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New Gig, Old Approach

By Lawrence C. Strauss

(The following has been excerpted.)

By the time he left Merrill Lynch in the spring of 2009, Richard Bernstein was one of the most respected strategists on Wall Street.

So why did he walk away?

"I had been a sell-side strategist for more than 20 years, going back to my days at E.F. Hutton," Bernstein, 52, recalled recently. "But the routine was kind of getting boring. How many times can you get on a plane and give a speech and write a research report?"

Shortly after leaving the sell side, Bernstein went to the buy side and started his own company. He is the chief executive and chief investment officer of Richard Bernstein Advisors, a boutique money manager, headquartered in midtown Manhattan.

"I wanted to put into practice a lot of the research I had done over 25 years," he says.

Although running a portfolio is a lot different than formulating asset-allocation recommendations for a big brokerage house, Bernstein does see similarities in that he is trying to build a portfolio based on his firm's quantitative research – in particular, its weightings for countries, sectors and investment styles.

The nascent firm oversees more than $100 million, a big chunk of it in the recently launched Eaton Vance Richard Bernstein Multi-Market Equity Strategy Fund (ticker: ERBAX). His firm is the load fund's subadvisor.

Bernstein had a wide following as a strategist, but forecasting the market is a tough task and, of course, not all of his calls panned out. After correctly being bullish in the mid-1990s, he became concerned in July 1998 about equity valuations, which he feared were becoming too frothy. It turned out he was too early, though his instincts were correct about the market getting too expensive. "1999 was out of control," he says. "People were basically telling me, literally to my face, that I didn't know what I was doing."

Bernstein also missed the big stock rally in 2003. But his work, which features a healthy skepticism, earned many plaudits, and he was elected to Institutional Investor's All-America Research Team 18 times.

As a strategist, Bernstein had a good eye for figuring out "what was wrong with the consensus and that would point to underpriced and overpriced securities," says Charles Clough, formerly the head strategist at Merrill Lynch who is now the chairman and chief executive of Clough Capital Partners, a money manager in Boston.

One of Bernstein's most prescient calls came in 2000 when "I told people to start buying energy and commodities," he recalls.

Matthew Furman for *Barron's*

Wall Street Veteran

Managing money poses a challenge for Bernstein, but he's faced some before. The year "1999 was out of control," he says. "People were basically telling me I didn't know what I was doing." Below, the weightings in his Eaton Vance fund, versus those of its various benchmarks.

	Mutual Fund*		Mutual Fund*
U.S.	65%	**Mid Cap**	19%
Developed	34	**Small Cap**	26
Emerging	1	**Growth**	41
Large Cap	55	**Value**	59

*Richard Bernstein Multi-Market Equity Strategy Fund. **MSCI All Country World Index. As of Oct. 31.
Source: Eaton Vance Investment Managers

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He wrote a note urging venture capitalists to leave Silicon Valley and head for West Texas.

Bernstein says he had plenty of freedom at Merrill to call the markets as he saw them. "But whenever you are the salmon swimming upstream, that's really not conducive to the brokerage business," he says. "It is not so much the research director, who supports you 99.9% of the time, but it is the other entities in the firm that get very, very upset because they believe you are ruining their business."

In preparing to switch to the buy side, Bernstein knew that one of the first questions he would get from prospective clients was how he could be an effective money manager if he hadn't run a portfolio previously. So he hired experienced buy-side hands, including Charles Simon, the head trader who spent many years at Lazard Asset Management, and Matthew Griswold, a seasoned quantitative analyst who came over from State Street Global Advisors.

Still, the transition from being a strategist to running a portfolio can be very tough. "When you are on the buy side, rather than the sell side, you are not trying to articulate a strategy; you are trying to implement one," says Clough. It's crucial as a fund manager, Clough adds, not to be "so wedded to your strategy that you don't see evidence of change" that needs to be addressed.

Bernstein's firm is very small, with two traders and three others whose duties include research, strategy and portfolio management. In running the Eaton Vance portfolio, Bernstein and his team take a top-down approach. After crunching a lot of data, they try to "pinpoint roughly where we are in the cycle."

Bernstein maintains that the U.S. economy is entering the mid-phase of the economic cycle and that the recovery "is not as abnormal as everybody wants it to be."

Bernstein also believes that emerging markets are too expensive, that the prospects for the U.S. economy and stocks are underrated and that small-cap value shares are very attractive. He insists that investors are "taking a lot of risk in emerging markets, and I think they are going to be disappointed."

The firm's quantitative model helps determine the various portfolio weightings. For example, the Eaton Vance fund has a 65% weighting in the U.S., versus 42% for its benchmark, which is the MSCI All Country World Index.

Once they figure out the portfolio's weightings, Bernstein and his associates use their quantitative model to find "the most diversified, least risky portfolio that has the exposures we want," he says. The fund holds about 320 stocks so that "if one blows up, it is an annoyance, but it doesn't ruin the whole portfolio."

Bernstein points to the fund's various weightings that differ from the benchmark, as evidence that he's not a closet indexer.

He says that beta, not alpha, is the key to investment success for his fund, an approach that differs markedly from Warren Buffett's. (Beta indicates how closely an investment's return tracks that of an overall market; the farther the beta diverges from 1, the less correlated the returns. Alpha measures an investment's performance in excess of the risk it entails.)

"Over 90% of Buffett's returns are probably attributable to stock selection," says Bernstein. "He is an alpha manager. We are the other extreme. Over 90% of our returns are from bets on market capitalization, size, style, geography and things like that."

The fund is in its infancy, so it doesn't have a meaningful track record. Bernstein insists that its go-anywhere style makes more sense than a more specialized approach. "A large-cap value guy says: 'I can outperform other large-cap value managers.' But the question, which they don't address, is: Should you even be in large-cap value and what's the appropriate weight?

But do Bernstein and his team have the necessary expertise to invest across the different style boxes? They do, he says, because they aren't stockpickers: "It is basically how much do you weight to size? How much do you weight to a sector? And how much do you weight to a country?"

That sounds a lot like what he used to do at Merrill Lynch. But this time, his performance is being measured by his portfolio's returns – a much sterner test. ■

Primary Risks: Fund share values are sensitive to stock market volatility. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging countries, these risks may be more significant. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, established companies. Derivative instruments can be used to take both long and short positions, be highly volatile, result in economic leverage (which can magnify losses) and involve risks in addition to the risks of the underlying instrument on which the derivative is based, such as counterparty, correlation and liquidity risk. No Fund is a complete investment program and you may lose money investing in a Fund. The Fund may engage in other investment practices that may involve additional risks and you should review the Fund prospectus for a complete description.

Richard Bernstein Advisors LLC, is the Subadvisor to the Eaton Vance Richard Bernstein Multi-Market Equity Strategy Fund.

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