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Listen Up, Class: Here's How to Profit

By **LAUREN R. RUBLIN**

The Barron's Roundtable sees trouble in Europe, but bargains in the U.S. and emerging markets. Marc Faber and Oscar Schafer share their 2012 investment picks.

Inflation. Deflation. Refinancing. Bad rap lyrics, or the poetry of finance? You can judge for yourself when you finish this first installment of *Barron's 2012 Roundtable*, a verbal free-for-all that features high-falutin' words, scary predictions and, yes, some sound advice on how to prosper in the year ahead.

After a year of political turmoil in the U.S. and debt-fueled chaos in Europe, it's no wonder the 10 investment experts whom *Barron's* assembled last Monday at the Harvard Club of New York were eager to dissect the big picture: how the U.S. should get its house in order (the Senate, too), whether Greece will get booted from the euro, why central bankers might print money until the world's ink supply runs dry, and, not least, when World War III will erupt (sooner than you think). To a one, these leading lights of Wall Street agreed that the world is a lot more dangerous than it was 10 or 20 or 30 years ago, when investors worried more about return *on* their capital than return *of* it.

That said, most Roundtable members also think pessimism equates with opportunity -- in this case, the opportunity for gains in 2012 in relatively undervalued U.S. stocks. Fred Hickey, our resident expert in all things tech, even allowed that the 12-year bear market in technology shares could be ending, which really would be something to celebrate.

You'll note a new face at this year's Roundtable, that of Brian Rogers, chairman and chief investment officer of Baltimore money-management powerhouse T. Rowe Price. He takes the seat long occupied by Archie MacAllaster, who sadly passed away in 2011. Archie likely would be pleased to know that Brian too is an optimistic sort; he lives by several upbeat maxims, including that the world doesn't end often. Try to remember that when you read the downbeat stuff in the pages that follow.

Marc Faber, who describes himself as the world's No. 1 pessimist, is responsible for much, though not all, of it. He lives in Thailand but roams the globe, and starts off the stock-picking portion of this year's Roundtable. Not surprisingly, perhaps, he remains a fan of emerging markets and thinks they will offer ample rewards to long-term investors, especially after their shellacking in 2011. Most of all, he believes in diversification -- into equities and fixed income, real estate and gold -- in a world where it is hard to fathom what policymakers might do next.

Hedge-fund manager Oscar Schafer, of New York's O.S.S. Capital, also takes his star turn in

Our Panelists

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this first of three Roundtable issues, making the case for a quartet of misunderstood companies with deceptively bright prospects for the new year. His attention to industry dynamics, capital-allocation strategies and valuations helps explain why he has not merely survived but thrived for decades on the Street.

Want the details? Please read on.

***Barron's*: Let's not dwell on last year's mistakes, because all of you have taken vows to pick nothing but winners now. So we'll start with the economy and interest rates, and even Europe, which called so much of the tune in 2011.**

Oscar, what's ahead?

Schafer: The U.S. economy will continue to bumble along. The stock market will do all right if we avoid the "fat tail" outcomes of either hyperinflation or deflation that Bill Gross recently wrote about. Joe Rosenberg [chief investment strategist of Loews] said in a *Barron's* interview last month that you can't have good news and cheap stocks at the same time. We might have not-so-great news but cheap stocks, so I'm pretty optimistic.

Last year was strange, with the Standard & Poor's 500 ending exactly where it started. Within the year there was huge volatility, however, which is hurtful to individual investors. Leveraged ETFs [exchange-traded funds], which deliver two or three times the market's return, could be to blame for the huge upswings and downswings at the end of the day, as they need to rebalance their positions by buying or selling more stock before the close.

But leveraged ETFs are just a small part of the market.

Gabelli: There are many inter-related dynamics that account for the volatility: the elimination of the uptick rule [which forbade short-selling of shares unless they were rising], arbitrage between markets, high-frequency trading, flash trading.



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Jennifer Altman for Barron's

The consensus at the Roundtable was that one or more countries will have exited the euro by this time next year.

years. It drives the small investor away from the market. He doesn't understand it. He doesn't trust Wall Street, and rightly so, and he finds the whole system corrupt and dominated by people with inside information.

Faber: But why is there leverage? It is a symptom of artificially low interest rates -- essentially zero interest rates -- that force everybody to be a speculator because you're not earning anything on your money. This volatility won't disappear anytime soon, because it has little to do with the problems in Europe and everything to do with excessive liquidity that is being created in the system. Unless there is a general collapse of liquidity -- in other words, a credit-market collapse -- the volatility will continue, perhaps for five or 10

Gross: It isn't just the small investor but the big investor. When the headlines hit about MF Global's collapse, along with the realization that a financial firm could take money from one pocket and put it in the other, I quickly diversified my own brokerage accounts to avoid such a thing. Large savers are diversifying against the risk of leverage and the misappropriation of that leverage.

Schafer: The stock market's volatility is hurting the country's role as a capital-raiser.

Hickey: We have seen a big decline in venture-capital activity and IPO [initial public offering] activity.

Gabelli: Unstable markets impact the cost of capital for corporations. The enactment of the Sarbanes-Oxley Act has dulled enthusiasm for the U.S. market.

Cohen: Volatility also can be attributed to worry about economic activity. There is a strong correlation. One reason IPO activity has been less than robust is that the price the seller can achieve might not be what the seller would like. The equity market's valuation looks to be quite low right now, and many people would rather hold on to what they have, whether we're talking about harvesting investments made over the years or taking companies public.

Schafer: If valuations are so low, why did 70% of last year's IPOs end the year down?

Cohen: There has been extraordinary divergence sector. Technology-related IPOs traded well and are selling at higher valuations than a lot of other new issues.

Hickey: China had a lot of IPOs last year and they were a huge bust.

Cohen: Transparency of data is a big issue with Chinese stocks. It is something that concerns the Securities and Exchange Commission, which, in a time of constrained resources and staffing, is shifting resources to look at publicly traded Chinese companies and companies with subsidiaries in China.

Gabelli: We started with a 30-second observation by Oscar on the economy, and we went into a long-winded discussion of volatility. How did we get here?



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OK, so it's not quite round, but the participants are plenty astute. Our panelists expect oil prices to rise in 2012, buoyed by demand from emerging markets.

Good point. Marc, what do you think?

Faber: We could have high volatility not only in financial markets but economic activity. Corporate profits, for example, collapsed in 2008-09, and then, within a year, rebounded to record levels.

They didn't do it unaided. Government helped, with a few trillion dollars of spending.

Faber: Three professors named Baker, Bloom and Davis created an index measuring policy-related economic uncertainty. It is now at a record high. The index averages several components that reflect the frequency of news-media references to economic policy uncertainty, the number of federal-tax-code provisions set to

expire in future years and the extent of forecaster disagreement over future inflation and federal government purchases. The government's intervention makes it practically impossible to make accurate forecasts. We don't know how big the fiscal deficit will be. We don't know how much more money they will print.

Governments around the world will print massively, which is why I agree to some extent with Joe Rosenberg's statement that markets live on bad news. The worse the news gets, the more the U.S. and the European Central Bank and China will print money. Then the average person's economy will go downhill but stocks and corporate profits will go uphill. When we talk about the economy, remember that the economy of Aspen and the economy of Detroit are two different things.



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Marc Faber: "It is not that the gold price will go up. It is that the value of paper money will go down."

And neither tells you much about the economy.

Cohen: There is also a growing divergence between the U.S. economy and U.S. stocks that has to do with where companies in the S&P 500 conduct business. Nearly 40% of S&P revenue is generated outside the U.S., and our tax system provides an incentive for U.S. companies to keep the money earned abroad overseas. They have to pay yet another tax when they repatriate it. Everyone knows there

is a lot of cash on the balance sheets of S&P 500 companies. What most people don't realize is that much of that cash is sitting outside the United States.

Faber: What will happen to overseas profits if Europe goes into a recession or doesn't grow, and if there is a more meaningful slowdown or crash in China?

Gabelli: Companies will face real headwinds in the first half, particularly in the second quarter, from a combination of sluggish economic activity and a negative change in the euro/dollar relationship.

Zulauf: From a currency standpoint, the dollar was weak relative to the euro for much of last year, and that benefited U.S. companies. Now the relationship is changing.

Gabelli: That will hurt reported earnings of a lot of companies I follow.

Cohen: Europe will present head winds due to slower growth. The currency issue won't be quite as important, because the sensitivity of the U.S. economy to currency changes is smaller than that of most other economies. We sell high-value-added goods and services, most of which aren't as price-sensitive as what other nations sell. U.S. earnings growth will be pretty lackluster this year -- let's call it mid-single digits. We're looking for pressure on margins, which will be an important aspect of stock selection.

Isn't Europe's economy in a recession now?

Faber: It is difficult to measure economic growth because you must make so many adjustments in different industries. In the U.S., for example, housing is bottoming out. For the

first time in a while, household formation is increasing. But while this segment of the economy is stabilizing, a tax break allowing companies to write off 100% of new capital expenditures has just expired.

Gabelli: It was cut to 50% on Jan. 1.



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Faber: "People say large-cap stocks are inexpensive. I would buy a basket of high-quality big-caps in Europe and the U.S."

Faber: The regulatory environment is bad under the current administration. I don't see a lot of people wanting to invest in the U.S. Statistics show that net capital formation is negative. In Europe, the problem is an overleveraged banking system and bankrupt governments.

Is that all?

Faber: The combination makes for a nice fruit cocktail. European governments, and the U.S. government, can sell assets, but they can't do it

overnight. Governments such as Italy own large stakes in corporations. They own land. They could also tax the church once in a while, which would bring in a lot of money. That would solve all the problems of the world.

Gabelli: Many not-for-profits in the U.S. are looking at pilot programs, or payments in lieu of taxes, to help their local communities.

Faber: It doesn't matter if the U.S. or Europe grows by 2% or contracts by 2%. For the world as a whole, it's irrelevant. Say someone sends his laundry out to be washed. When he doesn't have the money any more, he washes it himself. That will lower GDP [gross domestic product], but it won't impact the global economy.

Zulauf: I disagree.

Gross: It matters because nominal GDP determines whether debt is destroyed or reflat.

It also matters because it influences expectations.

Faber: If I own stocks, whether Europe and the U.S. contract 2% or grow 2% won't make me change my allocation.

Zulauf: But the market will put a different price on your stocks.

Cohen: The U.S. and Europe aren't just huge consumers of what they produce, but huge importers. They promote aggregate demand for companies in emerging nations, so there is a ripple effect.

Faber: The world has now wasted almost nine months talking about Europe. This isn't an economic issue but a political issue. The weak countries should be kicked out of the euro and the losses taken. The longer you support



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Oscar Schaffer: "We invest in companies"—like United Rentals—"whose cyclical exposure is misunderstood."

countries like Greece, the more the crisis will drag on and the losses will increase. The Greeks will get more money and pretend to implement austerity, and then buy a few more BMWs. Greece's bonds need a haircut of about 90%, and even then, the country might not pay off the rest of its debt.

Do you agree, Bill?

Gross: Euroland is a dysfunctional family. It is the parental north versus the spoiled children of the south. The children have spent their

inheritance, so to speak. Although the family is attempting a reconciliation, it can't come together. By the time we meet here next year, one or more countries will have departed the euro zone in currency terms.

Faber: You could have a dual system whereby countries have local currencies but many transactions still occur in euros as people don't trust the local currencies.

Zulauf: Europe is going to be key this year for the markets and the economy. China is slowing; the emerging world is slowing, and the U.S. is barely above water, constrained by its structural problems. I have called the euro a misconstruction since its birth. The problem is a difference in competitiveness among European countries, and you can't solve it by lending money to the less competitive countries. You have to deflate wages and prices in the south, and inflate the north. But given Germany's history, it will never inflate.

The members of the euro zone agreed in December that each country could have a structural deficit of no more than half a percent of GDP. If a deficit goes above 3% of GDP, the country will be sanctioned. This agreement now has to be ratified in all countries. But when you agree to such a prescription and you are uncompetitive, your currency is overvalued by 30%, you can't devalue, and your nominal interest rates are too high, that is a recipe for a depression. It is a death sentence. Several countries won't ratify the contract, and the next day their markets will be repriced accordingly. They will exit the euro, and the turmoil will go to the next level. Greece is bust in either case. If you can devalue your currency by 40% or 50% in that situation, at least you will have the chance to see the sun again and recover.

What happens at the next level of turmoil?

Zulauf: The banking system goes bust. Assume Greece won't repay anything, or at most 10% of its total debt. It is not just the government but the private sector that is bust. That means banks in other countries will be in trouble, which means they will be nationalized.

Governments won't have the money to pay for this, so they will assume even more debt. That is the chain of events I expect in 2012, and if you believe it won't affect the U.S. you are dreaming. The estimated notional value of the over-the-counter fixed-income-derivatives market in Europe is estimated to be about 60 trillion euros. There are many links to the U.S. banking system, although we don't yet know who is positioned how. If one country exits the euro, all hell will break loose.

Hickey: Mario Draghi [president of the European Central Bank] has already admitted Europe is in a recession. Only a couple of countries aren't in a recession now.

Zulauf: Every European country will be in recession in 2012, and probably in 2013.

Gabelli: How bad is bad, and how long will it take to recover? Felix, what happens 18 months from now?

Zulauf: Fiscal stimulation is out of the question. That will come at the depths of the crisis, not before. Central bankers are more at ease with the problems and will continue to print money, but if the ECB overdoes it, Germany will say it isn't participating in the game.

Hickey: Aren't they overdoing it already? The ECB's balance sheet has gone to \$3.5 trillion.

Zulauf: So far, the expansion is passive. The banks are requesting help to refinance their operations because they can't refinance in the interbank-loan market and are losing deposits. Now the Bank for International Settlements is demanding higher capital ratios. That means European banks will shrink their balance sheets and weaker countries with balance-of-payment deficits will have a harder time funding their deficits, which leads to economic contraction. The European crisis has a global dimension.

Witmer: Is there a mechanism whereby a percentage of the sovereign debt can be eliminated and the CDS holders get paid? For example, in a U.S. corporate bankruptcy, a debtholder might have to accept 70 cents on the dollar and move on.

Zulauf: When the banks agreed to a "voluntary" 50% haircut on Greek debt last year, they basically undercut the whole CDS market. Greece technically didn't default.

Witmer: But defaults likely have to happen, and not only in Greece. So accept it, and move on.

Zulauf: I agree, but there are consequences. Investors will lose a lot of money. The banks could go bust. Consumers will lose confidence. I have been coming to the U.S. for about 40 years. In the past few years I have detected a loss of optimism. When people lose that, their economic behavior changes. They save more and spend less.

Gross: The bell-shaped curve of probabilities is out. The probabilities in the next few years are bimodal: deflation or reflation. In policy terms, we have reached the point where money is scarce and credit is overabundant. Think of the financial system as one giant bank. It was a wonderful life for the past 30 years, but now the bank is overextended. It has lent out too much and depositors want their money back. In this bank, \$7 trillion or \$8 trillion of reserves support \$120 trillion of credit. If you include the shadow banking system and rehypothecation [repledging of bank customers' collateral], the global bank is 15 or 20 times levered. All the bad debt that has accumulated is migrating back to the central banks. That's where bad debt goes to die.

Secondly, there is too little return on money. Central bankers don't understand that because their models don't permit it. There has never been a time, other than the Japanese experience of the past 10 years, when money that doesn't pay a return deflates instead of reflating. In the past 30 years the Federal Reserve lowered interest rates in the hope that credit markets and risk assets would expand proportionately. It worked. But when you get down to zero interest

rates, things start to change. The world changes from Newton to Einstein with regard to the physics of money.

Explain that, please.

Gross: When money yields nothing, banks won't lend it. If a bank can keep money on deposit with the Fed at 25 basis points [a quarter of a percentage point] or lend it at 27 basis points, the yield on a two-year Treasury, why take the two-year risk? The combination of low return and high risk basically freezes the system. The global system is trying to delever and central banks are trying stop that process and pump trillions of dollars in. In a bimodal world, we could have reflation in 2013-14, or deflation in 2012. The probability of both is high.

But there is no freeze on credit. You can borrow money now, unlike in 2008 and 2009.

Gross: That's at the extremes of the circle. In the middle is a tremendous black hole. It is sucking in all the credit. There is no reason for **JPMorgan Chase** [ticker: JPM] or **Goldman Sachs** [GS] or Pimco to lend money at 25 basis points by taking duration risk. This is an endpoint that central banks and credit markets didn't envision.

Yet, you have been buying bonds.

Gross: But the returns are low. We've bought on the assumption that the Fed and other central banks will continue on this path for as long as necessary. That is the reflationary scenario. If they abandon their quantitative easing and Operation Twists and policies of the future, there's deflationary potential. You have to invest in the cleanest dirty shirts and the U.S. is one. If all that money managers and hedge funds can produce is a 2% or 3% return, it signals to investors that putting your money under the mattress might be a better alternative.

Rogers: Bill inadvertently makes a good case for investing in equities. Felix is depressing me, but in a very articulate way. I operate by several maxims. One is that the world doesn't end often. Another is that people generally react rationally. If I were an ECB policymaker, I would try to find a way to ringfence Greece, and toss a lot of money at Spain and Italy to try to save them. My third maxim is something I adopted today: 2% growth is always better than negative 2%.

Felix touched on the most critical thing driving our markets with his reference to the American psyche. After the lost decade in equities, the individual investor is terrified. That investor will have an adverse reaction if and when Greece defaults. But that investor will come back. The individual investor panicked after the flash crash of the market on May 6, 2010, and after Standard & Poor's downgraded the nation's debt. People have become risk-averse. A crisis of confidence is what's driving the market.

Gabelli: Let's look at the history of delevering. How do you get out of it?

Zulauf: You either default and have a large deflationary accident or hyperinflate, which just delays the collapse. Politicians are trying to find a painless solution, which doesn't exist.

Gabelli: You're just describing the lobster trap we're in. Give us the pain now.

Zulauf: Default.

Gabelli: Across the board.

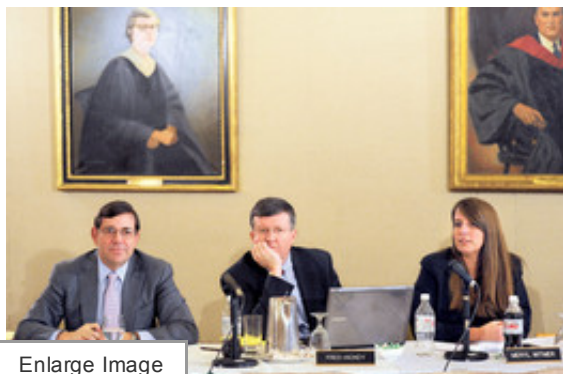
Zulauf: Yes. Or raises taxes, which further destroys confidence.

Faber: It would be best for all governments to cut spending by 50%. Then the private sector would expand again.

Gross: The best thing would have been to stop the nonsense before the growth of the subprime market, the dot-com bubble and the creation of Long-Term Capital Management. The best would have been to stop it in 1970s and '80s and '90. But no one did.

Scott, you haven't said a word.

Black: You're leaving out the politics of Europe. How to proceed is up to [German Chancellor Angela] Merkel and [French President Nicolas] Sarkozy, and there is no quick solution because they don't agree. As Margaret Thatcher said, socialism is great until you run out of other people's money. That's what has happened here, and the imbalances of the past 40 or 50 years aren't going to be rectified with a stroke of a pen. Mario asked about the solution. In the U.S. it is more of a pro-growth agenda. We have to overhaul the tax code, and we should follow the path set by Simpson-Bowles [the National Commission on Fiscal Responsibility and Reform].



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Jennifer Altman for Barron's

Scott Black: "If Europe doesn't have a major crisis, investors could see gains of 6% to 7% this year, plus dividends."

I agree with Abby that the market looks cheap. It is selling for 13.2 times last year's expected earnings of \$97.05. My estimate for 2012 is \$103.65, which is lower than the Street. The other good news is that corporate balance sheets are in great shape, with \$2.1 trillion of cash, including \$1.1 trillion overseas. If the congressional supercommittee had actually reached an agreement to pare the deficit through some budget cuts and incremental tax increases, the stock market would have exploded upward. But Congress can't get

anything done, and that will be the case through next November. Another negative is that China is slowing, as are other emerging economies. That doesn't bode well for a lot of commodities. The market seems cheap, but I'm not that optimistic. If Europe doesn't have a major crisis, investors could see gains of 6% to 7%, plus dividends.

That sounds optimistic.

Black: One thing that is hard for stockpickers like me is the correlation in performance among stocks. It doesn't matter if 95% of your companies had record earnings. The stocks didn't go anywhere because they moved with the market.

Schafer: Some industries, such as utilities, did extremely well last year.

Hickey: Utilities did well because the industry has consistent cash flow and an unbelievably consistent return on equity.

And utilities pay big dividends.

Gabelli: Money flowed into the utility area as investors sought higher current returns. Also, there were seven or eight deals in the sector.

Gross: They pay big dividends because they continually are granted a 10% return on equity by regulators in a world where returns are moving much lower. After earning 10% they can pay out 4% to 5% to investors.

Rogers: Utilities were cheap coming into 2011.

Hickey: The global economy will have a rough year. That's what stock markets around the world have told us. The European recession probably will get worse. China is slowing and manufacturing, housing and land sales are falling dramatically there. Japan's exports to Europe and China have weakened. The governments of Japan, India and Korea all lowered their economic forecasts. Brazil is in contraction. The U.S. is the only place that is holding up, and that might not be sustainable.

This global slowdown is having an impact in the tech world. **Hewlett-Packard's** [HPQ] latest quarter was a disaster. It is the largest computer company in the world. **Dell** [DELL] cut its sales forecast by \$1 billion, blaming weak global demand, particularly in Western Europe. **IBM's** [IBM] growth slowed in all major regions. **Oracle** [ORCL], which never misses earnings, just had a shocking miss and blamed much of it on Europe. When fourth-quarter earnings come out in January, the numbers will be poor. Companies also have a currency head wind that will only get worse.

We take it you're not bullish.

Hickey: I'm not bullish on the economy. Technology is something else. Tech has been in a 12-year bear market and we're now seeing very low P/Es [price/earnings multiples]. Hewlett-Packard sells for eight times earnings. You haven't seen 10 P/Es on **Intel** [INTC] and **Microsoft** [MSFT] for 20-plus years. The secular bear market is coming toward an end. Maybe we'll get a bottom in October.

Faber: If someone told me an asset had been in a 12-year bear market that was coming to an end, I would think about buying. Whether the end is tomorrow or in October, I'm intrigued as a long-term investor.

Brian, what do you make of the market?

Rogers: I'm never really strongly bullish, but I always find interesting things to buy. Some of the valuation data on equities suggest that the return opportunities are relatively decent compared to a lot of other asset classes. They aren't heroic when you're talking about buying decent-quality companies at 10, 11, 12 times earnings, with yields of 2%, 3%, 4%, but that's not a bad proposition. Most companies don't know what to do with all their money. Payout ratios are at a 75-year low of 26% because companies are scared, just like the individual investor. Corporations are putting money in money-market funds and short-term bond funds. People are acting defensively after a decade of valuation compression. The market is in a reasonable place again, assuming things don't totally fall apart in Europe.

Schafer: Most of us have been in the business long enough to remember when the Aug. 13, 1979, cover of BusinessWeek declared the death of equities. The next year the market was up 13%. In the next five years it was up more than 50%. In the next 10 years it rose more than 250%. There is a lot of pessimism around, and a lot of opportunity.

Witmer: It is astounding that people will trample each other to get a cheap TV, but when shares of great companies get cheap, they sell them. It makes no sense.

Zulauf: People don't care if the TV gets cheaper later, but they care when their stocks get cheaper.

Black: The U.S. doesn't have the same financial flexibility today that it had in 1979 and 1980. Government debt is 100% of GDP, compared with 32.6% then. The huge debt overhang is a ticking time bomb.

Gross: The biggest difference is that long-term Treasuries were yielding 14.5% in 1981, and now they yield 3%. The federal funds rate was approaching 20% then, and it is basically zero now. To do well, stocks and other asset classes have to fight a tremendous head wind of overvaluation in the price of money.

Faber: Ten years ago we had relatively low inflation in the Western world. Now, with interest rates at zero, we have high asset valuations. Asset prices have gone ballistic in stamps, modern art, wine, you name it. Gold, silver, other commodities, equities in emerging markets, high-end real estate -- all have done well. When assets become like cash, it may be safer to hold your money in the bank. If asset prices collapse, you'll be better off in Treasury bills with zero yields. Then the central banks will print money and bail you out. At least you'll get your principal back.

With money-printing, you never know what sector of the economy will be inflated. Maybe we have had profit inflation and there will be a severe correction. I don't expect corporate profits in the U.S. to collapse by more than 20% in the next 12 months.

Cohen: If you look at dividend-discount models such as the Fed model [it compares the stock market's earnings yield to the yield on long-term government bonds], that is pretty much what is priced in. The presumption is that there will be multiple years of notable profit declines.

Gross: There is a new balance. Profits now account for a larger percentage of GDP than wages. Government and business have been advantaged relative to labor for a long, long time. That's what Occupy Wall Street is all about. Eventually this will reverse, not just in the U.S. but around the world.

Zulauf: Money-printing is splitting society. It is only a question of time until there is a social backlash. It will result in dramatic changes in the political arena, the economic agenda and the tax agenda. Corporate profits might not look like what we're expecting today.

Faber: On another optimistic note, World War III will occur in the next five years. That means the Middle East will blow up. New regimes there will be less Western-friendly. The West has also figured out it can't contain China, which is rising rapidly and will have more military and naval power in Southeast Asia. The only way for the West to contain China is to control the oil

tap in the Middle East.

Gross: How does your World War III hypothesis affect the financial markets? Is it positive for stocks?

Faber: It is very positive for stocks and negative for bonds, because debt will grow dramatically. There will be massive monetization of debt. When the U.S. entered World War II total credit equaled 140% of GDP, and there were no unfunded liabilities. Now total credit-market debt is 380% of GDP, and unfunded liabilities make that 800%.

Rogers: How is World War III good for stocks?

Zulauf: Unused capacity in an economy can be directed to the defense and war industry. That will be paid for by new government debt, and that keeps the economy growing.

Black: Marc, if Israel strikes Iran's nuclear facilities, they will use air power. They aren't going to commit ground troops. It won't be the kind of conflagration you're thinking.

Gross: War takes place today in cyberspace and in terrorist space. Whether or not there will be a land war isn't the question.

Zulauf: From time to time there will be military actions. You make each other's lives miserable.

Mario, give us your view of the world.

Gabelli: I make peace, not war. China is more important than Germany and France combined in terms of global GDP. Let's assume China has a soft landing. The U.S. is deleveraging. Will the U.S. resume its role as an engine of global growth? Let's start with autos. The automotive sector continues to improve. First-quarter production will be 3.6 million vehicles, against 3.4 million a year ago. Other sectors of the economy are quite strong, including commercial aviation. **Boeing** [BA] is finally delivering the 787 Dreamliner and 10 shipsets will be produced per month by the end of 2013, versus two per month currently. The ramp-up rate is high. In the infrastructure business, U.S.-centric companies say they are seeing significant improvement. Housing is starting to flatten out. If I were president, as opposed to the guy there now who is in training...

Witmer: You've got my vote.

Gabelli: I can't afford the job. But I would try to help home owners. For those who aren't current on their mortgages, I would make it easier to refinance. If I am running for office in 2012, I need to find a way to jump-start housing, because autos and housing have always led us out of recessions. You need a multiphase approach, but that won't happen. So, 10 months from now voters will decide what they want. Do they want more or less regulation? Tax reform? A revamped education system?

Some 20% of S&P profits come from Europe, and they will get hurt. Another 20% is from financials. The industry's profits won't rise much, but they won't go down a lot in 2012. It looks like another year in which the market probably doesn't do much. However, if it looks in late summer like there will be a change in the White House, the market will go up, and we could

have a pullback after the election to finish the year unchanged.

Gross: I will bet you a steak dinner the market will be either up 10% or down 10% this year. You can have everything in the middle.

Gabelli: Done.

Cohen: History shows that markets tend to do well after an election. The U.S. has been one of the strongest economies in recent months. Fourth-quarter GDP was probably 3% to 3.5%. In the first half of 2012 we expect a notable deceleration. Europe could be a problem, as could oil. Crude prices are up sharply. The other factor that could mute growth is fiscal policy. Federal stimulus is over. State and local governments are still in the process of tightening budgets. We stand a better-than-usual chance of a more extreme scenario, however. Felix has laid out a gloomy scenario, but the alternate scenario, though not our base case, is that things get better as job creation grows.

Schafer: How much of the growth in fourth-quarter GDP is due to the drawdown of the savings rate, and how sustainable is that?

Cohen: The savings rate fell from about 5% earlier in the year to 3.5%. We don't know yet how much consumption was borrowed from the current quarter, but there are jobs out there. Most likely, the market will be volatile this year but it won't change much. We are seeing almost unprecedented risk aversion. Some people here don't think Europe will muddle through, but if it does, and the U.S. job market gains more traction, and the level of discord in Congress abates, investors might feel better toward the second half of the year and looking out to 2013. By then larger European economies could be out of recession, and U.S. profit growth could reaccelerate.

Right now everyone is looking about two weeks into the future. At the height of bull markets people are happy to look out five years. Perhaps by the end of this year they will look out six to 12 months. Political concerns seem to be priced into the market. Also, balance sheets are improving at U.S. banks. The U.S. has practiced tough love toward its banking system, which isn't the case in Europe.

Faber: The U.S. stock market did quite well last year compared with emerging markets, which were down between 15% and 30%. If you are optimistic about equities, wouldn't it be better to wait for great buying opportunities in emerging markets? Some stocks in Singapore are down 50% from the highs in 2010, and some property companies in Singapore and Hong Kong are selling at 50% discounts to asset value. Sometime in 2012 I would rather be more positioned in emerging economies than the U.S.

Cohen: It's not enough to look at 2011 alone. Emerging markets dramatically outperformed in 2009 and '10. One year of underperformance out of three doesn't tell you about relative valuations.

Faber: According to BCA Research, global equities returned 4% per annum in real terms from 1970 through 2009. That is about the return we can expect, on average, which is fantastic compared to zero interest rates. The developed markets have returned 3.8%, and emerging markets, 9.9%. In the long run you will do better in emerging economies.

Gross: Marc has a point. Emerging markets don't have the same capitalization and liquidity as developed markets, and when financial markets implode they get hit. But their fundamentals don't get hit as much if they produce real products that the rest of the world wants.

Faber: In Chiang Mai [Thailand], where I live, 95% of people wouldn't know there is a crisis in Europe.

Rogers: Marc is also right from the standpoint of valuations. Aside from India, which trades for 12 to 13 times earnings, good companies in Singapore and Hong Kong trade for five, seven, eight times earnings.

Faber: And yield 5% to 7%.

Gross: France versus Brazil: Which economy would you bet on for the next five years?

Zulauf: That's easy. You'll have higher volatility on the way up and down, but at the end of the day you're better off with Brazil.

Gross: It's a slam-dunk.

Black: Brazil has a socialist president.

Gross: Brazil has oil. It's the bread basket of the world. It exports commodities to China. They have everything going for them, and they are pretty smart people.

Speaking of oil, what do you think about oil and gold? They are of interest to many investors.

Faber: Oil has further upside potential. Long-term demand is there. Per capita consumption in India and China is low and will increase. Supplies might be rather limited. Oil is around \$100 a barrel now. How high it goes depends on how much Mr. Bernanke [Federal Reserve Chairman Ben Bernanke] prints. If there is a disturbance in the Middle East, the sky is the limit.

Cohen: Demand for industrial metals might also be good because of the growth in emerging economies. Brent crude could rise to \$120 to \$130 in the next two years, partly on higher global demand. Also, most capital spending has been directed at technology, leaving little for investment in the petroleum infrastructure, and for finding new fields.

Hickey: If all economies are in decline, I would be less interested in oil than gold.

Gabelli: Technology wins. We will drill for shale oil, which will make us less dependent on foreign energy sources. But something may happen in Saudi Arabia in the next few years and oil prices will go up. You can't have an Arab Spring that affects all other countries but Saudi Arabia.

Gross: The price of oil and gas is dependent on real interest rates and the real rate of economic growth. Gold is more of a store of value. The safer bet right now is gold but both look good.

Rogers: It is easier to get your arms around oil than gold in terms of the numbers and

demand. Oil is a good investment in the next few years, with optionality to the upside if something extreme happens in the Middle East. Gold is a good diversifier, but not a great way to make money.

Faber: In the past 10 years gold and silver have performed superbly. The gold price overshot on the upside when it reached \$1,921 an ounce on Sept. 6. Now it is in a correction phase and could fall another \$200.

Hickey: Gold will rally, then have a seasonal selloff. By the end of the year it could be up 15%, as has been typical in this 11-year secular bull market for gold.

How do you feel about gold-mining stocks?

Hickey: Gold stocks have been terrible. They dropped 20% last year, so that makes them a better buy relative to the price of gold. Last year I owned a lot of gold. Now I have more money in gold stocks than in physical gold or the GLD [[SPDR Gold Trust](#)].

Faber: Do you own exploration companies or producers?

Hickey: I own a smaller amount of exploration companies through the GDXJ [[Market Vectors Junior Gold Miners](#) exchange-traded fund] and a larger percentage of producers.

Zulauf: The world economy will experience a brutal slowdown. Deflationary forces are going to strengthen and commodities in general will decline. You can buy oil to hedge a decline in base metals. Gold started a cyclical correction within a secular bull market last summer. The first wave of selling is ending now. Gold has to be bought some time this year, probably in the second half, below \$1,600. Then the monetary authorities will load their guns again and print more money, which will make investors buy more gold. The gold market is so tiny that when people want to shift just a small piece of their wealth into gold, the price flies to new highs.

Faber: It is not that the gold price will go up. It is that the value of paper money will go down. Diversification is important, and people should put 15% to 25% of their assets in gold.

Black: A lot of people own gold as a hedge against inflation. I don't see inflation in the cards in the U.S. Capacity utilization in the manufacturing sector it is only 77%. We own a couple of gold stocks but buy them as we do other stocks. We look for high returns on equity and low P/Es. We own [Barrick Gold](#) [ABX], which trades for 7.8 times this year's expected earnings. Even absent a big upswing in gold prices, it will do well because production is growing.

Let's switch to your investment picks. Marc, you're first.

Faber: My preference is asset diversification, as we don't know how much money governments will print, the size of fiscal deficits and so forth. The biggest uncertainty is what will happen to the Chinese economy. The Chinese probably can continue to muddle through, easing interest rates again to keep things up. But we're dealing with an economy driven by capital spending, which is driven by credit, which wasn't the case until 2008.

A lot of the lending isn't even on the books.

Faber: There is a huge amount of underground lending throughout Asia. Mr. Bernanke can drop his dollar bills on the U.S., but the growth in dollars here can lead to strong economic

growth and inflation in other countries. That has happened in the past few years. I am the most bearish person you can imagine on earth, which is why I recommend putting, say, 25% of your money in equities, 25% in precious metals, 25% in cash and bonds and 25% in real estate. These assets won't go up substantially this year, but they could preserve your wealth.

Marc Faber's Picks

Investment/Ticker	Price 1/6/12
Big-Cap Stocks	
Total/TOT	\$50.75
Nestlé/NESN.Switzerland	54.00 CHF
Novartis/NVS	\$57.31
Pfizer/PFE	21.57
Singapore	
SATS/SATS.Singapore	S\$2.23
K-REIT Asia Management/KREIT.Singapore	0.89
StarHub/STH.Singapore	2.9
Wing Tai Holdings/WINGT.Singapore	0.99
Fraser & Neave/FNN.Singapore	6.35
Hong Kong	
Sun Hung Kai Properties/16.Hong Kong	HK\$98.20
Swire Pacific/19.Hong Kong	75.45
Hang Seng Bank/11.Hong Kong	92.9
India	
India Capital Fund*	\$66.24
Short	
International Business Machines/IBM	\$182.54
Salesforce.com/CRM	101.06
Australian dollar	A\$1=\$1.02

*Price of A shares as of 9/30/2011.

Source: Bloomberg

People say large-capitalization stocks are inexpensive, and I agree. I would buy a basket of high-quality big-caps in Europe and the U.S. You can buy **Total** [TOT], in France, which yields more than 5%, and **Nestlé** [NESN.Switzerland] and **Novartis** [NVS] and **Pfizer** [PFE]. These stocks don't have huge downside risk. Because emerging markets saw big declines last year, you could also buy **SATS** [SATS.Singapore], in Singapore, which provides catering services to the airline industry and ports. It yields 5% and trades for 13 times earnings. I also like **K-REIT Asia Management** [KREIT.Singapore], a real-estate investment trust that yields 7%. The stock has fallen by about 50% and the dividend might be cut. But even if it is cut to 4%, this is an OK investment. These stocks won't go up right away, but reinvesting dividends will yield an adequate return over time. **StarHub** [STH.Singapore], the mobile-phone company, yields 6.9% and the P/E is 14.

Zulauf: If China decelerates sharply, won't markets like Singapore have another big hit?

Faber: The question is, to what extent has that been discounted already? They could fall another 20%, but a luxury-property developer like **Wing Tai Holdings** [WINGT.Singapore] already sells for half its book value. I am positive about Singapore in the long run because more Europeans are moving there, and to Hong Kong. Because of banking-secrecy laws it is probably safer to have a bank account in Singapore than Europe.

The Hong Kong market was hit hard, and stocks haven't bottomed yet. But you can buy **Sun Hung Kai Properties** [16.Hong Kong], with a P/E of five and a yield of 3.5%. **Swire Pacific** [19.Hong Kong] is a blue-chip, a well-managed conglomerate. It yields almost 5% and the P/E is 11. **Hang Seng Bank** [11.HK] yields 5.6% and trades for 11 times earnings. There isn't a huge risk in these stocks, but maybe I'm too bullish.

Why don't you indulge your bearish side and give us some stocks to short?

Faber: **IBM** [IBM] is a good short. It is the back office of the world. There is room for earnings disappointment. If China implodes, the Australian dollar will go downhill. That's

another short. A third is [Salesforce.com](https://www.salesforce.com) [CRM], which I recommended shorting in the June Roundtable ["Buy Low, Stay Nimble," June 13, 2011].

Hickey: One reason IBM performed so well last year is that it bought back lots of shares. In addition, Warren Buffett bought \$11 billion of IBM stock, driving the price up. You had two big buyers going at it.

Schafer: Buffett only buys companies he understands.

Black: Suddenly, at 80-something, he understands technology.

Hickey: His purchase didn't make a lot of sense. He talked about the company's five-year plan and its ability to meet earnings expectations. IBM's ability to make its numbers is scary sometimes. They are rolling up a lot of other software companies, and their internal growth rate is poor.

Faber: Order, order. I haven't finished. [Fraser & Neave](https://www.fraserandneave.com) [FNN.Singapore], in Singapore, is a conglomerate similar to Swire. It sells for 10 times earnings and yields about 3%. It could become a takeover target at some point. Lastly, I am the chairman of the India Capital Fund [an open-end fund sold outside the U.S.]. The fund and the Indian currency have been hit hard, and the fund could go lower. But the U.S. outperformed India last year on the order of 40%, and the Indian market looks attractive at 12 times earnings. As Chen Zhao at BCA Research said, in China the macro backdrop is fantastic and the micro is a disaster, but in India the macro is a disaster and the micro is fantastic. India has very good companies. The fund is overweight the banks and has a P/E of 10.

Last year I was overweight the U.S. relative to emerging economies. At what stage will the outperformance of the U.S. cease and emerging markets rise again? It could be three or six months, or a year. I am gradually increasing my exposure to emerging markets. Thai and Indian banks have no exposure to Europe. Indian banks lend domestically.

Why is the Indian economy having trouble?

Faber: Money-printing in the U.S. created food and energy inflation. In poor countries the percentage of per capita income spent on food and energy is much higher than in advanced societies.

Zulauf: But central banks in those countries also did their share of money-printing.

Faber: Yes. Credit was growing rapidly and the hangover period could last for a while but these markets are good long-term investments. I travel extensively in these countries and you can see the growth of economic development. People go from bicycles to motorcycles, and from motorcycles to cars. First-time buyers of cars jump socially, as do first-time buyers of homes. Thailand has several consumer-credit companies. Buyers will do everything to pay off their loans. They aren't going to walk away. Plus, bankruptcy laws are tough.

Hedge funds performed badly last year, with few exceptions. Why is that? The bond market was strong, gold was up 11% and the U.S. market was flat, but sectors such as utilities did well. This year the economy could contract and stocks could go ballistic as central banks print money. If investors are diversified, they might do all right.

Thank you, Marc. Let's give the floor to Oscar.

Schafer: My first pick is **United Rentals** [URI], the largest equipment-rental provider to industrial and nonresidential construction centers in the U.S. and Canada. It rents aerial work platforms, forklifts and earth-moving equipment, and the business is driven by fleet size, utilization and pricing. The company is growing revenue by 17% and achieving incremental Ebitda [earnings before interest, taxes, depreciation and amortization] margins of more than 60%. United Rentals recently announced the acquisition of its largest competitor, **RSC Holdings** [RRR], which we also own. We invest in companies whose cyclical exposure is misunderstood. Despite its cyclical end markets, United Rentals is a secular growth story. It is gaining market share, and could realize synergies from acquisitions. The tempered economic recovery is good for the company.

While end markets remain stagnant, the rental market is growing nicely as potential customers opt to rent versus buy. Rental penetration climbed in the past decade from 20% to 40% of the equipment in the field. The pace of growth is accelerating as customers are less inclined to make large capital outlays or are constrained by the lack of capital and financing. The U.K. and Japan, at 80% penetration, show the upside potential here. United Rentals is gaining share as small, local competitors can't get financing to expand their fleets. Competitors who bought equipment prior to the downturn are approaching the end of the useful life of their fleets. Even with the acquisition of RSC, the company will have less than 15% of the market.

How about some numbers?

Schafer: In times of softening demand, the company can generate significant cash flow by delaying capital spending and selling its equipment for more than book value, using the cash to delever. The business is even healthier today than in the prior downturn due to a higher mix of more stable industrial customers; a strong used-equipment market, and cost synergies derived from the RSC acquisition. United Rentals sells for \$30 per share. Pro forma, accounting for RSC, the shares sell for 5.5 times consensus 2012 Ebitda of \$1.7 billion. My base case assumes a 5.5 multiple of 2013 Ebitda of \$2.2 billion, yielding a \$52 stock-price target or more than 70% upside. If nonresidential construction picks up, the stock could at least double.

Oscar Schafer's Picks

Company/Ticker	Price 1/6/12
United Rentals/URI	\$29.63
Verint/VRNT	27.48
Crown Holdings/CCK	34.26
Walgreen/WAG	33.08

Source: Bloomberg

Verint Systems [VRNT] is a software company with a \$1.1 billion market cap. It enables analytics of unstructured data -- linguistic, visual and auditory -- across multiple applications such as call centers and wiretapping. It is based in Long Island with global sales offices and a research and development center in Israel. Verint generates

\$700 million in annual revenue with 70% gross profit margins and 20%-plus operating margins, and trades for 10 times our forward earnings estimate. Top-line growth has been in the high single digits, but could accelerate to 10% to 15%. This is an inexpensive way to capitalize on companies' growing desire to analyze data across an increasingly diverse set of touch points. **Comverse Technology** [CMVT] owns more than 50% of Verint. Comverse previously was involved in a stock-options-backdating scandal and the CEO fled the country.

That sounds promising.

Schafer: Half of Verint's revenue comes from its leading position in the global call-center-software market. It offers a suite of services that allows call-center managers to manage agents and call flow, and analyze various aspects of speech, including tone, inflection and key words. If a telecom operator sees a spike in customer churn, instead of listening to a random sample of calls to see what is frustrating customers, it can use Verint software to pick out calls with certain tones or words that I wouldn't use in *Barron's*. Verint also analyzes newer touch points like texting. We estimate Verint has about a 35% or 40% share of the call-center software market. The rest of revenue comes from voice and video analytics.

Verint sells to large retailers and banks, which can use data streams generated from video-monitoring equipment to analyze security issues and customer behavior. Verint's growth is being driven by the shift from analog surveillance to IP [Internet-protocol]-enabled cameras. Software also is used by law-enforcement agencies around the world to analyze video data generated at ports and airports, as well as voice data from wiretaps. As customers and agencies shift from analog to IP, the market will grow at high-single or low-double digits. Verint's price/earnings multiple is depressed due to its association with Comverse, which sells billing software. The Comverse options scandal spiraled into a five-year revenue-recognition investigation that ended in September. Any move to unlock Verint's value was on hold. Now Comverse may be evaluating strategic alternatives, including the disposition of its Verint stake. [Comverse announced Wednesday that it will spin off its telecom business. O.S.S. thinks this is the first step toward freeing Verint.]

What could Verint fetch as a standalone?

Schafer: Based on a competitor's multiple, Verint could trade in the high-\$40s, up 70% from its current price of \$27.48. It could sell for 16 times next year's \$3 a share in earnings. Verint and its competitor, **NICE Systems** [NICE], also could merge, and cost synergies could give Verint 100% upside. Large software providers also might be interested in buying Verint.

In a low-growth environment we look for companies with shareholder-friendly capital allocation. **Crown Holdings** [CCK] is in a boring business with a cash-flow profile and capital-allocation policy that are anything but boring. The company manufactures beverage and food cans and generates stable and ample cash flow. In the past decade, it has used this cash flow to pay down debt and, more recently, invest aggressively in growth projects in Brazil, Southeast Asia and Eastern Europe. Return on invested capital has grown from the low single digits to the high teens. Management now is using excess cash flow to buy back stock. The company repurchased nearly 10% of its publicly traded shares in the past 18 months, and bought back minority interests in many foreign subsidiaries.

Moreover, capital expenditures peaked in emerging markets in 2011, and Crown will start generating significant returns on these investments in coming years. In China alone, Crown is opening three new plants in the first three quarter of 2012. As the projects come online and capex declines, free cash flow will



Enlarge Image

Jennifer Altman

Laughter just might be the best medicine for dealing with the global challenges our panelists anticipate this year.

surge. Shares trade for \$34. Free cash flow will be \$3 in 2012, \$4 in 2013 and \$5 in 2014, depending on the pace of buybacks. Fair value is \$45.

Faber: Why doesn't Crown pay a dividend?

Schafer: The company thinks shareholders are better served by stock buybacks. Once you issue a dividend, you can't reduce or eliminate it. You can always adjust how much stock you repurchase.

Walgreen [WAG], my final pick, is the largest pharmacy chain in the U.S., with 7,800 retail stores in all 50 states. The business has grown relentlessly for the past three decades in sales, square feet and earnings. Yet, one can argue the best days are ahead. Baby boomers are aging and taking more and more drugs. The government is expanding access to drugs to underserved parts of the population, and the generic drug wave is about to lower costs and raise profits for everyone in the value chain. Even so, Walgreen stock is down by about a third in the past six months.

When did you buy it?

Schafer: We bought it in the past three or four months, after the shares came down. Walgreen is in the middle of a public and protracted fight with **Express Scripts** [ESRX], one of the three major pharmacy-benefit managers. Express Scripts controls 11% of Walgreen's prescription volume, which works out to 90 million scripts filled per year. As of Jan. 1, Express Scripts plan members aren't able to fill their prescriptions at Walgreen. Bearish analysts say the fight will get even worse. Express Scripts is acquiring **Medco Health Solutions** [MHS], which would give it control of another 12% of Walgreen's prescription volume, or nearly 180 million scripts in all. I'm not taking sides or predicting the outcome. Rather, the situation is reaching the point of maximum uncertainty. Even bullish analysts have removed Express Scripts' business from Walgreen's earnings estimates. The bears are removing Medco from Walgreen's numbers as well. The math might be correct but the analysts are shortsighted. No matter how you slice the profits, Express Scripts and Walgreen will make more money as partners, so it is reasonable to expect they will come to an agreement sooner rather than later. The pressure to make a deal will build.

Walgreen shares are \$33. The market cap is \$30 billion. The stock trades for six times Ebitda and 12 times earnings. Ten years ago the company was showing 20% earnings growth. Free cash flow rose as expansion slowed, and Walgreen raised its dividend by 28.6% last year and instituted a \$2 billion share repurchase, of which \$975 million is still outstanding. Downside is 10%, upside 40%. My target price is in the mid-\$40s.

Do you still like Mako Surgical? It rallied almost 80% since you recommended it here last year.

Schafer: Yes. Mako [MAKO] is where **Intuitive Surgical** [ISRG] was in 2004; Intuitive was a lot lower than it is now. In the past five years, since the company introduced its robot,

doctors have performed 15,000 robotic partial-knee replacements. The company's forecast for this year alone is 15,000. It is a spectacular stock and company.

Thanks, Oscar.

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