Richard Bernstein Advisors

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Insights

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Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager 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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"Innovation" and "Disruption" are "BS"

This month's commentary has a deliberately provocative title. Something seems amiss within the equity markets, and investors might benefit from a cold slap in the face.

Let's set the record straight: innovation and disruption have always been the heart of a functioning capitalistic economy. History shows well that goods and services improved through time because of competition. Despite their multi-century contributions to economic history, the terms "innovation" and "disruption" seem to have today taken on new meaning and purpose. A cynic might argue "innovation" and "disruption" have been hijacked by marketers ready to sell the latest overvalued IPO, raise the largest venture capital fund, or gather exchange traded fund assets.

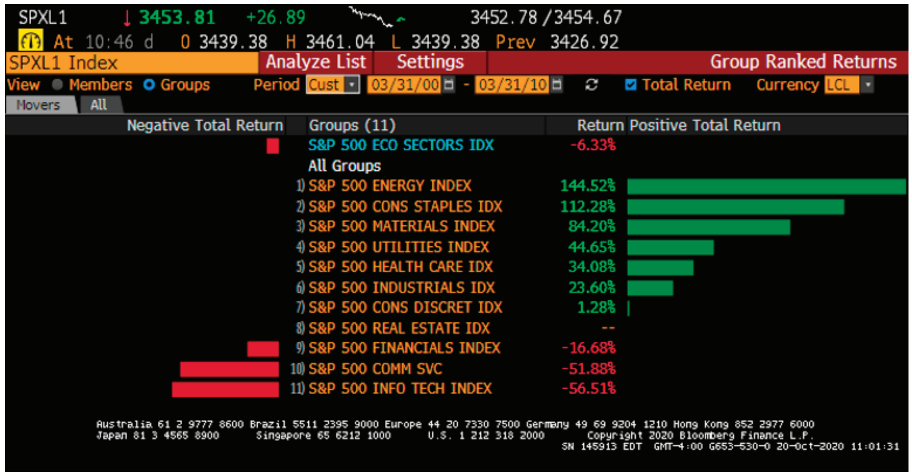
The current environment is not unique. There have been many times in financial history during which excess capital was misdirected to speculative investments promising huge growth and profits. There are of course changing secular technological trends today, but investors should be wary because valuations and profit cycles - not hyped stories - primarily drive stock performance.

Whether hyped forecasts of growth occur in the overall economy is vastly different from stocks outperforming in the future. The economy often evolves as futurists believe it will, but investors' returns often end up suffering because the associated stocks were overvalued and the companies' profits and cash flows disappointed.

CHART 1:

S&P 500® Sector Performance

(Mar. '00 – Mar. '10)



Source: Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document.

For example, the economic changes foreseen during the Technology Bubble actually did come true, as internet and cell phone use grew exponentially between 2000 and 2010. However, the Technology and Communication Services sectors were by far the worst performing stocks during the decade when that important technological transformation occurred (See Chart 1).

Profits cycles drive growth and value

Our ground-breaking research in the early-1990s uncovered profits cycles not economic cycles determine the performance of equity market segments like growth and value or large and small. Today, RBA incorporates a later-generation of that original research into our portfolios and funds. The research helps explain why value has so significantly underperformed growth during the past several years.

Our research hypothesized markets become very "Darwinistic" (i.e., survival of the fittest) when profits cycles decelerate. As cycles decelerate, earnings growth becomes increasingly scarce and investors bid up the prices and the valuations of the fewer and fewer companies that can maintain their growth rates. In other words, leadership and outperformance narrows as profits cycles decelerate. Growth tends to outperform value during those periods because value investors simply will not pay such lofty valuations for growth.

However, value tends to outperform growth when profits cycles accelerate. Earnings growth becomes more abundant as the cycle turns up and market leadership broadens. When the cycle turns up, investors can comparative shop for growth because earnings growth is everywhere. A comparison shopper within the stock market is called a value investor.

This theory helps to explain the relative performance of growth and value over the past several years. The profits cycle peaked in 2018 and has been decelerating since. The pandemic further accentuated the scarcity of growth and stock market leadership became extremely narrow because very few companies could maintain earnings growth during what was effectively a depression.

Admittedly, the theory has not worked perfectly in this cycle because the value universe is dominated by Financials, and the financial sector has come under significant regulatory scrutiny and damaging monetary policies since the Global Financial Crisis. Nevertheless, the theory does offer considerable insight into the narrowness of the recent stock market.

More important, the profits cycle seems poised to accelerate during 2021/2 simply because of easy profits comparisons to the pandemic's profits recession. The market may be starting to sniff out these easy comparisons. The Russell 2000 (the broader, smaller stock market) has been outperforming the narrow NASDAQ leadership since the end of August (See Chart 2).

CHART 2:

Performance of Russell 2000, Nasdaq Composite and NYSE FANG+

(8/31/2020 – 10/20/2020)

Source: Bloomberg Finance L.P. For Index descriptors, see "Index Descriptions" at end of document.

Technology and Anti-trust?

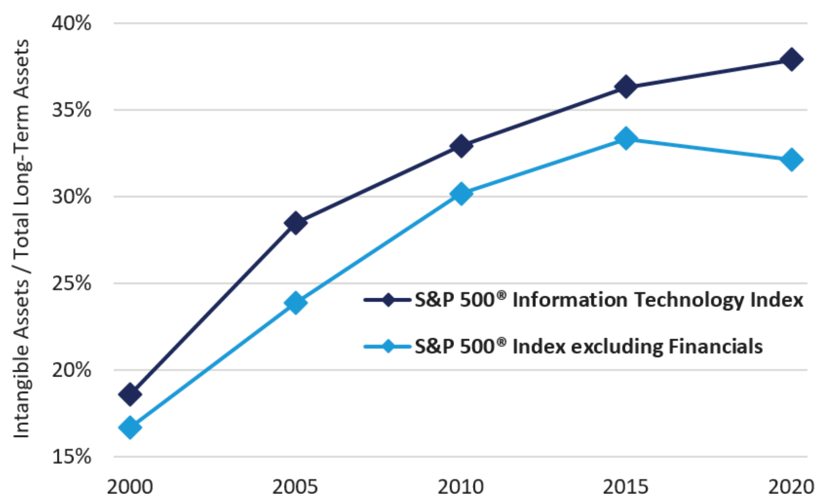
Some of today's largest Technology companies are starting to come under anti-trust scrutiny perhaps because they have fought disruption by buying potentially competitive companies. We realize Technology anti-trust has become a political issue, and we have no intent to take a political side. However, it does seem odd that a sector rife with innovation and disruption has a small number of extremely large and dominant companies.

Similar issues in the energy and the telecommunications industries led to now famous anti-trust breakups. Investors may not be incorporating these potential anti-trust risks into Technology sector valuations.

How long do ideas stay unique?

Some observers have commented regarding the growing proportion of intangible assets on technology companies' balance sheets. Intangible assets arise from paying premium valuations when acquiring other companies, patents, brands, and the like. Longer term tangible assets, as the name implies, are hard assets like machinery, plant, real estate, and other physical assets. Chart 3 shows balance sheets have skewed toward intangible assets over the past 20 years. Intangibles have increased for the overall S&P 500®, but especially so for the Tech sector. Currently almost 40% of the typical technology company's long-term assets are intangible.

CHART 3:
Intangible Assets as a Percent of Long-Term Assets: Ratio for Median Company



Source: Richard Bernstein Advisors, Bloomberg Finance L.P.

Recent history shows the value of technology intangibles might decrease faster than many believe. Intangible assets are typically amortized over 10-15 years, but Tables 1 and 2 suggest many highly proprietary technologies of 10 years ago are basically worthless today. The tables highlight the 10 most popular cellphones and the 10 most popular apps in 2010. Manufacturers of 6 of the top 10 phones in 2010 basically aren't serious competitors anymore. Apple and Samsung remain on the list today, but no Chinese brands appeared on the 2010 list. The list of 2010's most popular apps is simply a stroll down memory lane.

TABLE 1:
10 Most Popular Cellphones in 2010

Rank	Phone
1	Apple iPhone 4
2	Nokia 3720 Classic
3	HTC HD2
4	Apple iPhone 3G
5	Nokia E52
6	Samsung 19000 Galaxy S
7	Nokia 6700 Classic
8	HTC Desire
9	Nokia 6303 Classic
10	Samsung B2100

Source: Krusell & Mobile88 © 2011

TABLE 2:
10 Most Popular Apps in 2010

Rank	App
1	MLB.com At Bat 2010
2	Angry Birds
3	Call of Duty: Zombies
4	Bejeweled 2 + Blitz
5	FriendCaller 3 Pro
6	Zombie Farm
7	TomTom U.S.A.
8	TETRIS®
9	Plants vs. Zombies
10	Doodle Jump

Source: TechCrunch

Is it "BS"?

Many will argue I'm simply a Luddite stuck in the past who doesn't understand this unique period of innovation. Quite to the contrary, I fully embrace technological advancement and believe that innovation and disruption are necessary components of a well-functioning capitalist economy. I've wondered for years why certain sectors, like energy, not only haven't embraced technological advancement but have actually fought it, and why the US government hasn't kept the country's technological infrastructure up to par with that of other countries.

However, investors always need to dispassionately assess the distinctions between technological advancement, antitrust, and good old-fashioned snake oil.

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To learn more about RBA's disciplined approach to macro investing, [please contact your local RBA representative.]

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.

Indexes are not available for direct investment.

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

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.

Sector/Industries: Sector/industry references in this report are in accordance with the Global Industry Classification Standard (GICS®) developed by MSCI Barra and Standard & Poor's.

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.

Nasdaq: The Nasdaq Composite Index: The NASDAQ Composite Index is a broad-based market-capitalization-weighted index of stocks that includes all domestic and international based common type stocks listed on The NASDAQ Stock Market.

NYSE FANG+: The NYSE FANG+ Index is an equal-dollar weighted index designed to represent a segment of the technology and consumer discretionary sectors consisting of highly-traded growth stocks of technology and tech-enabled companies such as Facebook, Apple, Amazon, Netflix, and Alphabet's Google.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $10.5 billion collectively under management and advisement as of September 30th, 2020. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, 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. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.