Richard Bernstein Advisors

The Leaders In Pactive® Management

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Richard Bernstein, Chief Executive and Chief Investment Officer

Unicorns exist only when money is free

A ***unicorn*** *is a privately held startup company valued at over $1 billion. The term was coined in 2013 by venture capitalist Aileen Lee, choosing the mythical animal to represent the statistical rarity of such successful ventures.* – WIKIPEDIA

It is debatable how much the Fed's former zero interest rate policy (ZIRP) stimulated the overall economy. However, we believe that the "unicorn" investing phenomena has been a direct result of the policy. When the cost of capital is basically free (as was the unstated goal of ZIRP), investors become more willing to invest in companies with little or negative cash flow that offer no indication of certain profitability.

Investment time horizons shorten when interest rates increase, and unicorns have accordingly started to come under pressure as the Fed tightens monetary policy and cost of financing begins to increase. The need for near-term positive return-on-investment generally goes up as hurdle rates increase and as the potential return of other less risky investments increases.

One "visionary" recently described this issue as "boring". He apparently doesn't realize that his company's vision has been financed by nearly un-ending free money. Investors aren't asking boring questions. Rather, they are concerned about potential returns and cash flow when interest rates increase. They are merely signaling that promises about the future are devalued when interest rates rise and the cost of capital increases.

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an independent investment adviser focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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Let's all go to Mars!

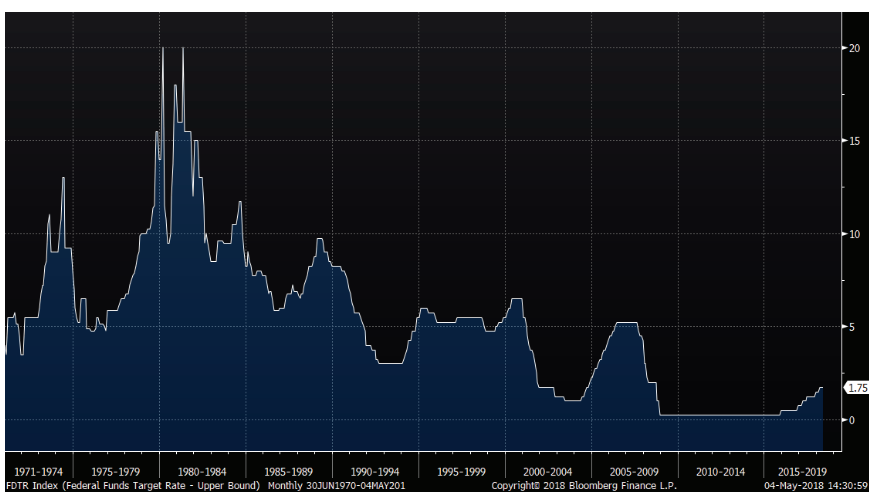
When I began on Wall Street in the early-1980s, the Fed raised interest rates dramatically to fight inflation. The Fed wanted to set an exceptionally high "risk free" hurdle rate that could stymie overall economic activity. It worked perhaps too well (the economy experienced a "double-dip" recession), but the Fed did indeed end the inflation spiral.

A risk-free rate of 15% curtails activity for two reasons. First, investors shunned equities because money market funds were returning roughly 20%. Many investors felt no need to invest for any conceivable investment time horizon when short-term riskless paper was yielding 20%. In turn, companies' hurdle rates, or minimal acceptable return for capital investment, was also prohibitively high. Companies could not find projects in which to invest that returned more than 20%.

Through time, hurdle rates came down as inflation subsided and the Fed eased monetary policy. At 10% short-term rates, more investment projects became acceptable and more investors found equity returns competitive. 5% stimulated even more investment and economic activity, and 2.5% even more. When the Fed instituted ZIRP investors eventually realized money was free, and no investment seemed unworthy or too long.

Wild promises of future growth seemed to trump the attractiveness of rational traditional investment projects, which is an effect the Fed probably never anticipated. For example, there are now four companies that have plans to provide transportation to Mars, yet commuters in New York/New Jersey can't arrive at Penn Station on time. Exactly as financial theory suggests, ZIRP and a zero-hurdle rate has led investors to irrational decision-making.

CHART 1:
Fed Funds Target Rate Index June 1970 – April 2018



Source: Bloomberg Finance L.P.

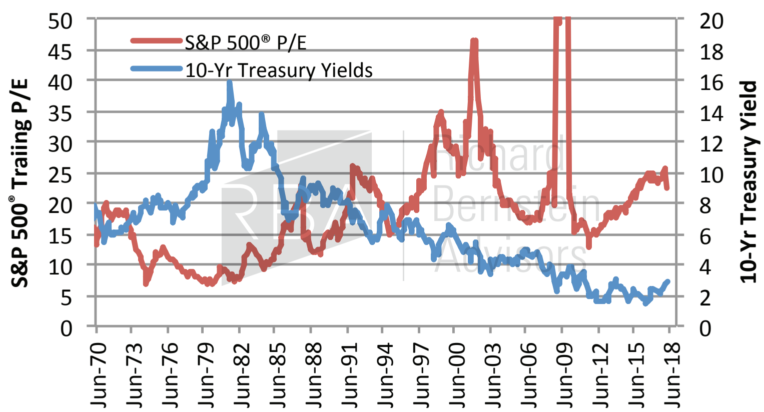
 PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

Time horizons shorten when interest rates rise

Chart 2 demonstrates the inverse relationship between 10-year T-note rate and S&P 500 PE ratios. History clearly shows that PE ratios tend to contract when interest rates increase. Another way to think about this relationship is that investors shorten their time horizon when rates increase.

Investors seem to be in the process of once again shortening their investment time horizons when interest rates increase, and this is another challenge to unicorn companies. Promises of future growth can be very enticing when investor time horizons are long. However, such promises seem empty and immaterial when investors' time horizons shorten.

CHART 2:
10-Year T-Note Yield vs. S&P 500® P/E
June 1970 – April 2018



Source: Richard Bernstein Advisors LLC, Standard & Poors', Bloomberg Finance L.P.

The return of "boring"

Free money allows one to dream the largest dreams about a wonderful future, like going to Mars. Rising interest rates bring investors back to earth. Our expectation is that interest rates are still at the beginning of an upward trend. If we are correct, then "boring" may win versus vision, positive cash flow may triumph over negative cash flow, and rational investing might kill the unicorns.

To learn more about RBA's disciplined approach to macro investing, please contact your local RBA representative.
[***www.rbadvisors.com/images/pdfs/Portfolio_Specialist_Map.pdf.***](www.rbadvisors.com/images/pdfs/Portfolio_Specialist_Map.pdf)

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $7.6 billion collectively under management and advisement as of April 30th, 2018. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund and the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF and the First Trust RBA Quality Income ETF. Additionally, RBA runs ETF asset allocation SMA portfolios at UBS, Merrill Lynch, Morgan Stanley Smith Barney, Wells Fargo, RBC, Janney and on select RIA platforms. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.

RBA Investment Process:

- ➜ Quantitative indicators and macro-economic analysis are used to establish views on major secular and cyclical trends in the market.
- ➜ Investment themes focus on disparities between fundamentals and sentiment.
- ➜ Market mis-pricings are identified relative to changes in the global economy, geopolitics and corporate profits.

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