



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.

CONTACT RBA

Website: RBAadvisors.com

Twitter: @rbadvisors

Phone: (212) 692-4088

What to do when black swans swim



Black Swans

If you're not familiar with the term, "black swan" typically refers to highly unusual and unanticipated events that disrupt the financial markets. Most swans are obviously white in color, but in rare occasions a black one is hatched. The term, therefore, refers to low probability events. Of course, the term is typically used to refer to bad events. Nobody gets anxious when unexpected good events occur.

The question is whether investors can predict black swan events? By definition, the answer is no. However, black swan events happen all the time. Why do some black swan events, like the two current ones (coronavirus and an oil shock), have an outsized influence on the markets whereas others have no meaningful effect at all?

The answer is fundamentals matter more than black swans. When fundamentals are improving, black swan events become short-term distractions. The power of improving fundamentals overwhelms the negative black swan event. However, black swan events take center stage when fundamentals are deteriorating. We would argue that fundamentals must previously be deteriorating for black swan events to cause bear markets.

That has been true this time as well. Deteriorating fundamentals caused the black swans to have importance. There were plenty of warnings signs which investors totally ignored. Despite claims of the US economy's strength,

statistics reflected a meaningful slowdown. Consider the following facts that investors largely ignored:

1. US GDP growth had been below average for three straight quarters.
2. US leading indicators had been decelerating all during 2019.
3. Employment growth had slowed to only about 1.5% y/y.
4. S&P 500® corporate profits growth had slowed from over 20% to about 5%.
5. Small cap US stocks were in a deep profits recession.
6. Globally there was a full-blown profits recession.
7. Despite the notion that liquidity was everywhere, the US yield curve inverted, and global yield curves overall were extremely flat.
8. Short-term funding issues were mounting as the Fed needed to respond to problems in the repo market.

There are others we could point to as well, but the bottom line is that fundamentals were slowing or outright deteriorating, investors ignored the warning signs, and then the black swan events surprised.

RBA's positioning

Did RBA see the black swans coming? No way, but we did see the deteriorating fundamental backdrop and positioned our portfolios accordingly.

RBA's October 2019 Insights report was titled "*Dusting off the 'fire extinguishers'*" in which we outlined how fundamentals were starting to erode and how RBA was preparing our portfolios. In November 2019's Insights, we took issue with the notion that investors were fearful. In January 2020, we discussed how the financial markets were taking on bubble-like characteristics. The wide-eyed (I would argue ridiculous) stories of vacations in outer space have been replaced with the harsh reality of pandemic and recession.

The black swan events are now exacerbating the existing slowdown in economic activity. They are NOT the cause of the slowdown in economic activity. Rather, they are salt in the wound.

Because we saw the slowdown in economic activity and corporate profits, our portfolios were defensively positioned. Here are several of the most significant positions in our portfolios:

1. We have been overweighted defensive sectors: Consumer Staples, Health Care, Utilities, REITs, large cap, and high quality.
2. Our equity weight was reduced to benchmark in late last September from an extended period of significant overweight.
3. Our equity beta became amongst the lowest in the history of RBA, whereas our volatility beta (i.e., the portfolio would benefit if volatility went up) became amongst the highest in the history of the firm.

Looking forward

Bear markets go through several stages. First, investors believe the market's downdraft is temporary ("It'll be ok." "The market will look through the bad news." "The market has already discounted the bad news."). Second, investors become shocked by the reality of recession. ("Gee, it's worse than anyone could have thought."). Finally, investors resign to the situation. ("It'll never end.").

It seems that we are presently in the first stage. The general belief is that the situation is temporary, and many observers are searching for buying opportunities. Yet, the economic data does not yet reflect either black swan event, and the market never...never...looks through bad data. Investors in every cycle suggest the market will overlook bad data, but that never happens. The market does tend to look upward from a trough, but it rarely if ever totally ignores incrementally bad news.

Right now, we view investing in the current environment using the hackneyed phrase of "catching a falling knife." We see no need to rush into markets. Fortunately, we have been positioned well and will wait for the right opportunity to add risk. That opportunity from our perspective will come when the data begin to improve (remember they haven't yet deteriorated) and investors don't believe the improvement is sustainable. That combination of improving fundamentals and disbelief has historically been a potent combination. 2009 to 2018 was a perfect example.

Final thought

Most bear markets correct excesses. So far this time, that has not been true. Everyone always looks for bubbles, and the bubble in this cycle wasn't in a specific asset class or sector. **We think there was a bubble in duration.** Long-duration equities and long-duration bonds have been tremendously overvalued and seem to be getting more so in reaction to the black swan events.

We remain hesitant to join in the fun. These sectors are performing very well, but it has rarely been a prudent strategy to buy historically overvalued assets.

Bottom line

Consumer Staples, Health Care, Utilities, REITs, Large Cap, and high quality remain the dominant themes in our US equity portfolio. Our cyclical continues to be in China for the many reasons we've outlined previously.

Our fixed-income exposure remains in short-duration treasuries and TIPS. Our TIPS positions have obviously been derailed by the oil shock, but we continue to believe that the risk/returns in TIPS are superior to those in nominal treasuries.

Gold remains in the portfolio as it's been for the past 2+ years as a hedge against uncertainty. One thing seems certain: coronavirus isn't going to add to certainty, so we feel gold should remain a core part of our portfolios.

The keys to success over the next year may be summed up in two parts: 1) don't panic and 2) have patience. History suggests that fundamentals will turn positive more slowly than investors expect. That delay typically results in investors panicking. The patient dispassionate investor will be presented with ample investment opportunity, but the key is not to panic and be very patient.

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