Richard Bernstein, Chief Executive and Chief Investment Officer

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an independent investment adviser 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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Taking Grounders In Spring Training

Derek Jeter, undoubtedly soon to be a first-ballot Hall of Famer, never forgot the fundamentals. Regardless of how many records he broke, of how many World Series rings he wore, and of how successful the New York Yankees were under his captaincy, Jeter routinely practiced baseball fundamentals during every spring training. He realized that success was based on mastering basic fundamentals.

It seems as though investors have forgotten about the basic fundamentals of investing. Metaphorically, they seem to be forgetting to cover first base on a grounder to the right side of the infield, to hit the cutoff man on an outfield throw, and to never pitch to a batter's sweet spot on an 0-and-2 pitch.

The stock market is behaving exactly as fundamentals suggest it should, but investors' recent range of emotions suggest they have taken their eye off the ball.

Profits fundamentals

In 1995, I wrote a book called "Style Investing – Unique Insight into Equity Management", which demonstrated the relationship between corporate profits and style rotation. Several conclusions from the book:

- Profits cycles, not economic cycles, drive stock markets and style rotation.
- Investors should focus on GAAP reported earnings because that definition of earnings skews analyses in investors' favor. Other definitions of earnings hide important information.
- There is typically a tug-of-war between interest rates and earnings. Rising interest rates are not a death knell for the stock market unless their negative effect is stronger than the positive effect of profits. Similarly, falling rates are not necessarily a boost to the stock market if earnings are too weak.

20 years later, investors still seem unaware of the book's conclusions. Investors pay much more attention to GDP than to profits. A recent New York Times article pointed out the use and

pitfalls of "adjusted" earnings. General consensus is that the current bull market must end if the Fed raises rates.

Investors apparently have not learned the importance of practicing basic fundamentals, and continue to make the same infield errors. "Score that E6 for those of you keeping score at home."

Earnings and interest rates

Basic finance says that there are two, and only two, variables that affect equity prices: earnings and interest rates. Consider the basic valuation formula for a stock:

$$V = \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} \cdots\cdots \frac{CF_n}{(1+r)^n}$$

Where,

V = value or price of a stock

CF = dividends, earnings, or cash flows expected into the futur,

r = interest rate used for comparison

Consider all the variables to which investors pay attention that are not in that formula. Just to name a few, geopolitics, politics, GDP and other macroeconomic variables, and fund holdings may provide more noise and distraction than useful investment information if one doesn't directly connect them to earnings and interest rates.

Of course, the formula incorporates a risk premium into the interest rate variable (i.e., a hurdle rate or required rate of return), but if one knew the correct risk premium for a security with certainty, then all other analyses would be superfluous because the reassessment of inaccurate risk premiums is basically what drives financial markets.

We pointed out last month, that a basic fundamental analysis of earnings and interest rates helps to explain why the stock market has recently gyrated. The Fed is "threatening" to tighten interest rates, while the US is in a profits recession. Within the context of the basic valuation formula, interest rates might rise while earnings forecasts are being revised downward. The numerator in the formula is going down, while the denominator is expected to soon increase.

If one thinks the Fed will wait to raise rates (as we do) and if one thinks that the profits cycle will trough by year-end 2015 (as we do), then it follows that 2016 might be a good year for US stocks. However, if one thinks the Fed will raise rates sooner and the profits cycle will trough later, then the basic formula suggests that stock market volatility could continue.

However, it all comes down to the basic fundamentals: earnings and interest rates.

RBA Investment Process:

- Quantitative indicators and macro-economic analysis are used to establish views on major secular and cyclical trends in the market.
- Investment themes focus on disparities between fundamentals and sentiment.
- Market mis-pricings are identified relative to changes in the global economy, geopolitics and corporate profits.

Taking grounders in spring training

Practicing basic fundamentals is critical to one's success in any endeavor. In baseball, it means the mundane and repetitive task of taking ground balls in spring training. Successful baseball players are typically willing to go through the monotony in order to hone their skills.

Investors too often forget their practicing the fundamentals is critical to their success, too. For equities, it's all about the basics of earnings and interest rates, and ignoring the ever present distractions. It isn't very sexy to invest in equities using this commonplace approach, but no one gets to the Hall of Fame without mastering the basics.

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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 and First Trust Portfolios LP, and currently has $3.1 billion collectively under management and advisement as of September 30, 2015. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and the Eaton Vance Richard Bernstein Market Opportunities 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, Merrill Lynch, Morgan Stanley Smith Barney 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.