

Gundlach sees 'kaboom' ahead, touts hard assets

Bond whiz foresees loads of defaults ahead; 'pressure cooker'

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It's mid-October, and Jeffrey Gundlach is giving a stump speech to a luncheon crowd of about 200 **financial advisers** and investors at Los Angeles's City Club. The renowned money manager's theme: the financial catastrophe on the horizon.



The co-founder and chief executive officer of DoubleLine Capital LP explains that the first phase of the coming debacle consisted of a 27-year buildup of corporate, personal and sovereign debt. That lasted until 2008, when unfettered lending finally toppled banks and pushed the global economy into a recession, spurring governments and central banks to spend trillions of dollars to stimulate growth, Bloomberg Markets reports in its January issue.

In the ominous third phase, he predicts another crisis: Deeply indebted countries and companies, which Gundlach doesn't name, will default sometime after 2013. Central banks may forestall these defaults by pumping even more money into the economy -- at the risk of higher inflation in coming years.

Gundlach, 53, doesn't know when the third phase will get here, but he tells his audience they need to gradually get ready for it.

"I don't believe you're going to get some sort of an early warning," Gundlach, who's also chief investment officer at Los Angeles-based DoubleLine, tells his listeners. "You should be moving now."

Gemstones, Art

He recommends buying hard assets: Gemstones, art and **commercial real estate** are high on his list. And DoubleLine has been buying the stocks of Chinese companies, U.S. natural gas producers and gold-mining firms because it considers them to be bargains.

Gundlach himself has amassed a contemporary art collection of about 100 pieces, with works by Jasper Johns and Franz Kline. The **money manager** drew on abstract painter Piet Mondrian's double-line style for the name of his firm and its geometrical, crosshatched logo.

Gundlach, who correctly predicted the subprime mortgage disaster, has a proven record as a prognosticator -- and the performance numbers to go with it. At his former firm, TCW Group Inc., his Total Return **Bond Fund** (TGLMX) earned an annual average of 7.9 percent in the decade ended in November 2009, according to data compiled by Bloomberg.

His flagship \$35.8 billion DoubleLine Total Return Bond Fund (DBLTX) gained an annual average of 13.2 percent from its inception in April 2010 through Nov. 28, topping the performance of Gundlach's more famous neighbor to the south, Bill Gross.

Topping Gross

The co-chief investment officer at Newport Beach, California-based **Pacific Investment Management Co.** earned an average of 7.6 percent during the same period in his much larger, \$281 billion Pimco Total Return Fund. (PTTRX)

Gundlach's performance convinced Andreas Lehmann, chairman of Luxembourg-based Alma Capital Investment Funds, to hire him to manage a fund for European investors. "Ultimately, what matters are the returns over time, and on that count, Jeffrey stands out," Lehmann says.

If Gundlach's outlook for the possibility of higher inflation comes true, his bond funds could suffer like most fixed-income investments. Since he opened DoubleLine in December 2009, it had gathered about \$50 billion in assets as of mid- November, and it was the fastest-growing **mutual fund** firm ever in its first year, according to Strategic Insight, a New York- based research firm.

Mortgage Holdings

Most of DoubleLine's assets are in the Total Return Bond Fund, which has 78 percent of its holdings in residential mortgage-backed securities -- both those guaranteed by the U.S. government and those that are not and have discounted prices.

The mix should help the fund weather either inflation or deflation because the securities should move in opposite directions if interest rates go up or down. Because higher rates could mean the economy is improving and housing prices are recovering, there would be fewer defaults on the riskier nonguaranteed bonds, and prices would rise, says Philip Barach, DoubleLine's co-founder and president.

And he says the fund's duration, a measure of how much bond prices will change when yields rise or fall, is low, making it less sensitive to shifts in interest rates.

"Jeffrey and I are more risk averse than you might imagine," Barach says.

Gundlach is so confident that phase three is coming that he's planning to start an equities fund and a long-short hedge fund in early 2013 to offer investors additional protection from inflation. Gundlach, who says he buys assets only on the cheap, is also sitting on cash in anticipation of scooping up securities at fire-sale prices. Cash makes up 17 percent of his Total Return fund.

Kaboom

He says the amount of money investors can make in phase three will dwarf what they can earn now.

"I'm waiting for something to go kaboom," Gundlach says in his office a week before the L.A. speech. "If phase three takes two years, it's worth waiting for. The markets don't have lots of opportunity now."

Gundlach has a history of making brash pronouncements. At a conference in New York in April, he told a Bloomberg News reporter that he would abolish the 99-year-old Federal Reserve, a position espoused by failed Republican presidential aspirant Ron Paul.

“That's a very extreme view,” says Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York. “Given how the Fed has evolved since the early 1900s, to say we're going to change all that and start over is absurd.”

Rock Drummer

Gundlach has a propensity to stand up for his ideas even at the risk of jeopardizing his career. He dropped out of a Yale University theoretical math Ph.D. program because he was told his idea for a thesis proving infinity didn't exist was out of the mainstream of the department. He then moved to Los Angeles and performed as a drummer in two rock bands before landing a job as a quantitative analyst in 1985 at TCW.

Gundlach soon became a star manager of mortgage-backed- securities funds and, in 2009, was on the losing side of an internal struggle over the leadership of the Los Angeles firm. TCW fired Gundlach and sued him a month later, accusing him of breach of fiduciary duty and theft of trade secrets.

Gundlach shot back with a countercomplaint, accusing TCW of ousting him to keep up to \$1.25 billion in future fees that his team would have been paid. The suits were settled, though Gundlach hasn't left behind his combative ways. Since 2010, he's been complaining to [Morningstar Inc.](#) (MORN), claiming the research firm's analysts are biased against him.

No Noodge

“Jeffrey didn't gather \$50 billion in assets in three years because he's some little noodge in the corner with his eyeshades on,” says Tania Modic, a DoubleLine investor at Western Investments Capital LLC in Incline Village, Nevada. “Jeffrey wants to be an outstanding thought leader, and you're not going to get it by just being a bland personality.”

Gundlach also isn't shy about touting his own exploits and expertise.

On art: “I seriously doubt there's anyone who knows more than me about Mondrian.”

On the New York Times Saturday crossword puzzle, the hardest one of the week: He completes them in pen and often skips Sunday because it's too easy, like counting Cheerios in a box. “You can do it, but what's the point?”

On his Total Return Bond Fund, which attracted the most deposits of all U.S. mutual funds in 2012 through Oct. 31, according to Morningstar: “I have the most popular fund in the world.”

J. Alfred Prufrock

Those who work for Gundlach are intensely loyal to him. As he was starting DoubleLine in December 2009, more than 40 people from TCW -- including Barach, his right-hand man -- joined him at the new firm. Bonnie Baha, who followed Gundlach from TCW and now oversees DoubleLine's investments in corporate bonds, says her boss's eclectic mind is part of his charm.

One time, Baha cited a line from T.S. Eliot's “The Love Song of J. Alfred Prufrock” during a meeting, and Gundlach began reciting the first stanza of the poem from memory. He peppers his unscripted

investor presentations with references to James Bond movies, William Shakespeare, Karl Marx and rock songs from Nirvana and The Who.

And in addition to rooting for his hometown Buffalo Bills football team, he likes to garden, pruning back his Betty Boop and Gemini tea roses.

“He's a much more complex human being than an egotistical blowhard,” Baha, 53, says. “The guy is a paradox. He is crazy about football. Then he recites a T.S. Eliot poem.”

Subprime Warning

As an investor, Gundlach goes on buying sprees when asset values plunge. After warning investors at a 2007 Morningstar conference that the subprime lending market was a “total unmitigated disaster,” he started to load up about a year later on the distressed mortgage-backed securities that most of the world was shunning.

The winning bet produced a return of 21.7 percent in the Total Return Bond Fund in 2009 through Dec. 4, when he was booted from TCW.

Now, after a global financial debacle, bank bailouts, the European debt crisis, a slowdown in China and a halting U.S. recovery, Gundlach is preparing for another bout of bad news -- his so-called third phase. While he doesn't expect any countries to default in 2013, he points to Japan as an example of a government that may have to embark on more-aggressive asset buying that could lower the value of its currency.

Its economy contracted at an annualized rate of 3.5 percent in the third quarter. Japan's trade deficit rose to a half-year record 3.22 trillion yen (\$40.5 billion) in the six months ended on Sept. 30. And the central bank increased its asset purchase program on Oct. 30 to 66 trillion yen to overcome deflation.

European Events

“Japan is running out of policy tools,” he says.

Following actions by the European Central Bank that pumped \$355.4 billion into the region starting in 2010, DoubleLine managers see several possible events that could hammer markets, from Finland exiting the euro zone to another near default of a Spanish bank.

“The only reason asset prices are up is because of all the liquidity in the system,” says Luz Padilla, manager of the \$707 million DoubleLine Emerging Markets Fixed Income Fund. (DBLEX) “Our concern is that it can turn very quickly.”

In the U.S., Gundlach sees a postelection, pre-fiscal cliff economy that's growing anemically and only because of consumer loans, government stimulus and the Fed. He says inflation could jump by 2 percentage points if the Fed ramps up its purchases of government debt beyond what it has done so far.

Pressure Cooker

Led by Chairman Ben S. Bernanke, the Fed has purchased \$2.3 trillion in securities in two rounds of quantitative easing since 2008. And it may extend its third round through 2013 and climb past a total of \$1 trillion in purchases, according to economists interviewed by Bloomberg.

“You're just going to build up pressure in the pressure cooker, and when it blows, the lid will blow sky-high, and that's when you get to phase three,” Gundlach says.

His pessimism sets him apart from other prominent money managers, notably Larry Fink, chairman of **BlackRock Inc.** (BLK) Fink says the U.S. banking system is in relatively good shape and the large supply of natural gas in the U.S. will create jobs. The economy grew at a stronger-than-forecast annual pace of 2 percent in the third quarter.

“In the long run, I'm very bullish on the United States,” Fink, 60, said at a BlackRock iShares conference in November.

Fiscal Cliff

Gundlach says he has no faith that President Barack Obama in his second term will reach an accord with Congress to make significant cuts in the \$1.09 trillion deficit. He says the tax hikes proposed by Obama on the wealthy wouldn't bring in enough revenue to have a significant impact and politicians probably won't make major cuts in entitlement programs because the public overwhelmingly supports them.

Gundlach dismisses the chances of a grand compromise on the so-called fiscal cliff of automatic spending cuts and tax increases totaling \$607 billion if an agreement isn't reached by January. Rather, he expects politicians will find a way to push the deficit issues into 2013 and beyond.

“I don't think Obama is likely to give on anything, and I doubt the Republicans are going to roll over because they failed to regain the White House,” Gundlach says.

In making his case to abolish the Fed, Gundlach cites an argument made by former Texas Representative Ron Paul in 2002. Paul said the U.S. Constitution grants Congress the authority to coin money and regulate the value of currency and that it doesn't give Congress the right to delegate control over monetary policy to a central bank.

Emerging Markets

Richard Pildes, a constitutional law professor at the New York University School of Law, says that line of thinking has been widely discredited. “The constitutionality of Congress creating independent agencies like the Fed has been long settled,” he says.

Gundlach's outlook isn't uniformly bleak. He sees some opportunities in emerging-markets equities, particularly in China, where the Shanghai Stock Exchange Composite Index (SHCOMP) fell 3.5 percent in the first 10 months of 2012.

Chinese stocks make up the majority of international equity holdings in the DoubleLine Multi-Asset Growth Fund (DMLIX), says Jeffrey Sherman, a portfolio manager for the fund. It increased its exposure to international equities to 6.7 percent as of Oct. 31 from 4.9 percent a month earlier.

Beyond China, Gundlach says, the demographics in some emerging markets will support sustained growth. While developed nations will have fewer than three workers for every retiree by 2025, Brazil, India and Mexico will have almost six to seven workers, according to the U.S. Census Bureau.

Expensive Equities

“Retirees take resources from a society, and workers produce resources,” he says.

In line with Gundlach's gloomy outlook for America, the Multi-Asset fund recently dumped some of its U.S. equities. Sherman says the stocks are too expensive and U.S. companies don't have much potential for growth. But the fund has added to its holdings of gold-mining companies and natural gas producers in 2012 because these stocks are cheap, he says.

Gundlach has made some prescient calls on stocks. He recommended in April that investors short Apple Inc. (AAPL) and hedge that bet by going long on natural gas. He said Apple was priced too high at \$606 after the stock had risen more than sevenfold from January 2009 to April 2012. After that call, Apple stock fell about 4.7 percent through Nov. 29.

Even after the September release of the iPhone 5, which shattered Apple's pre-sale order records, the company will struggle to reach its earnings potential without an innovator like Steve Jobs at the helm, he says.

Natural Gas

Gundlach made his recommendation on natural gas stocks after they fell 59 percent from January 2009 to April 2012. The prices plunged as producers extracted gas trapped in shale and created a supply glut. Gundlach says investing in natural gas now is similar to buying gold in 1997, when prices hit an 18- year low before a surge in the precious metal's value.

The Standard & Poor's GSCI Natural Gas Index increased more than 77 percent from April through Nov. 28, partly on demand from electrical utilities switching to gas from coal.

Even with timely calls like these, Gundlach has to overcome skepticism from investors that a bond guy can succeed in equities and other investments. DoubleLine, which had \$39.8 billion in assets in its four bond funds as of mid-November, had gathered only \$190 million for its Multi-Asset Growth Fund.

Lagging Returns

Started in December 2010, the fund includes natural gas exchange-traded funds, gold futures and currency and agriculture options as well as U.S. and international stocks. The fund returned only 4.3 percent in 2012 through Nov. 28, trailing the 14.4 percent gain in the Standard & Poor's 500 Index.

"We have confidence that when the opportunities arise within fixed income, DoubleLine will be able to take advantage of that," says Jeremy DeGroot, who helps oversee \$8 billion in assets as chief investment officer of Orinda, California-based [**Litman Gregory Asset Management LLC**](#). "When you go outside of fixed income into broader multiasset allocation, we don't have that conviction. We haven't done the work to give us confidence that they can successfully do it."

Self-assured as ever, Gundlach says he's indifferent to his reputation as someone without a track record outside of bond funds. "I couldn't possibly care less; I don't have anything to prove," he says.

Morningstar Fight

Gundlach does care enough about what Morningstar opines that he's now fighting with the mutual-fund industry's preeminent rankings and research firm. In meetings, e-mails and phone calls, he has repeatedly complained to Chicago-based Morningstar's executives that their analysts are biased against DoubleLine.

In a July 18 report on DoubleLine's flagship fund, entitled "Swim at your own risk," Morningstar senior analyst Sarah Bush cautioned investors about Gundlach's use of volatile mortgage-backed derivatives such as inverse floaters, which are debt instruments whose coupon payments decrease when short-term interest rates increase.

DoubleLine co-founder Barach dismisses Bush's concern, saying the securities make up less than 3 percent of the fund's investments and have performed well over the past 20 years while also providing cash flow.

“Morningstar has been dead wrong on DoubleLine since December 2009,” Gundlach says, referring to the month he started the firm. “They don't understand what I'm doing.”

Bush says she met with Gundlach in April. She says DoubleLine later declined to fill out a detailed questionnaire that would have helped explain the Total Return Bond Fund's performance.

TCW Cheerleader

“We got a call saying they had cooperated enough,” says Bush, who stands by her analysis.

Gundlach also accuses Morningstar senior analyst Eric Jacobson of being a cheerleader for TCW, Gundlach's former employer.

“What's so reprehensible here is, Jeffrey called and said, 'If I were you, I would fire Eric,’” says Don Phillips, Morningstar's president of investment research and Jacobson's boss. “Eric was one of the most early and ardent supporters of Gundlach.”

Gundlach's quarrel with TCW began when the firm appointed then-Vice Chairman Marc Stern as chief executive officer over the objections of Gundlach and four other executives. They wanted to form a management committee to lead the firm. A TCW spokesman declined to comment for this story. Both the TCW and Gundlach lawsuits were settled in a confidential agreement at the end of 2011.

Art Passion

One subject the money manager is happy to talk about is art. His passion is on display throughout DoubleLine's offices, with many of the paintings from his personal collection hanging on the walls.

In designing DoubleLine's logo, Gundlach borrowed from Mondrian, the abstract Dutch artist whose career spanned almost five decades until his death in 1944. His works are characterized by grids of black lines, white space and rectangles in primary colors.

Gundlach began buying valuable art in the 1990s, favoring what he calls pretty pictures of landscapes. In 2002, he went to the Tate Modern in London and wandered into a room where he saw a Mondrian and had an aha moment. It was the first abstract work that he truly appreciated.

“I got it,” he says, snapping his fingers. “I was like, 'I really like this thing.’”

Gundlach's Painting

Gundlach says he likes how Mondrian's paintings express balance without symmetry and achieve the elimination of figure and ground.

“They seem to exist at the scale of a galaxy,” Gundlach says. “Mondrian is able to capture the infinite and the finite.”

Today, visitors stepping off the 18th-floor elevator at Gundlach's offices are greeted by a painting inspired by Mondrian that the money manager himself created. It features double black lines on a white background with a blue rectangle.

“My problem is, I'm too much of a perfectionist,” Gundlach says of the Mondrian-inspired pieces he's made. “Mine are more perfect than the real ones.”

For all his braggadocio, Gundlach has a strain of humility, especially when it comes to his employees, corporate bond manager Baha says. In its early days, DoubleLine's existence was threatened, as the TCW lawsuit and its potential liabilities scared away institutional investors, she says.

Fighting Tears

Fighting back tears, Gundlach stood before his staff of about 40 people and told them he felt responsible for their careers after they had left TCW to start DoubleLine, she says.

“He said he would walk if he proved to be a liability,” she says. “His firing made him more appreciative of family connections, friendships, people who stuck with him.”

Gundlach was forced to build his firm with retail investors, who were pouring into bond funds after the S&P 500 Index closed at 676.53 in March 2009, a 12-year low.

“We needed to show success quickly because of the litigation,” says Ronald Redell, president of DoubleLine Funds Trust, which offers funds to investors.

DoubleLine got help from Howard Marks, another former TCW star, who left the firm 17 years ago with four other distressed-debt experts to start Oaktree Capital Management LP. Oaktree, with \$81 billion in assets as of September, bought a 22 percent stake in DoubleLine for an undisclosed price and assigned 60 of its people to help set up the firm's back office and other support functions.

Under Attack

“Since we had started a firm ourselves, the founders of DoubleLine enlisted our help in their startup,” Marks says. “When you are under attack, you've got to take extra steps to make it 100 percent certain you won't make a misstep.”

Whether three-year-old DoubleLine continues to thrive will rest largely on the investment instructions that Gundlach gives to his senior portfolio managers. They all debate the broad investment categories in which DoubleLine will place its bets during monthly asset allocation meetings in the Warhol conference room, named after the flamboyant pop artist.

Gundlach acts as the final judge, signing off on the percentages of investments of particular assets for the firm's funds. Once he settles on a strategy, Gundlach leaves it up to his managers to execute the trading, with oversight but little interference.

“He's very much hands-off,” Padilla says. “Once that allocation is made, he says, 'You manage that portion.'”

Stolen Artwork

Hands-off, though, isn't normally the first description that comes to mind when discussing Gundlach. In mid-September, thieves robbed the money manager's Santa Monica home in a quiet residential neighborhood, taking more than \$10 million in artworks as well as his red 2010 Porsche Carrera 4S, wine and watches. The robbers also snatched two works by Gundlach's late grandmother, Helen Fuchs, who was an amateur painter.

The money manager first offered \$200,000 for tips leading to the recovery of his art and days later boosted the reward to \$1.7 million. Santa Monica Police Department Sergeant Richard Lewis says the large sum of money was key to cracking the case, which the Federal Bureau of Investigation assisted on.

In late September, two suspects were arrested and all of the stolen art was recovered.

The cerebral Gundlach also gave investigators a tip for solving the crime. He says that while he was at home in his family room, it dawned on him that thieves would do a Google search using his grandmother's name to find out more about the paintings and how much they might be worth.

Gundlach told the authorities that they should check the Internet to see who might have googled the name Helen Fuchs. He says exactly two such searches were executed: one by him and one by the thieves.

Gundlach says his Internet idea impressed investigators.

“The FBI,” he says, “thought it was brilliant.”

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