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HYPE OR HIGH YIELD?

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Richard Bernstein

Q&A

RICHARD BERNSTEIN DISCUSSES HOW SECTOR SELECTION IS MORE IMPORTANT THAN WHAT ETF YOU EMPLOY

IT'S EASY TO GET LOST IN PRODUCT SELECTION when you have more than 1,600 different ETFs to choose from. But when it comes to building portfolios, asset allocation—and sector allocation—is far more important than product choice, and that's something many investors often forget, Richard Bernstein tells us.

Bernstein, the well-known macro portfolio manager who heads Richard Bernstein Advisors and oversees more than $3.4 billion in assets, is pitching a simple tune: Remember the basics.

That includes carefully making allocation decisions first, choosing products second. Just as important, he says, is looking past the broad asset classes, and honing in on sectors, which are the real drivers of returns.

A lot of investors, when building a portfolio, look at asset classes as the primary building blocks. But sectors really are the drivers of returns, correct?

One has to remember that there are economic cycles. That's something that people have ignored in this cycle. And different sectors will outperform in different parts of that economic cycle. I know a lot of people like to think that one sector might outperform for the entire cycle, but that's rare. To have some insight in terms of how that sector rotation plays out as the economic cycle matures can be very helpful.

Is a sector's performance in a given time of the cycle predictable? For instance, do utilities always outperform at, say, the end of a cycle?

The word that I wouldn't use is "always." There are certain vagaries to sectors that are particular to that sector at some point in time, like regulation or lack thereof, which might skew that performance for a particular time. But in general, one can say that, early in the cycle, you should invest in some sectors, and later in a cycle, invest in others, and that plays out with reasonable consistency.

How should investors who subscribe to the nine-style-box investing approach look at sector investing? Are sectors more effective portfolio building blocks than, say, growth and value?

There's some overlap, because some sectors at different times will be growth, others will be value. What you can do is try to figure out what kind of exposure you actually want to have, and if it is more effective to play it as growth and value, or play it as an individual sector investment.

As an active investor, how do you go about finding opportunities in different sectors?
It depends. One has to realize that certain sectors are really not related to fundamentals. It's very hard to argue that the biotech sector is related to fundamentals when you consider the valuations of some of these stocks, or social media, if you will. It's very difficult to argue that these sectors are trading on true fundamentals. They are trading more on a hope of future fundamentals than on actual fundamentals.

But with other sectors, depending on how you choose to slice and dice different industries and sectors, you'll find fundamental stories in some of them. You can definitely play the historical sector rotation—early cycle, midcycle, late cycle. There're lots of different ways to play it.

What one has to be very careful about is getting too much into the minutiae. If you are investing in ETFs, you don't need to get into the companies' minutiae. When you talk about economic sector and industry ETFs, a lot of times, people start to talk about individual companies, but that defeats the whole purpose of investing in ETFs.

Do you use ETFs for sector investing?
We use ETFs for a lot of what we do. We also build our own baskets of stocks, so we build our own ETFs to some extent, if you will.

What sectors are your favorites today, and in which are you most underweight?
Most underweight for us would be energy and materials, and most overweight would be consumer staples.

So, you like the more safe-havenlike sectors, and dislike the ones that are probably most impacted by the decline in oil prices?
We haven't been fans of commodities in general for a long time because they are very credit-sensitive investments. If one believes we're on the deflationary part of a global credit bubble, it doesn't make that much sense to be excited about credit-related asset classes such as commodities and energy. We are underweight both sectors.

In the current environment, with the Fed talking about raising rates and the ECB starting QE, what assets or themes in general do you like right now?
We've been playing things like Japan. We've been quite overweight Japan, in fact. What's rather ironic is that despite the fact that surveys show now that investors are the most bullish they've ever been on Europe—which is extraordinary—investors are still basically ignoring Japan. Yet Japan has a great story going. Corporate profits are revving up in Japan—the currency is contributing to a lot of that—so we've been overweight Japan using Japan equities and Japan ETFs.

We are not event-driven investors, so we don't share everyone's enthusiasm over what's going on in Europe quite yet. The stocks are performing well, but there's no hint of anything in fundamentals passing through to corporate profits yet; in fact, corporate profits in Europe still look quite weak. So, we'll see what happens. Europe is still a wild card. We've been underweight Europe, but we have some weak euro beneficiaries, which has been helping us quite a bit.

At the end of the day, the key driver of your portfolio decisions is fundamentals?
Macro fundamentals, yes. Very often, when you say "fundamentals," people think income statements and balance sheets—the micro economics of a firm. That's not us. We are a macro firm that pays a lot of attention to macro fundamentals around the world, but spend no time looking at individual companies, which is why ETFs are in our wheelhouse.

What worries you the most right now? Anything keeping you up at night?
The one thing that is troublesome is the Fed could be raising rates prematurely. I think that has to be everyone's No. 1 concern right now because it's clear there are certain members of the FOMC who believe the Fed should have already been raising rates because they want rates to be "normalized."

We don't understand the concept of normalizing interest rates. What determines when you "normalize" interest rates or not is the strength of the nominal economy. There are reasonable and significant questions out there as to whether the nominal economy is strong enough to withstand multiple interest rate hikes by the Fed.

What's your baseline view?
I think cooler heads will prevail in the Fed, and the Fed will be very, very slow in raising interest rates.

You'll be speaking at our upcoming Global Macro conference on sector investing. What's the main message you're hoping to convey then?
Certain ETF providers have marketed ETFs as a cure-all. If you're investing in sectors, the really important question is which sector to be in and when. That's much more important than choosing if you're going to use ETFs from provider No. 1 or provider No. 2.

Asset allocation, sector allocation is the most important thing, not whether provider No. 1 has come up with a better mousetrap than provider No. 2. ●