Richard Bernstein Advisors

An Alternative to Alternatives

Richard Bernstein

May 2012

An Alternative to Alternatives

Alternative assets (such as hedge funds, private equity, direct real estate, etc.) have been quite popular among institutional investors, and are gaining interest among individual investors. Investors' perception is that these assets provide higher returns through time and are uncorrelated with other asset classes. Alternatives have become the accepted norm (and in some cases the core of the portfolio) among pension and endowment investors.

While those attractive investment characteristics might have been true in the distant past, they certainly have not been true over the past five years. Many alternative investments have provided questionable returns, have been highly correlated with other asset classes, and have constrained investors' cash flows. Surprisingly, these facts have not spurned investor interest.

The continued popularity of alternative assets is even more puzzling when one considers that traditional asset allocation strategies (i.e., vanilla stock/bond/cash strategies) have again been working. These strategies have provided better risk/return profiles than have alternatives, and have done so with lower fees.
In this report, we examine the initial rationale for investing in alternative assets, why that rationale may no longer be appropriate, and the reasons for the renewed success of traditional asset allocation strategies.

1980-early-2000s: Treasuries were not a diversifying asset class

Correlation is the key to diversification. Regardless of the number of asset classes in a portfolio, the portfolio will not be "diversified" if the assets have a high correlation (i.e., their returns move in tandem). A portfolio with only two asset classes might be better diversified than one having five or ten asset classes if those two asset classes are negatively correlated.

We like to think of diversification as a see-saw. Some assets in the portfolio sit on one side of the see-saw, while others sit on the opposite side. Some assets appreciate, while others depreciate, meaning that the fulcrum of the see-saw represents the volatility of the overall portfolio.

Treasuries and stocks had a positive correlation through much of the 1980s and 1990s (they sat on the same side of the see-saw). It was, therefore, difficult to diversify a portfolio using traditional stock/bond/cash allocations because stocks and bonds appreciated or depreciated together. Few investors cared when stocks and bonds were appreciating, but they quickly realized their portfolios were under-diversified when stocks and bonds both depreciated.

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

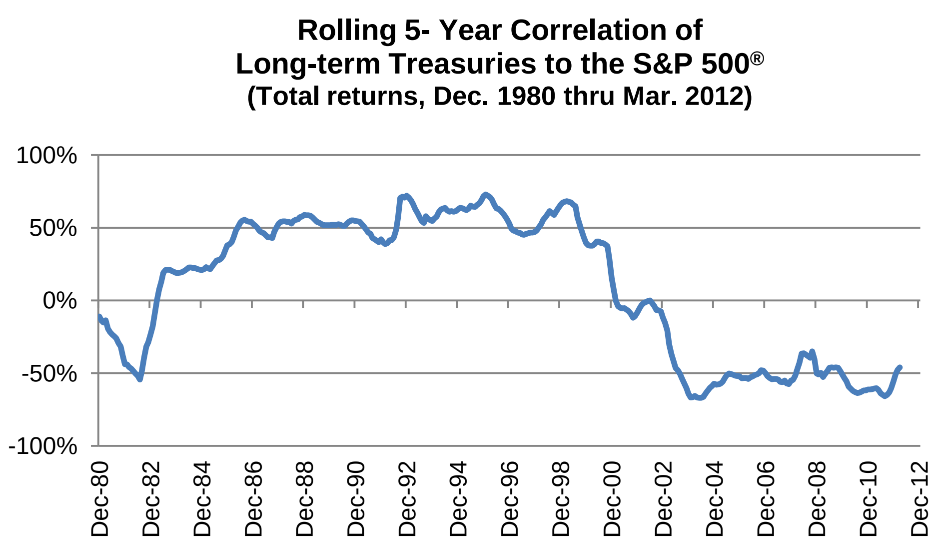
www.RBAdvisors.com
@RBAdvisors

Richard Bernstein Advisors

Chart 1 shows the rolling five-year correlations between the S&P 500 and treasury bonds. The average correlation between the two was 0.55 between 1982 and 2000. Treasuries and stocks clearly sat on the same side of the diversification see-saw during that period.

Importantly, the impetus behind the search for alternative diversifying assets was bonds' positive correlation to stocks. If treasuries' correlation to stocks was negative during this time period, we strongly doubt that alternative asset classes would be as popular as they are today.

Chart 1:



Source: Richard Bernstein Advisors LLC, Standard & Poors, BofA Merrill Lynch, Bloomberg.
For Index descriptors, see "Index Descriptions" at end of document.

2000: Short tech/long anything else = "uncorrelated"?

Investors increased their searches for assets uncorrelated with equities after the bear market associated with the deflation of the technology bubble. In response to that search, many alternative asset managers began to highlight that their funds' returns were uncorrelated to equities. In particular, these funds provided positive absolute returns during the bear market versus the stock market's negative return.

Some observers, however, questioned whether these funds' uncorrelated returns were attributable to managers' skills or whether it was attributable to one significant trade. The extremely narrow leadership during the technology bubble quickly reversed once the bubble began to deflate. During the bubble, technology, media and telecom companies dominated performance. Once the bubble began to deflate, this narrow leadership completely reversed so that nearly anything outperformed other than technology, media, and telecom.

Thus, managers who shorted technology shares in favor of nearly any other equity group not only outperformed the market, but provided positive absolute returns versus the market's negative return. Effectively, one trade caused many alternative managers' performances to be negatively correlated with equities.

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.RBAdvisors.com
@RBAdvisors

The diversification benefits of hedge funds meaningfully decreased once the technology sector's effects on performance and correlations began to wane. Asset class correlations during 2006 began to show that previously "uncorrelated" assets, like hedge funds, were quickly starting to highly correlate with equities.

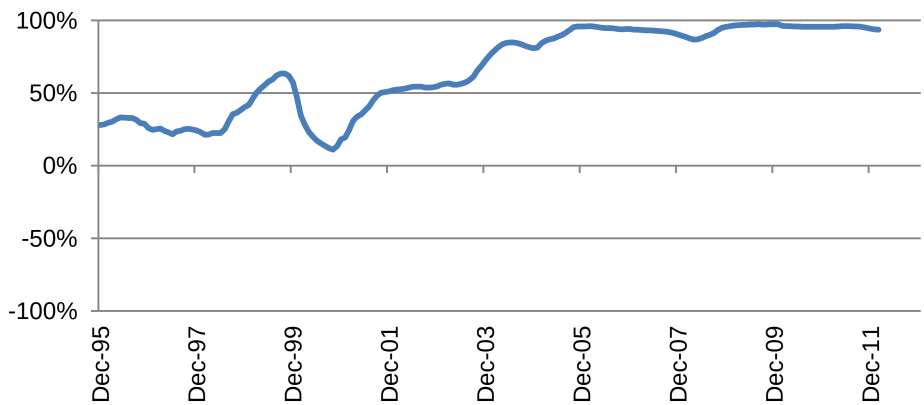
The notion that increasing correlation was a result of 2008's bear market is not accurate. Investors may have felt that 2008's bear market was extreme because asset correlations were already high before the bear market began. Unless one held sizeable positions in treasuries during 2008, there was mathematically no place to hide.

Chart 2 shows the correlation between the S&P 500 and hedge funds. The effect that the technology bubble had on correlations is apparent. Correlations began to rise during the late-1990s perhaps because hedge funds were long technology, media, and telecom. However, the correlation between hedge funds and the S&P 500 moves toward zero as they short technology and go long virtually anything else.

Hedge funds' poor performance during 2008 should not have been a surprise though. Even before the bear market, hedge funds had over a 90% correlation to the S&P 500.

Chart 2:

Rolling 5- Year Correlation of Hedge Funds to the S&P 500®*
(Total returns, Dec. 1995 thru Feb. 2012)



Source: Richard Bernstein Advisors LLC, Standard & Poors, BofA Merrill Lynch, Bloomberg. For Index descriptors, see "Index Descriptions" at end of document. *3/31/12 Hedge Fund data not yet available.

Richard Bernstein Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.RBAdvisors.com
@RBAdvisors

Post-2005: Back to the future. Treasuries again provide diversification

Whereas supposedly uncorrelated assets, such as hedge funds and other alternatives, have been quite highly correlated for some time, old-fashioned stock/bond/cash asset allocation has been quite effectively reducing portfolio volatility.

Charts 3 and 4 show risk/return combinations of stocks/hedge funds and stocks/treasuries for two time periods. During the earlier period, hedge funds do provide diversification and also offer higher returns. However, the story changes dramatically during the more recent period. Combinations of stocks and treasuries are consistently superior to combinations of stocks and hedge funds.

In fact, the angle and the straightness of the line denoting combinations of stocks and hedge funds, as opposed to the "hook" often seen in risk/return charts, suggests that hedge funds might be a replacement for traditional equities, but should not generally be considered a diversifying asset class.

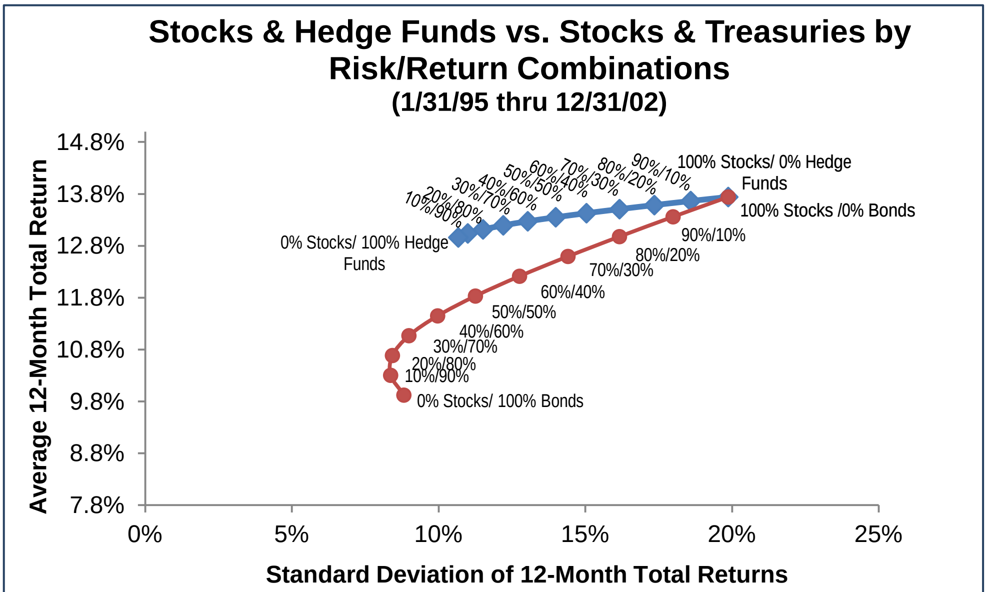
Treasuries, however, have provided both superior returns and offered diversification. Once again, traditional stock/bond asset allocation is working. These data suggest that attempts to diversify a portfolio using alternatives remain questionable at best.

Investors' refusal to embrace treasuries remains very curious

History shows well that diversifying asset classes tend to outperform. That has been happening with respect to treasuries for quite some time, yet investors refuse to embrace treasuries. Fears regarding federal finances, inflation, and the willingness of foreigners to continue to own treasuries have generally scared investors away from treasuries.

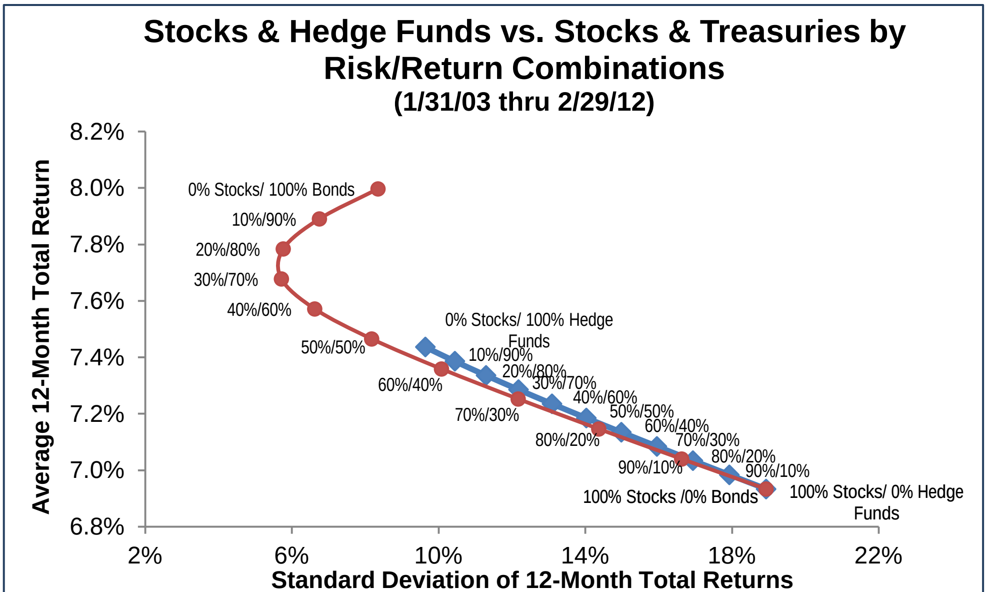
The proverbial "wall of worry" continues in the treasury market. When will investors realize that it's not the 1990s, and that high-fee, alternative assets continue to offer inferior diversification opportunities relative to good old-fashioned stock/bond/cash asset allocation?

Chart 3:



Source: Richard Bernstein Advisors LLC, Standard & Poors, HFRI, BofA Merrill Lynch, Bloomberg. For Index descriptors, see "Index Descriptions" at end of document.

Chart 4:



Source: Richard Bernstein Advisors LLC, Standard & Poors, HFRI, BofA Merrill Lynch, Bloomberg. For Index descriptors, see "Index Descriptions" at end of document.

Richard Bernstein Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.RBAdvisors.com
@RBAdvisors

Richard Bernstein Advisors

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: Standard & Poor's (S&P) 500® Index. The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

Hedge Fund Index: HFRI Fund Weighted Composite Index. The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to the HFR (Hedge Fund Research) database. Constituent funds report monthly net-of-all-fees performance in USD and have a minimum of $50 million under management or a twelve (12)-month track record of active performance. The Index includes both domestic (US) and offshore funds, and does not include any funds of funds.

Long-term Treasury Index: BofA Merrill Lynch 15+ Year US Treasury Index. The BofA Merrill Lynch 15+ Year US Treasury Index is an unmanaged index comprised of US Treasury securities, other than inflation-protected securities and STRIPS, with at least $1 billion in outstanding face value and a remaining term to final maturity of at least 15 years.

The views expressed are those of Richard Bernstein Advisors LLC, not necessarily those of UBS or any of its affiliates, and may in some cases be different from, or inconsistent with, views expressed or taken by UBS. Nothing contained herein constitutes tax, legal, insurance or investment advice, or the recommendation of or an offer to sell, or the solicitation of an offer to buy or invest in, any investment product, vehicle, service or instrument. Such an offer or solicitation may only be made by delivery to a prospective investor of formal offering materials, including subscription or account documents or forms, which include detailed discussions of the terms of the respective product, vehicle, service or instrument, including the principal risk factors that might impact such a purchase or investment, and which should be reviewed carefully by any such investor before making the decision to invest. Specifically, and without limiting the generality of the foregoing, before acquiring the shares of any mutual fund, it is your responsibility to read the fund's prospectus. Links to appearances and articles by Richard Bernstein, whether in the press, on television or otherwise, are provided for informational purposes only and in no way should be considered a recommendation of any particular investment product, vehicle, service or instrument or the rendering of investment advice, which must always be evaluated by a prospective investor in consultation with his or her own financial adviser and in light of his or her own circumstances, including the investor's investment horizon, appetite for risk, and ability to withstand a potential loss of some or all of an investment's value. Investing is an inherently risky activity, and investors must always be prepared to potentially lose some or all of an investment's value. Past performance is, of course, no guarantee of future results.

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.RBAdvisors.com
@RBAdvisors