSCHMIDT: A REIT that invests in malls. Now everybody knows the mall is dead, and malls are dying and many are.

CONSUELO MACK: And we're way over-malled.

ROBERT KLEINSCHMIDT: And we're way over-malled. Anyway, this company – CBL is the name of the REIT – invests in malls that are in more rural areas. I guess you'd call them B level malls.

CONSUELO MACK: Where there's nothing else going on?

ROBERT KLEINSCHMIDT: That's right. I think that's the key, and I think one of the keys is ... and there's another company that we like in this space too called Tractor Supply but they both share a similar thing which is that particularly in less urban areas shopping is a social experience, and it's one thing when you live in New York City like we do and it's like everything is everywhere all the time, and it's easier to click on a computer, but if you're living miles away from everybody else, you can still buy it online if you want, but then you don't have any social interactions. So there's a reason that people go to stores that is beyond simply wanting to pick up the latest item. I mean they want a social interaction. In these smaller areas, there's some panache to that. So we're fairly confident that if we buy these things ... and in this particular case the stock is trading at eight dollars a share. There's a ten

percent dividend as a result of the flow of funds from the REIT, and we think that when it settles down that the stock could be a $20 stock. Now why should it settle down?
Among other things, go back to the tax agenda that we were talking about. If the tax agenda gets through, it's going to put more money in the hands of middle income Americans, and that money usually gets spent. So I could see a rebound in retail that could occur as a result of better tax policy and the elimination of the Obamacare penalty on payroll taxes and all the rest. So a modest increase in consumer spending power could manifest itself in better retail number. Again, not necessarily across the board, but in this particular case in those particular markets ...

CONSUELO MACK: These niches.

ROBERT KLEINSCHMIDT: .. and those niches, I think that's a good place to look.

CONSUELO MACK: Energy. You mentioned energy as well.

ROBERT KLEINSCHMIDT: I used to be dangerous because I used to know a lot about energy. I was the oil and gas analyst years ago. What you want to own in the energy space I think are companies that are not dependent on higher prices and in the United States there are a number of them that can make a very decent living at $40 oil, $45 oil, $50 oil because of if they're in the right market at the right basins and particularly the Permian Basin in west Texas, and if they're fracking. So the United States has become the swing producer in both oil and gas, and that status may eventually discipline OPEC. I don't know, and I'm not sure it necessarily will, but here again if you have economic growth, it all goes back to economic growth which we didn't have or we had very tepid economic growth, and if we now have more normal economic growth in the United States, you will get a stronger bid underneath the oil price, and companies that make money at $40 a barrel will do a lot better at 50 and 55 dollars a barrel. So I think it's too soon to throw in the hat on the energy industry. That is clearly what has been happening for the last several years and clearly this year where it's been the worst performing group.

CONSUELO MACK: Is $40 the floor? I mean we've seen it go down to the 20s.

ROBERT KLEINSCHMIDT: No. I don't think it is necessarily a short-term floor. You could go anywhere based on the inventory numbers, and it's important what the weather is like. The weather has an impact on heating demand or cooling demand, and that really affects natural gas prices, and a lot of these companies are still levered to natural gas. So I think you could go to a very low price, but the cure for low prices in the oil industry has always been low prices.

CONSUELO MACK: Because then your supply gets shut down.

ROBERT KLEINSCHMIDT: Exactly right. So I think that oil traded between 18 and 22 dollars a barrel for 20 years before it ran up. It could trade between $40 and $60 a barrel for the next 20 years, but if you have companies that are in the right basins and have the right technology – and technology makes a big difference in terms of production costs these day – I think you can do very well.

CONSUELO MACK: Such as ...

ROBERT KLEINSCHMIDT: SM Energy is one that we like. It's a $15 stock. I think that it's got a very, very large acreage position in the Permian Basin, and they bought it at a really good price. They have yet to exploit it all, so they've got a lot of drilling to do, but I think that based on their position that it could be a $40 stock, and you don't need a higher price to get there.

CONSUELO MACK: One investment for a long-term diversified portfolio. I might add the last time you were on which was about a year ago, you recommended an area that none of us wanted to get anywhere near which probably still has a problem, Metals & Mining, XME, and it was way down then, and it's done quite well since then.

ROBERT KLEINSCHMIDT: It's doubled or more. I'll give you another one because we're talking about ETFs. I think you could buy the XOP which is the Oil & Gas Exploration ETF for the same reason. There's enough negativity there. It's down from 80 to 30. There's enough negativity in there so that if you did have a higher oil price, I think you could get a spike in it, and you don't really have a lot of downside risk to it I think, particularly if you're on a desert island for five years.

CONSUELO MACK: Any plans?

ROBERT KLEINSCHMIDT: Well, that's where I took my XME.

CONSUELO MACK: Exactly. Robert Kleinschmidt, always a treat to have you on WEALTHTRACK. Thank you.

ROBERT KLEINSCHMIDT: Well, it's always great to be here.

CONSUELO MACK: Thank you so much.

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 is: Think like a value investor.
That means seeking out what is unpopular. Where investors least want to be, frequently offers the best opportunity for appreciation. Year to date the worst performing of the eleven major S&P 500 sectors is energy, where every category is down with oil and gas drilling companies being the most depressed. There is a global energy glut now but it won't last forever. The sector

warrants a look.

Next week, Financial Thought Leader Burton Malkiel shares his views on successful investing four decades after writing his classic, *A Random Walk Down Wall Street.*

And if you go to the EXTRA feature on our website you will hear Robert Kleinschmidt's recommendation for a good summer read. Also keep us reading by connecting to us on Facebook and Twitter. We are always interested in what you have to say.

Thank you for watching. Have a great weekend, a super fourth of July and make the week ahead a profitable and a productive one.