Richard Bernstein Advisors

Uncertainty = Opportunity™

Richard Bernstein,
Chief Executive and Chief Investment Officer

Richard Bernstein Advisors

- *Independent investment advisor with a unique top-down, macro approach to investing with quantitative security selection.*
- *$3B AUM/AUA as of 4/30/14*
- *Strategies include global asset allocation, global equity allocation, income, and promising undiscovered investment themes.*
- *Investment themes focus on disparities between fundamentals and sentiment.*

Worried about the downside?

I have taught at the NYU/Stern Graduate School of Business Administration for many years. Each semester, I give students a quiz to see how they define risk. Academics define risk as the volatility or unpredictability of returns. However, students consistently define risk not as volatility, but rather as the probability of losing money. I've done many similar surveys with all types of audiences, and every audience defines risk as the probability of losing money (or as the probability of falling below some required rate of return). Never has a group I've surveyed defined risk as volatility.

Supporting these less-than-scientific results, there have been numerous academic studies that suggest investors' reactions to market risk are not symmetric. Investors consistently react more negatively to losses than positively to gains.

At RBA, we incorporate this asymmetry in our sentiment work. At the beginning of a typical market cycle, investors are more fearful of losses than normal. In the mid-cycle, they tend to be more accepting of risk, and appear to have more normal risk tolerances. In the late cycle, investors generally embrace risk and attempt to accentuate returns because they believe there is no downside risk.

Data clearly show that no group of investors is currently willing to take excessive US equity risk. Pension funds, endowments, foundations, hedge funds, individuals, Wall Street strategists, and even corporations themselves remain more fearful of downside risk than they are willing to accentuate upside potential.

One might argue that the valuations of stocks like social media, biotechnology, small energy argue that there is a "bubble" forming in stocks. These areas of the stock market do indeed seem excessively speculative, but the enthusiasm for these groups has not translated into enthusiasm for US stocks as a whole. As we have previously pointed out, high beta stocks within the S&P 500® are near historically low relative valuations.

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The probability of a bear market still seems low to us. Bear markets are made of tight liquidity, significantly deteriorating fundamentals, and investor euphoria. Although the Fed is starting to reverse course, there are no signs yet of a significant tightening of liquidity. Rather, the data are beginning to suggest that private sector credit growth is starting to replace the Fed as the provider of liquidity. Corporate fundamentals continue to be healthy, and investment, whether in inventories or capital equipment, has yet to show any sign of extreme. As mentioned, we can find no group of investors who are shunning diversification or leveraging upside participation in US equities as an asset class.

Regardless of these healthy signs, most investors continue to focus on protecting the downside. However, investors don't seem to have learned the lesson of the past cycle. Investors continue to confuse the number of asset classes with diversification. Diversification isn't based on the number of asset classes, it's based on the correlation of returns among the asset classes.

One central tenet of our portfolios remains that there are very few asset classes that truly "protect against the downside risk in equities".

Upside/downside capture

Upside/downside capture is a simple measure that shows how an investment relates to the movements of the stock market. Returns are separated into two groups: those when the stock market rises and those when the stock market falls. The capture shows the proportion between the asset's returns and the overall stock market's return. For example, if the average up return for the S&P 500® was 10% and the average up return for a particular asset was 7.5%, then the upside capture ratio would be 75% (7.5/10). Similarly if the average down return for the S&P 500® was -10% and the average down return for the asset was 12%, then the downside capture ratio would be 120% (-12/-10). The goal is to find assets that have a high upside capture, but a low or negative downside capture.

Chart 1 shows a scatter of upside/downside capture ratios for a broad set of asset classes based on returns during the past ten years. The quadrants depict the four possible combinations, i.e., lower upside/lower downside, lower upside/higher downside, higher upside/higher downside, and higher upside/lower downside. The 45-degree line shows equal upside/downside ratios.

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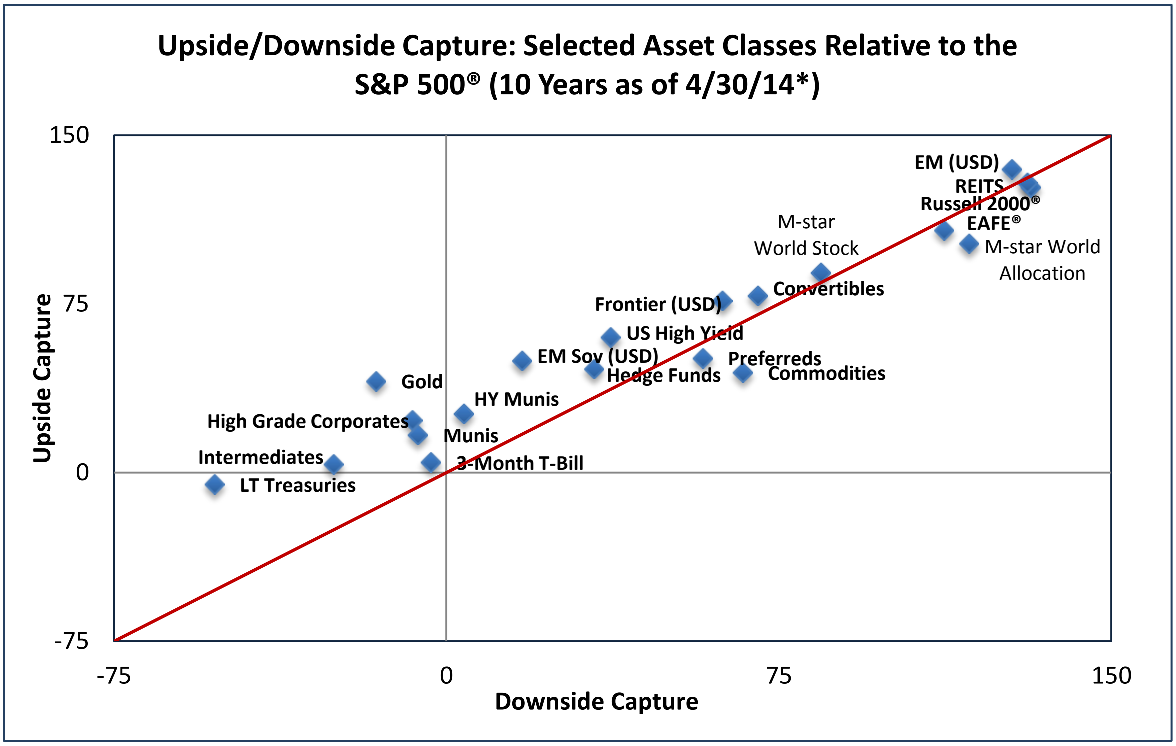
Chart 1:



Source: Source: Richard Bernstein Advisors LLC, MSCI, Bloomberg , Morningstar, HFRI, BofAML
*Based on monthly total returns . Hedge fund data is through 3/31/14 as hedge fund data for the month ending 4/30/14 is not yet available. For Index descriptors, see "Index Descriptions" at end of document.

There are several points that investors should consider when reviewing this chart:

1) **Very few asset classes have exhibited true downside protection.** Note that most asset classes fall close to the 45-degree line, which suggests that most asset classes participated equally in bull and bear markets.

2) **Only one asset class, long-term treasuries had negative correlation to stocks, i.e., negative upside and downside capture ratios.** Treasuries, and other fixed-income categories like high grade corporates and higher quality municipal bonds, should probably be the heart of any current strategy designed to truly protect against downside equity risk.

3) **Although we don't find gold attractive within the current market environment, gold was a reasonable diversifier** over the past ten years. However, it hasn't offered as much downside protection as it did upside participation. By contrast, commodities do not seem to offer an attractive upside/downside.

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4) **Hedge funds are not a panacea**. Note that hedge funds have historically offered about 70% of both the upside AND the downside. There seem to have been many asset classes that offered similar captures with considerably lower fee structures. For example, an indexed combination of riskier fixed-income (emerging market sovereign debt and high yield corporates) had a superior upside/downside capture ratio to hedge funds.

5) **Cash is generally a worthwhile diversifier**. It exhibited minimal upside, but slightly negative downside.

Asset allocation requires swimming against the tide.

Investors, regardless of whether they are institutional or individual, tend to follow trends when determining asset allocation decisions. Yet, history has shown that swimming against the tide and investing in unpopular asset classes has been the route to true diversification and investment success.

Our core investment philosophy has always been that uncertainty equals opportunity. The data suggest that we continue to differ with the consensus regarding our bullish views toward the US market, and regarding our views regarding which asset classes offer diversification and downside protection.

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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.

US Mid Cap : Standard and Poor's MidCap 400® Index: The S&P MidCap 400® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the mid-sized companies of the U.S. stock market.

Russell 2000® : Russell 2000® Index. The Russell 2000® Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

MSCI ACWI®: MSCI All Country World Index (ACWI®). The MSCI ACWI® is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets.

EM: MSCI Emerging Markets (EM) Index. The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

Frontier: MSCI Frontier Index. The MSCI Frontier Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of Frontier markets.

Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity. The Gold Spot price is quoted as US Dollars per Troy Ounce.

Commodities: S&P GSCI® Index. The S&P GSCI® seeks to provide investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index. The index is calculated primarily on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

REITS: THE FTSE NAREIT Composite Index. The FTSE NAREIT Composite Index is a free-float-adjusted, market-capitalization-weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ National Market.

3-Mo T-Bills: BofA Merrill Lynch 3-Month US Treasury Bill Index. The BofA Merrill Lynch 3-Month US Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. The Index is rebalanced monthly and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond, three months from the rebalancing date.

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INDEX DESCRIPTIONS cont'd:

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.

Intermediate Treasuries (5-7 Yrs): The BofA Merrill Lynch 5-7 Year US Treasury Index
The BofA Merrill Lynch 5-7 Year US Treasury Index is a subset of The BofA Merrill Lynch US Treasury Index (an unmanaged Index which tracks the performance of US dollar denominated sovereign debt publicly issued by the US government in its domestic market). Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of $1 billion. including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

Municipals: BofA Merrill Lynch US Municipal Securities Index. The BofA Merrill Lynch US Municipal Securities Index tracks the performance of USD-denominated, investment-grade rated, tax-exempt debt publicly issued by US states and territories (and their political subdivisions) in the US domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule, and an investment-grade rating (based on an average of Moody's, S&P and Fitch). Minimum size requirements vary based on the initial term to final maturity at the time of issuance.

High Grade Corporates: BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index. The BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index is a subset of the BofA Merrill Lynch US Corporate Index (an unmanaged index comprised of USD-denominated, investment-grade, fixed-rate corporate debt securities publicly issued in the US domestic market with at least one year remaining term to final maturity and at least $250 million outstanding) including all securities with a remaining term to final maturity of at least15 years and rated AAA through AA3, inclusive.

U.S. High Yield: BofA Merrill Lynch US Cash Pay High Yield Index. The BofA Merrill Lynch US Cash Pay High Yield Index tracks the performance of USD-denominated, below-investment-grade-rated corporate debt, currently in a coupon-paying period, that is publicly issued in the US domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long-term sovereign debt ratings), at least one year remaining term to final maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.

EM Sovereign: The BofA Merrill Lynch US Dollar Emerging Markets Sovereign Plus Index
The BofA Merrill Lynch US Dollar Emerging Markets Sovereign Plus Index tracks the performance of US dollar denominated emerging market and cross-over sovereign debt publicly issued in the eurobond or US domestic market. Qualifying countries must have a BBB1 or lower foreign currency long-term sovereign debt rating (based on an average of Moody's, S&P and Fitch). Countries that are not rated, or that are rated "D" or "SD" by one or several rating agencies qualify for inclusion in the index but individual non-performing securities are removed. Qualifying securities must have at least one year remaining term to final maturity, a fixed or floating coupon and a minimum amount outstanding of $250 million. Local currency debt is excluded from the Index.

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Convertibles: The BofA Merrill Lynch All US Convertibles EX Mandatory Index:
The Bank of America Merrill Lynch All US Convertibles Ex Mandatory Index (V0A0) is broadly representative of the U.S. convertible securities market, consisting of publicly traded issues, denominated in U.S. dollars, of all credit qualities, and excluding mandatory (equity-linked) convertibles. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the index proportionate to its market value.

Preferreds: The BofA Merrill Lynch Fixed Rate Preferred Securities Index (POP1): The BofA Merrill Lynch Fixed Rate Preferred Securities Index tracks the performance of fixed rate U.S. dollar-denominated preferred securities issued in the U.S. domestic market.

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.

REITS: THE FTSE NAREIT Composite Index. The FTSE NAREIT Composite Index is a free-float-adjusted, market-capitalization-weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ National Market.

M-star World Stock: Morningstar World Stock category : International funds having more than 20% of stocks invested in the United States. Additional detail available from Morningstar directly.

M-Star World Allocation : Morningstar World Allocation Category: World-allocation portfolios seek to provide both capital appreciation and income by investing in three major areas: stocks, bonds, and cash. While these portfolios do explore the whole world, most of them focus on the U.S., Canada, Japan, and the larger markets in Europe. It is rare for such portfolios to invest more than 10% of their assets in emerging markets. These portfolios typically have at least 10% of assets in bonds, less than 70% of assets in stocks, and at least 40% of assets in non-U.S. stocks or bonds. Additional detail available from Morningstar directly.

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

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About Richard Bernstein Advisors:

Richard Bernstein Advisors LLC is an independent investment adviser. RBA partners with several firms including Eaton Vance Corporation, First Trust Portfolios LP, and BNP Paribas, and currently has $3.0 billion collectively under management and advisement as of April 30, 2014. 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 and Merrill Lynch 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.