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FUNDAMENTALS OF INVESTING

Dueling Forecasts

Managers of two top-performing funds have different ideas about what lies ahead for investors; Here's how they see things unfolding—and why

By Diya Gullapalli

Many small investors are baffled about what to do next.

With the average U.S. diversified stock mutual fund topping 6% so far this year, but still down sharply over the past 12 months, according to preliminary figures from Lipper Inc., is it time to move out of hiding places like cash to join the rally? Or is it better to stay hunkered down with the expectation that this rally, like the one late last year, will be followed by a steep decline?

Experts, too, are widely divided in their opinions about what's likely to happen next and how to prepare for it. To find out what some of them are thinking—and investing in—we talked to the managers of two top-performing "world allocation" funds, the $15 billion First Eagle Global and $12 billion Ivy Asset Strategy. The funds rank in the top 20% of peers or better over the past three, five and 10 years, according to researcher Morningstar Inc.

We focused on these funds partly because world allocation funds have broad license to invest in stocks, bonds and cash both in the U.S. and overseas, which means their managers have to be familiar with global trends and opportunities, not just their home markets. We also singled these two out because their managers have some opposing ideas. One conclusion most world-allocation managers are reaching, though, much to the dismay of American investors, is the U.S. is generally not where growth opportunities lie for coming years. Many world funds are instead focusing on places like Asia.

Here are edited excerpts from our conversations with the two management teams:

When do you see the U.S. economy, and stocks, recovering?

First Eagle co-Manager Matt McLennan says he sees rays of sunshine in U.S. manufacturing data that show less deterioration in factory orders, and in the economic-stimulus efforts of various governments around the world. Reduced oil prices have helped to hold up consumers' real disposable income relatively well in the face of the grim labor market, he says.

Still, Mr. McLennan predicts a "tough environment for most of the companies we're watching in the U.S. for the foreseeable horizon." He thinks that even if there is an economic recovery in 2010, it will likely be a weak one.

"The fundamental echoes of this financial crisis will be deep and sustained," he says.

That said, he and fund co-Manager Abhay Deshpande think now is the time to buy stocks. The fund is 80% invested in stocks currently, compared with 70% in typical times.

First Eagle is willing to invest heavily in stocks in the face of the fund's grim economic outlook because the managers believe that the world's economies will certainly recover within the five-year horizon they use to make investing decisions. While they aren't bullish on the U.S. generally, the few stocks they are focusing on here, such as American Express Co. and Microsoft Corp., have been cutting labor and other costs and should sport more-efficient operations when the world economy starts to grow again.

Photo courtesy of First Eagle Funds

Matthew McLennan—Portfolio Manager
First Eagle Funds

Mr. McLennan says he thinks the U.S. stock market has gotten ahead of itself recently and will remain volatile. Still, "when things are uncertain, we're willing to invest in enterprise," he says, meaning companies in which First Eagle has faith.

At Ivy Asset Strategy, co-Manager Ryan Caldwell says the team is banking on an economic recovery in 2010. "We see corporate earnings bottoming in the second quarter of 2009, but no good growth trajectory will appear until the second half of 2010." The Ivy team doesn't see U.S consumer activity picking up in a meaningful way until then. Availability of cheap refinancing is easing but not erasing consumers' big debt burdens, while job losses are continuing to take their toll.

The team's expectations are not that different from First Eagle's, but Ivy is building its portfolio much more cautiously. It raised its stake in bonds to 13% from 10% in December, while steadily reducing its stock exposure to 40% of assets, or about half as much as peers. The fund has 17% in gold bullion. The last time it had so much was in 2006, when gold and gold-related stocks made up close to 30% of the fund. The remaining 30% of the fund is in cash, which is considered very high.

The Ivy managers expect a flat U.S. stock market in coming months, citing weak prospects for earnings growth and a financial system that remains pressured. They believe there will be ample time to find bargain stocks. In the meantime, they are bullish on bonds.

What financial-market issue is creating the most debate among your fund's analysts and managers?

At Ivy, it is whether U.S. consumers will respond to the government's stimulus plan in a way that accelerates recovery, or will they keep pulling back to lower their debt? It's a question of whether consumers will spend more at, say, Wal-Mart Stores Inc., or on automobiles, says Ivy Asset Strategy co-Manager Michael Avery.

For now, the firm's analysts lean toward believing that consumers will continue to restrain spending in hopes of paying off debt. Accordingly, the analysts expect recoveries to be muted in the U.S. and other developed economies.

At First Eagle, the debate is over which is the bigger risk: near-term deflationary pressures or long-term inflation. "Most commodities are down 50% year over year, labor costs are low and companies are at low levels of capacity utilization," which all point to a sustained decrease in prices, says Mr. McLennan. On the flip side, he notes, central banks and governments are keeping interest rates low and in some cases increasing the money supply—moves that tend to fuel inflation.

Hence, First Eagle is focusing mostly on foreign stocks that it thinks can perform well in either outcome, like Nestle SA. As First Eagle sees it, the Swiss food conglomerate has a large and loyal customer base, which gives it the ability to pass price increases for raw materials on to consumers. Meanwhile, low debt levels should allow it to withstand

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price declines for its products in the next year should deflation take hold.

"If things get worse before they get better, we want companies that can survive through that," Mr. McLennan says.

What are the best investment opportunities for the second half of 2009?

U.S. corporate bonds, both in the investment-grade and lower-quality junk areas, are a top opportunity this year, say the Ivy managers.

Ivy's Mr. Caldwell has found investment-grade bonds promising since the collapse of investment bank Lehman Brothers last September. From October through January, investment-grade "spreads"—the yield they pay above a comparable Treasury—were about four times wider than normal. Those spreads have tightened as credit markets have begun functioning better. But the Ivy managers still spot opportunities to pick up what they think are underpriced bonds. Recent purchases include bonds yielding 7% that drug maker Roche Holding Ltd. issued in March as it purchased Genentech Inc.

The Ivy managers think that defaults aren't a serious threat for selected junk bonds, and that these bonds have been overly beaten down by such fears. This includes new junk bonds from Wynn Resorts Ltd. Junk bonds issued by companies like this are selling at steep discounts, even though they can refinance debt in a variety of ways, the Ivy managers say.

First Eagle, meanwhile, is bearish on most bonds. Mr. McLennan is staying away from junk bonds because he expects a high frequency and severity of defaults. Nor does he find government bonds attractive.

"In a nutshell, stock-dividend yields around markets world-wide are in excess of 3%, and many government bond yields are below 3%," he says.

Outside bonds, says Ivy's Mr. Caldwell, another top opportunity is China. It fits one of the fund's main investing themes—an "emerging middle class globally," he says. The fund's top stock holdings include Chinese banks, life insurers and telecommunications companies.

One of its biggest holdings is Industrial & Commercial Bank of China, at 5% of the fund. The Chinese government is by far the biggest stockholder in the bank, which provides a solid safety net, according to Mr. Caldwell.

First Eagle, meanwhile, believes that, while China's economy is growing now, Japanese industrials will be Asia's winners in sustainable expansion. Mr. McLennan says his fund likes such companies as robotics-maker Fanuc Ltd. and factory-automation-parts producer Keyence Corp., both of which sell products in the U.S. and Asia.

Mr. Caldwell agrees about growth prospects in Asia in general. Asian countries generally have little debt now, he says. Their banks have excess savings and limited lending, which will let them generate faster growth rates.

By contrast, he says, U.S. shares, when compared with those of companies in China, India and Southeast Asia, have a flat earnings-growth trajectory.

Neither fund has much enthusiasm for most U.S. stocks. First Eagle's Mr. McLennan says he is staying away from many U.S. companies because he finds them overvalued compared with those in Japan.

What danger zones do you see?

The managers of both funds agree that financial stocks hold little opportunity for investors despite their seemingly dirt-cheap prices. They see banks as tough to value.

Ivy's Mr. Caldwell thinks that it is mainly U.S. banks that are troubled and that there is little incentive to wade into these stocks now. He says the main issue is that raising cash to buttress their capital bases dilutes existing shareholders, and that raising capital is expected to continue for a while, since U.S. government "stress tests" in May revealed that a number of large U.S. banks need more outside money to remain financially strong in the recession.

First Eagle's Mr. McLennan has stayed away from most financial stocks world-wide over the past 18 months. The area accounts for about 2% of the fund, compared with 5% to 10% in other years.

"There's an element of speculation to buying these stocks," even at what seems like low prices, he says.

It isn't just dilution he fears. He is concerned that most banks remain highly leveraged compared with other industries. He also worries that banks world-wide aren't showing sustainable improvement in their businesses.

The few financial stocks he does own, like American Express, Berkshire Hathaway Inc. and Japanese property-casualty company Aioi Insurance Co. Ltd., all have a common draw—solid earnings before provisions for loan losses, he says.

Average Annual Returns as of 12/31/2009:	Year to Date	1 Year	5 Years	10 Years	Expense Ratio
First Eagle Global Fund - Class A (w/o sales charge)(SGENX)	22.91%	22.91%	8.10%	12.36%	1.14%
First Eagle Global Fund - Class A(w/sales charge)(SGENX)	16.76	16.76	7.00	11.93	

The performance data quoted herein represents past performance and does not guarantee future results. Market volatility can dramatically impact the fund's short-term performance. Current performance may be lower or higher than figures shown. The investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Past performance data through the most recent month end is available at firsteaglefunds.com or by calling 800.334.2143. The average annual returns for Class A Shares "with sales charge" of First Eagle Global Fund give effect to the deduction of the maximum sales charge of 3.75% for periods prior to March 1, 2000 and of 5.00% thereafter.

There are risks associated with investing in funds that invest in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. Investment in gold and gold related investments present certain risks, and returns on gold related investments have traditionally been more volatile than investments in broader equity or debt markets. The holdings mentioned herein represent the following percentage of the total net assets of the First Eagle Global Fund as of December 31, 2009: American Express Co. 1.77%, Microsoft Corp. 1.68%, Wal-Mart Stores Inc. 0.30%, Nestle SA 1.31%, Lehman Brothers 0.00%, Roche Holding Ltd. 0.00%, Genentech Inc. 0.00%, Wynn Resorts Ltd. 0.00%, Industrial & Commercial Bank of China 000%, Fanuc Ltd. 2.33%, Keyence Corp. 1.66%, Berkshire Hathaway Inc. 2.27%, Aioi Insurance Co. Ltd. 1.54%. The portfolio is actively managed and holdings can change at any time. Current and future portfolio holdings are subject to risk.

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