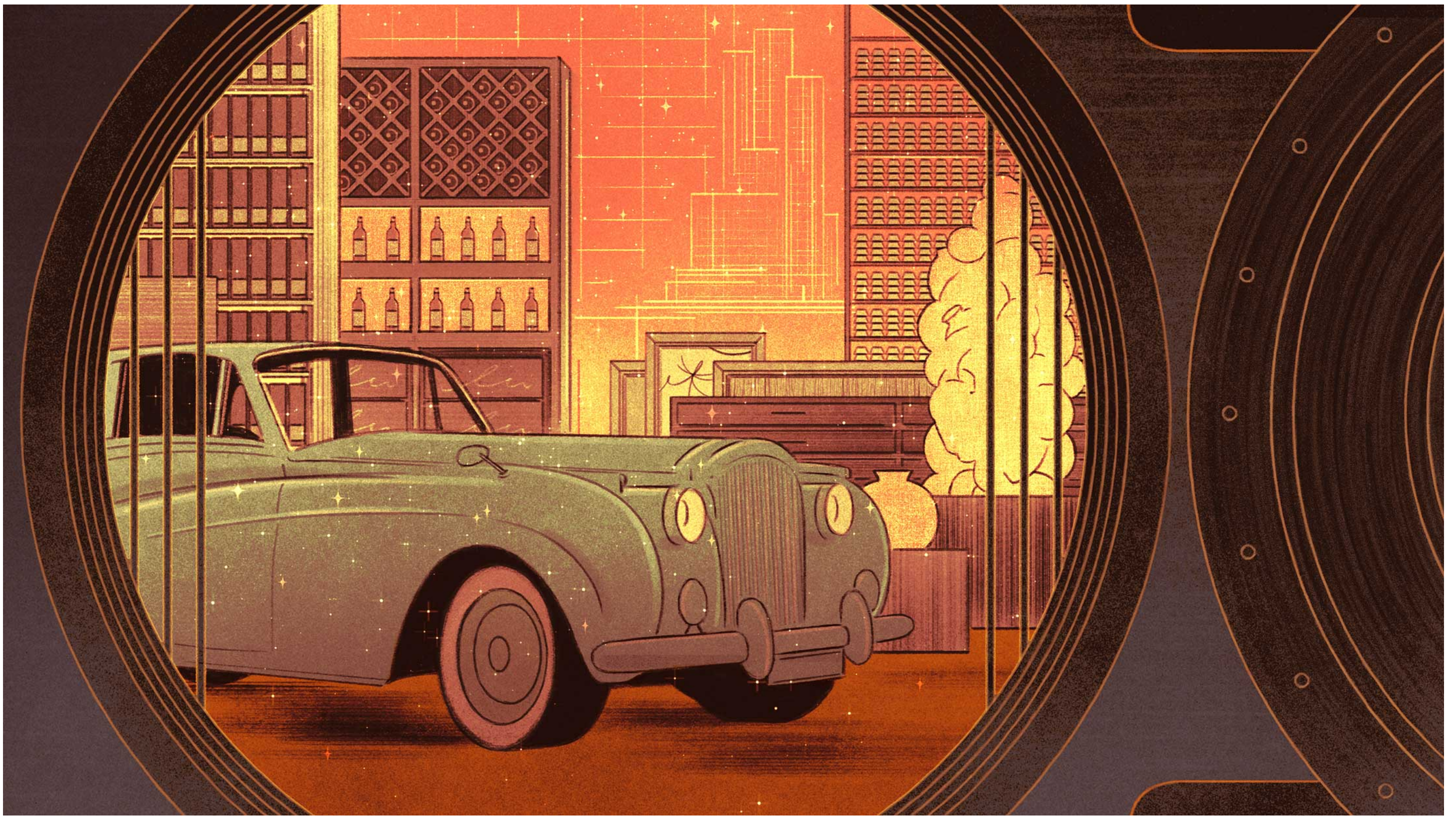

Illustration: Isabel Seliger

Wealth

Where to Invest $1 Million: Rob Arnott Says Stock Slump 'Far From Finished'

The pioneer in smart-beta investing said US markets aren't cheap yet and that better values can be found abroad

By Suzanne Woolley + Follow
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Famed contrarian investor Rob Arnott, co-founder of Research Affiliates, helped pioneer the wonky world of smart-beta ETFs. It's a rules-driven investing strategy that selects stocks using measures other than market capitalization, such as volatility, dividend growth or profitability.

In a phone conversation with Bloomberg News, Arnott shared his views on the recent rally in mega-cap tech stocks, where he sees value in US and international markets, and where he'd deploy a cool $1 million if he had to spend it on a more personal interest (it involves both art and exotic metals). Bloomberg Intelligence ETF analyst James Seyffart suggests some funds that regular investors can use to emulate Arnott's views.

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Rob Arnott , founder, Research Affiliates

The crash is far from finished

The big picture: Investors with new capital should be careful in allocating their money. Valuations are key. I see the tech stock rebound as a dead-cat bounce in speculative growth. It's very typical that when a bubble is bursting, you get bounces. This is a biggie, but it's triggered in part by tumbling inflation, which some people interpret as, "Oh, you can go back to those meme stocks." No, the crash is far from finished.

The idea: I'd frame a discussion about where to invest around three foundations: thinking long-term, diversifying, and managing risk relative to your human capital — where you work, where you live. If you live in the US, consider non-US and emerging market stocks. If inflation would hurt your income, consider Treasury Inflation-Protected Securities (TIPS), global real estate, and master limited partnerships in energy and other resources. If you're exposed to trendy growth companies in your work or portfolio, consider value investments outside the US, where geopolitical fears have put them in bargain territory.

In the US, small-cap value stocks are about the only thing that's cheap. The S&P 500 is back above 30 times earnings, if you use the Shiller price-to-earnings ratio. [The so-called CAPE ratio uses inflation-adjusted earnings from the previous 10 years.] Small-cap value is trading below 20 times — it's not cheap, but it's not bad. International value is trading at 11 times the 10-year earnings average, and emerging-market value is at nine times sustainable long-term earnings. That's cheap. People call me a perma-bear, but I'm not a bear when things are cheap.

If I had to cherry-pick between small-cap value, TIPS, global real estate, international value and emerging-market value, the last three would be the most interesting. Those three would give you a more focused return-oriented strategy with less diversification, but one could do a lot worse than putting 20% into each of the five. Each of the areas looks great on a risk-reward perspective, and each is likely to be a good diversifier for the typical US investor relative to where they have most of their personal risk.

Drilling down: The events of the past year have created some pretty good bargains. Our model shows international value having a 13% annualized return per year over the next 10 years, with risk no higher than that of the S&P 500. Meanwhile, we project an S&P 500 index fund will give you roughly 5.5% per year (up from 2.5% a year ago, before the bear market). Emerging-market value and global real estate will be a little more volatile, with projected returns of about 14% and 8%. TIPS is the lowest-risk strategy, and if you're investing in long-term TIPS the yield is about 1.5%. Our 10-year inflation forecast is 3.5%, so you get 5% at very low risk. Plus, if inflation rebounds, you're protected. US small-cap value is around a 9% return. A basket of the five holdings would give you a little over 10% every year over the next 10 years.

How to ETF it

- For small-cap value: Vanguard Small-Cap Value (VBR) is the largest, cheapest small-cap value ETF, at a $26 billion market cap and 0.07% fee. However, it offers a value tilt, not targeted exposure, says Bloomberg Intelligence's James Seyffart. A more targeted ETF is iShares US Small Cap Value Factor (SVAL), which has a fee of 0.3%.
- For TIPS: The largest and most liquid option is the iShares TIPS Bond ETF (TIP), but it charges 0.18%. The $13.7 billion Schwab US TIPS ETF (SCHP) offers very similar exposure but has a 0.04% fee.
- For global real estate: REITs tend to have much higher correlation to the equity markets than they do to the real estate markets over the short term, but there are a few global REIT ETFs. The largest and cheapest is iShares Global REIT (REET), with a cost of 0.14%. Avantis Real Estate ETF (AVRE) and Dimensional Global Real Estate ETF (DFGR) offer a more active approach at 0.17% and 0.24%, respectively.

- For international value: The Invesco FTSE RAFI Developed Markets ex-US ETF (PXF) and its emerging market cousin (PXH) offer fundamental value-based exposure, with fees of 0.45% and 0.5%, respectively.

Alternate idea

My wife, Marina, and I collect edgy contemporary art, and Banksy is a favorite. With a modest slice of your $1 million, you can get a pretty good portfolio of limited edition lithographs for four- to five-digit prices and they are fun and hilarious to look at. One we have is of a cute little girl holding a bomb, which is a commentary on war, of course, called “Bomb Love.” There’s a lot of street art that’s angry, and what I love about Banksy is, yes, he’s an anarchist and politically hard-left but he laughs at himself. It’s usually cheaper to buy at auction than from a gallery — Phillips is an auction house that has a lot of contemporary art auctions.

Another idea, for an odd flier: Consider that the green movement can’t possibly succeed without nuclear power and exotic metals. Two big producers are Rio Tinto and BHP Group. They have price-to-earnings ratios of six to eight, and dividend yields north of 9%, which tells you they’re seriously unloved. That gives us exposure to Australia, which is one of my favorite countries. Your broker will give you lots of reasons not to buy them, such as China being at economic war with Australia and banning their products — okay, but where else are they going to get those metals?

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