MarketWatch
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Opinion: Mutual-fund manager who is whipping the S&P 500 warns of inflation risks

By Philip van Doorn

Low inflation and interest rates, a growing economy, near-full employment and central-bank support have enured U.S. investors to typical stock-market risks.

In fact, passive index funds based on the S&P 500 SPX, +0.02% and Dow Jones Industrial Average DJIA, -0.02% are recording new highs weekly in what has become the seventh year of the bull market.

But with Federal Reserve officials hinting at an increase for official interest-rate targets before the end of the year and global risks piling up, investors may soon find themselves in defensive mode.

Michael Cuggino, president and portfolio manager of the Permanent Portfolio Family of Funds.

"I came of age in the late '70s and early '80s. I remember double-digit inflation, stagflation, double-digit short-term rates, the Hunt Brothers in the silver market and $800 gold," said Michael Cuggino, the president and portfolio manager of the Permanent Portfolio Family of Funds, in an interview.

His Permanent Portfolio PRPFX, -0.10% a mutual fund established in 1982, has returned 15.5% this year through July 29, which ranks it No. 1 among Morningstar's moderate-risk total return category. That's more than double the 7.7% return of the benchmark S&P 500.

The fund's objective is to preserve investors' capital while providing a return that beats the rate of inflation. Cuggino, who's been managing money since 1991, does so by favoring an asset-allocation strategy, which means selecting investments within varied classes — stocks, bonds, commodities — according to flexible targets.

"We are in the business of growing and preserving an investor's capital over a long period, with an 'inflation-plus' type of a product," Cuggino said. The fund has about $3 billion in assets, and the company is headquartered in San Francisco.

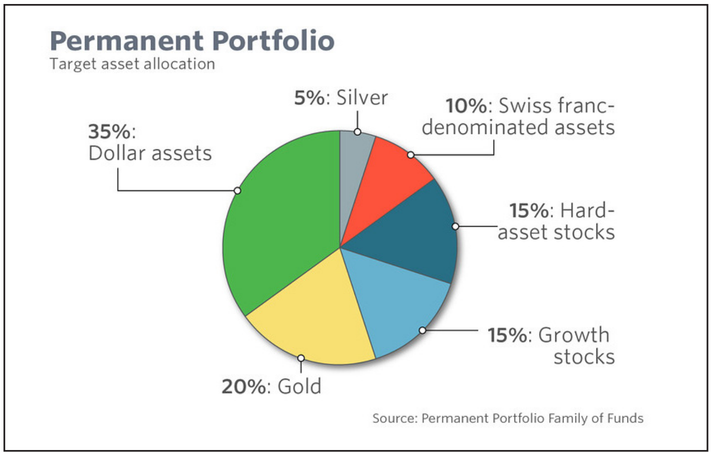
The S&P 500 has returned 123% since the end of 2009, with dividends reinvested. So it has been pretty much been a can't-miss environment for index-fund investors, as long as they haven't "bought high and sold low" during periods of volatility. It's never a straight ride, and twice over the past year there have been declines of more than 10% that scared, and scarred, some investors.

Accelerating inflation is one of the biggest long-term risks for U.S. investors. While the rate of inflation hasn't breached the Federal Reserve's 2% target since 2012, a jobless rate of 4.9% and steady economic growth eventually will lead to higher rates, putting a drag on corporate profits and dinging stocks.

"People talk about being diversified, but when certain trends are taking place, they want to be there. They have trouble taking money off the table and then they get burned."

While employed as a certified public accountant at Arthur Young & Co. and later Ernst & Young, Cuggino was the auditor for the fund from 1985 through 1991, when he joined the Permanent Portfolio as an adviser. Cuggino eventually bought out the fund's founders and has been the sole manager of the fund since May 2003.

Here's the target allocation for the fund, which is described in greater detail below:



Fund or index	Total return - Jan. 1 through July 29	Average annual return - 5 years	Average annual return - 10 years	Average annual return - 15 years
Permanent Portfolio - Investor Shares	15.5%	1.1%	5.8%	8.2%
S&P 500	7.7%	12.7%	7.8%	6.1%
				Source: FactSet

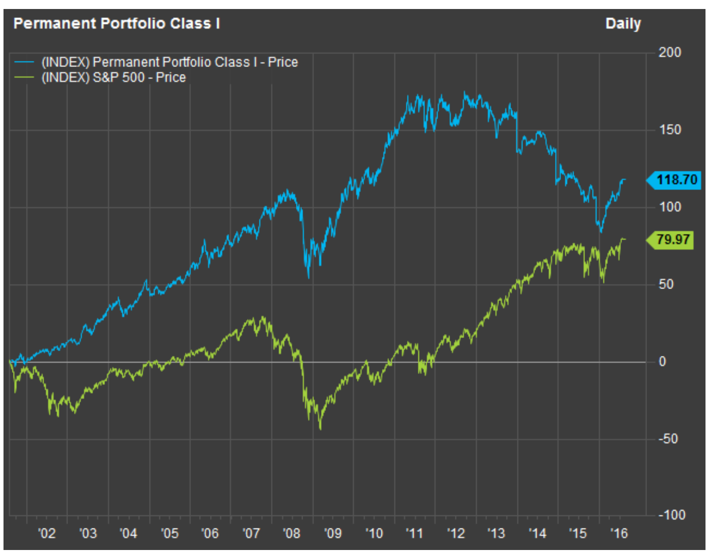
"For the Permanent Portfolio, there is no true benchmark for comparison of performance, since our mandate is to beat inflation," Cuggino said. But one measure is the S&P 500, an indicator of growth, and another is the three-month Treasury bill index.

Comparing the performance to the three-month Treasury bill index won't tell us much, since the index return has been running near zero for so many years. But it can still be useful to compare the fund's performance to the S&P 500.

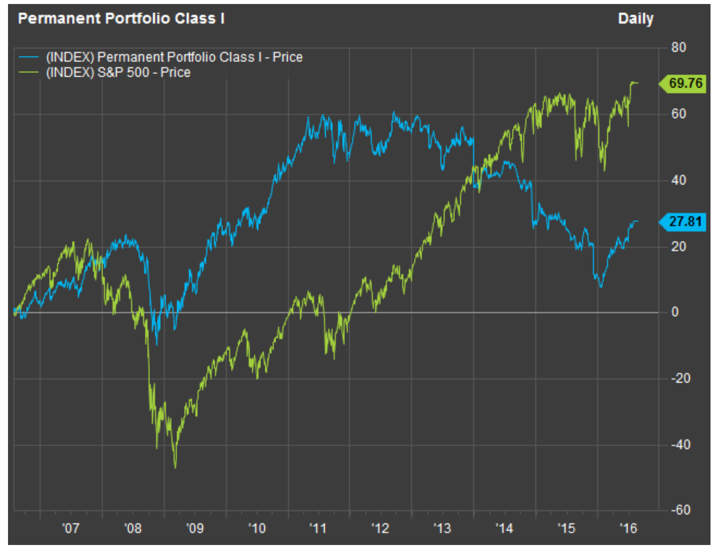
"The dollar is strong, U.S. equities are attractive for yield and so are U.S. government bonds, so we have a lot in our portfolio that we are exposed to, that has held up this year," Cuggino said, explaining the fund's recent performance.

Outperformance isn't a goal of Cuggino's. Looking at the allocation chart above, you can see just how focused the fund is on holding a basked of assets that will be solid during difficult times for the overall market. The fund's average annual returns for the past five and 10 years have been well below the averages for the S&P 500, but its 15-year average has been well above that of the index.

Here's a 15-year chart comparing the fund and the index through July 29:



This 10-year chart shows the index "catching up" during the start of the bull market and greatly outperforming the fund over the past few years, which, in hindsight, would be expected, considering the fund's investment allocation:



Hard times

When Cuggino was working in the early 1980s, the Federal Reserve's prime rate rose as high as 20%, as the central bank tried to combat runaway inflation. Stagflation — a combination of high inflation, high unemployment and reduced demand for goods and services — presented a no-win scenario for most investors.

"Yes, you could make 15% on a three-month T-bill, but inflation was eroding it away and if you held anything longer, you were getting absolutely killed," Cuggino said.

The Portfolio was founded by Terry Coxon, who was a research associate working for Harry Browne. Browne was an investor who wrote about asset-allocation theories and published several books on the subject.

"Browne predicted gold would go up after we took the dollar off the gold standard in the '70s," Cuggino said. "He was one of the first people to come up with allocation to asset classes and arrive at a 'permanent portfolio,' to produce a less volatile return over time, to preserve purchasing power."

"Nowadays almost every manager has some sort of asset allocation, but back then, in the mutual fund world, it was a novel format," he added.

Cuggino described himself as "a newbie with an accounting degree" from Bentley College, which is now called Bentley University, in Waltham, Mass., when he first started auditing the fund in 1985.

"Until then, growing up in Boston, I knew Fidelity had mutual funds, some with stocks, some with bonds, some with a combination," he said. "But when I read the prospectus to become familiar with my client, I was fascinated by the asset allocation."

He became convinced in the merits of the strategy. "I live, breathe and eat global macro thinking and multi-asset diversification," he said.

The volatility of the overall market may lead to excellent returns over a long period in a 401(k) or other retirement account, as it has for committed index-fund investors in recent years. But a conservative fund may be appropriate for a portion of your investments or for a time when you wish to take less risk.

Allocations

The fund's target allocation is only 30% U.S. stocks, with half of those in "hard assets," including producers of precious metals and other commodities, and real estate investment trusts, or REITs. Thirty-five percent is invested in U.S. Treasury and agency debt securities, as well as investment-grade bonds. Then there's 20% in gold, 5% in silver and 10% in assets denominated in Swiss francs.

When discussing how he selects companies for the roughly 15% of the Permanent Portfolio allocated to growth stocks, Cuggino said he tends to shy away from established slowgrowth companies like Coca-Cola Co. KO, -0.30% or Kimberly-Clark Corp. KMB, +0.96% He also avoids utility stocks.

According to the Permanent Portfolio's most recently published schedule of investments, real-estate and natural-resources stocks made up 19% of total investments as of April 30. The top real estate holding was Prologis Inc. PLD, -0.11% and the top materials holding was Freeport-McMoRan Inc. FCX, -0.56% Aggressive growth stocks made up 17% of the portfolio, and the top two holdings in that category were Facebook Inc. FB, +1.51% and Janus Capital Group Inc. JNS, -0.20%

The rapidly growing companies that Cuggino invests in "have not been as much in favor as the higher dividend payers," he said. "Think about the outperformance over the past couple of years in consumer staples and utilities. We don't think the long-term growth potential is big enough in those areas. We have been hurt over the shorter term by the aggressive stance" of the growth-stock portion of the portfolio, he said.

Cuggino said the Swiss franc is not subject to the devaluation risks faced by the dollar and the euro. "It's a hard asset that is similar to gold in a lot of ways. It is a currency that provides returns through its bonds and interest-paying capabilities," Cuggino said.

So you're looking at a conservative investment portfolio, with some growth potential through the exposure of about 30% to U.S. stocks.

"People talk about being diversified, but when certain trends are taking place, they want to be there," Cuggino said. "They have trouble taking money off the table and then they get burned. We're here to help them."