Richard Bernstein Advisors

The Leaders In Pactive® Management

Q&A with Rich Bernstein

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Are you bullish or bearish?

The answer is our portfolios are defensively positioned, but I wouldn't say we are either bullish or bearish. We are simply following the fundamentals rather than being event-driven during a period of unprecedented events. I don't think anyone truly knows how this double black swan of COVID-19 and a major oil shock will play out, so why try to guess? We know a dispassionate following of the fundamentals will guide us well.

What kinds of indicators are you following to guide you?

Most of our research is home grown, and we have hundreds of proprietary indicators relating to 3 basic categories: 1) corporate profits; 2) liquidity; and 3) sentiment and valuation. Liquidity is abundant as I'm sure everyone knows. However, corporate profits and cash flows are taking a monstrous hit and the ramifications of that massive downdraft in cash flow with respect to credit, leases, etc. are generally unknown. The 2nd and 3rd order effects from the hit to corporate and even household cash flow should be watched carefully.

What do you mean by 2nd and 3rd order effects?

COVID-19 and the closing of the global economy is the first order. The 2nd order is the layoffs and cutback in activity. The 3rd order is the resulting financial effects such as bankruptcies and defaults. An easy way to think about it is the 1st order is the health effect, the 2nd order is the economic effect, and the 3rd order is the financial effect.

How are you currently positioned?

As I mentioned, we are pretty defensively positioned with some exceptions. Last year we started lowering our equity weight after nearly 10 years of consistent overweight. Our equity portfolio is overweight Consumer Staples, Health Care, Utilities, large caps, and high quality. Pretty standard stuff for a downturn. We very recently increased our Energy weight as a hedge in case the economy rebounds more quickly than we might expect. Energy will likely underperform if the economy continues to slow, but then the remainder of our portfolio will likely outperform. In fixed income, we are very high quality and relatively short-duration. About 8% of our portfolios are in gold. Gold has been a good hedge the past 2-3 years against the unprecedented levels of uncertainty in the economy.

You mentioned lowering your equity weight last year. Why did you do that?

As I mentioned, we follow fundamentals and are not event-driven. Although no one wanted to hear it, the US economy was weakening all during 2019. It wasn't weak in an absolute sense, but it was weakening. Markets don't care whether the economy is good or bad. The market cares about whether the economy is getting better or worse, and during 2019 the economy was actually getting worse. No one wanted to hear that. It was amazing. For example, GDP growth the last 3 quarters of 2019 was below average, corporate profits growth had fallen to only 3%, and employment growth was about to go negative. Who talked about those risks??? No one, but history shows that's the time to start de-risking a portfolio.

Wait, are you suggesting you saw COVID-19 on the horizon?

Of course not. I think we did see it earlier than most because of our substantial overweight of Chinese stocks, but we didn't forecast a COVID-19 pandemic. It would be silly to imply otherwise. However, we did see a combination of a weakening fundamental backdrop and ebullient investors. That combination has historically suggested that bad outcomes tend to have a magnified effect on the markets. And then, we got the double whammy of COVID-19 and an oil shock. The economy was already on shaky ground, and then two historic black swans come swimming into the pond.

What combination of factors would make you bullish and cause you to increase your equity weight?

Historically, the combination of improving (not good but improving) fundamentals and extreme bearishness has been a very bullish sign. So far we are not there. Fundamentals are still eroding at an historic rate and investors are trying to time the bottom. Investors need to remember that bear markets go through three stages: 1) It's temporary – investors try to time the bottom; 2) It's worse than anyone could have imagined; and 3) It'll never end. Judging by that construction, I think right now we are still somewhere in Phase 1 or early Phase 2.

Do you think investors should stay out of the equity markets for now?

I think attempting to time the market's bottom is a fruitless exercise. It makes for nice headlines, but the historical risk/returns suggest that the risk of being wrong is so great that it outweighs the positives. However, that is vastly different from re-balancing a portfolio that has a plan. If a plan is off-kilter because of the markets' volatility, then it makes perfect sense to rebalance back to the plan. That's the point of a plan.

What do you think of non-US equity markets?

We have been significantly overweight China for a couple of years. I understand the politics these days, but that's not my day job. My day job is to try to find the best opportunities for our investors, and China has clearly been one. I'll bet most investors don't know that the two best performing markets during the downdraft were China and Switzerland. Who would pick those two as the safe havens?? We have little EM exposure outside of China, but it is worth watching especially if one has a longer-term/decade long view. We'd argue EM will outperform Tech and venture capital over the next decade.

Any final advice to investors?

In 2001, I wrote a book called "*Navigate the Noise – Investing in the New Age of Media and Hype*." Boy, it's much more appropriate today than it was 19 years ago. The point of the book was that we know that there are basic ways to build wealth through time, so why don't people do that? It's because there is this Siren's Song of news and other distractions telling you not to use those basic building blocks. In an unprecedented period like we're going through, it becomes more important to put on blinders, put in ear plugs, ignore the news, and stick to the basic fundamentals of investing.

If you have any additional questions on our thinking, please reach out to your regional RBA Portfolio Specialist.