Climbing the Wall of Worry

Richard
Bernstein

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Most investors have heard the phrase “bull markets climb the wall of worry”. However, they also have difficulty identifying whether the stock market is indeed in a bull phase that is climbing the wall of worry or whether fear is justified and the bull market is nearing an end.

We have observed that portfolios tend to perform less well when emotion is the guiding force, so we use very objective and well-tested indicators to assess fear in the marketplace. Currently, these indicators suggest that the bull market remains intact, and that the market is indeed climbing the wall of worry once again.

In this report, we highlight some of the indicators that we incorporate into our portfolios. They are uniformly suggesting that investors are too afraid, and that higher US equity allocations are probably warranted.

The Wall Street Sentiment Indicator

Approximately thirty years ago, we began to study the information content of Wall Street strategists’ consensus recommended asset allocations. We found, when adding a little math, that the consensus recommended asset allocation was a very reliable contrary indicator. That is, it paid to be bullish when Wall Street suggested underweighting equities, and vice versa.

Chart 1 shows one version of this indicator in which we plot the consensus recommended equity allocation for a balanced fund against the typical normal long-term equity weight of 60-65%. In this chart, a reading of 50% indicates that the average Wall Street strategist was recommending 50% of a balanced fund (i.e., stocks, bonds, and cash) be invested in equities.

As a fantastic example of bull markets climbing the wall of worry, Wall Street strategists never recommended overweighting equities at any point during the entire bull market of the 1980s and 1990s. They finally recommended overweighting equities subsequent to the Technology bubble. That overweight proved to be just in time for the so-called “lost decade in equities”, during which US stocks produced a negative return over ten years.

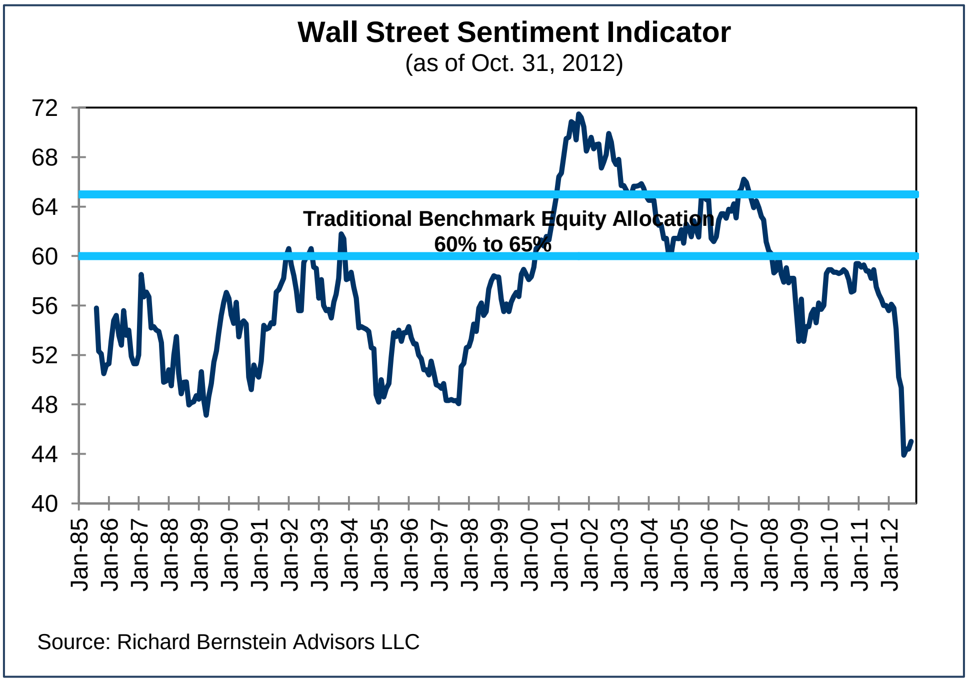
Today, however, Wall Street strategists are recommending the lowest equity allocation in the near-thirty year history of the data. As was the case before the lost decade, the stock market has performed well during a period of fear.

Richard Bernstein
Advisors LLC
520 Madison Avenue
28th Floor
New York, NY 10022
212-692-4000

www.rbadvisors.com

Richard Bernstein Advisors

Chart 1:



ISI Bond Manager Survey

The wall of worry isn't constrained to the equity market. The treasury market has been climbing for years a similar wall of worry. Chart 2 depicts the results of a weekly survey of bond portfolio managers conducted by ISI Group. The graph shows the percent of the bond portfolio managers who say that their portfolio duration is longer than that of the benchmark.

Positioning a portfolio with longer duration than benchmark means that a portfolio manager believes that interest rates are likely to fall, whereas a shorter duration implies positioning in anticipation of rising rates. The survey results show that bond portfolio managers have never in the history of the survey positioned for falling interest rates. Yet, during the time period of the survey, the ten-year treasury note rate has significantly fallen (see Chart 3). Bond portfolio managers continue to believe that rates will increase.

Many have suggested that there is a "bond bubble". We find it hard to believe that there is a bond bubble when bond managers' portfolios are short duration versus benchmark. If there were indeed a bond bubble, wouldn't these managers' portfolios be extremely long duration? Rather, it appears that there is a significant wall of worry in the bond market, and investors might consider positioning for rates that may continue to decrease.

Richard Bernstein
Advisors LLC
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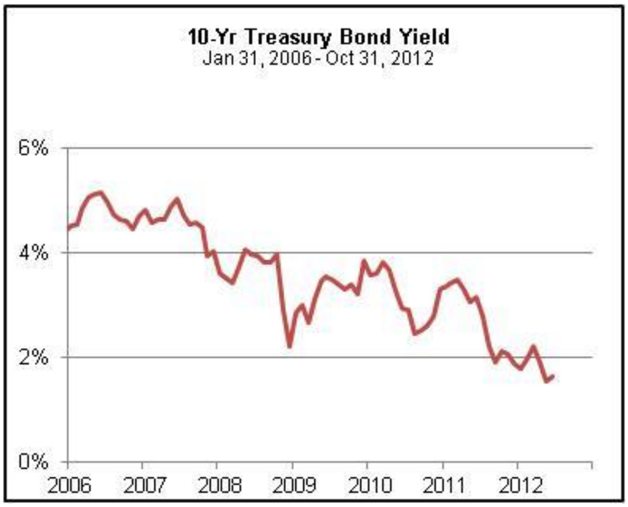
Chart 2:

Source: ISI Group

Chart 3:



Source: Richard Bernstein Advisors LLC, Bloomberg

Investment flows

We cannot find a period during which mutual fund flows anticipated a bear market. Rather, the data seem to suggest that significant flows to equity mutual funds are a warning signal, whereas significant outflows suggest opportunity. This cycle has so far fit that historical norm.

Chart 4 shows the wall of worry among mutual fund investors. Despite that the S&P 500 has produced a total return of about 15% over the past year, mutual fund investors have been consistent sellers of US equities.

Richard Bernstein
Advisors LLC
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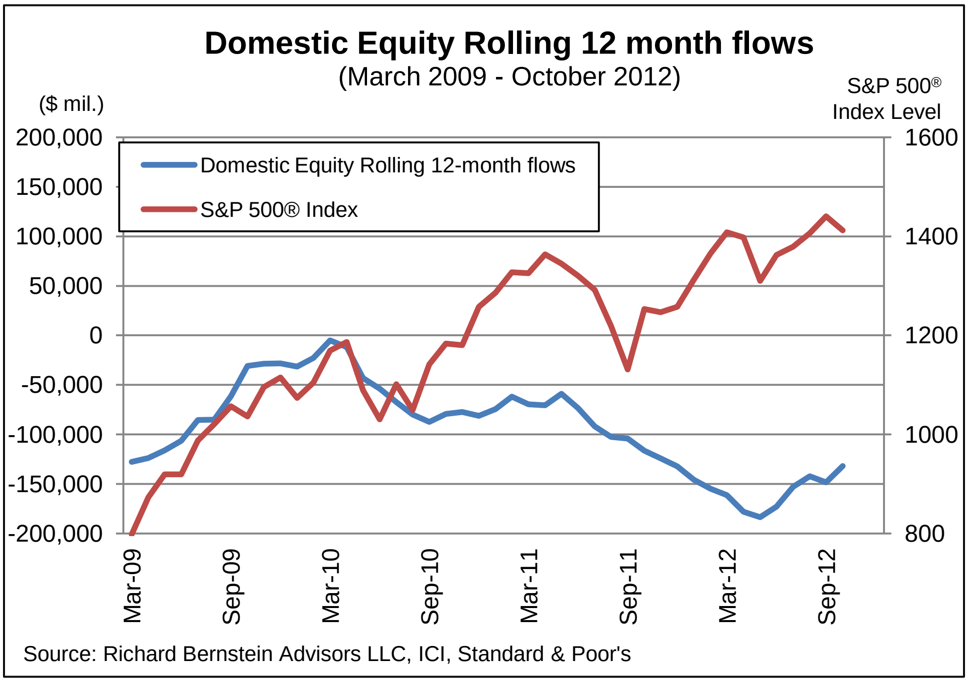
212-692-4000

www.rbadvisors.com

Chart 4:



Fears of inflation dominate

There appears to be a wall of worry with respect to inflation as well. It is unfortunate that investors have listened to politicians because printing money does NOT cause inflation. Economic textbooks say that printing money and using it to create excess credit causes inflation. The US is certainly printing money, but credit creation could hardly be called active let alone excessive. Thus, we view the risk of meaningful inflation as still quite low.

However, investors continue to perceive inflation risk to be very high. Our models currently suggest that investors are pricing nearly 6% inflation over the next twelve months into the valuation of the stock market. As Chart 5 shows, such expectations have nearly always been too pessimistic. The stock market appears to be climbing the inflation wall of worry as well.

Richard Bernstein
Advisors LLC
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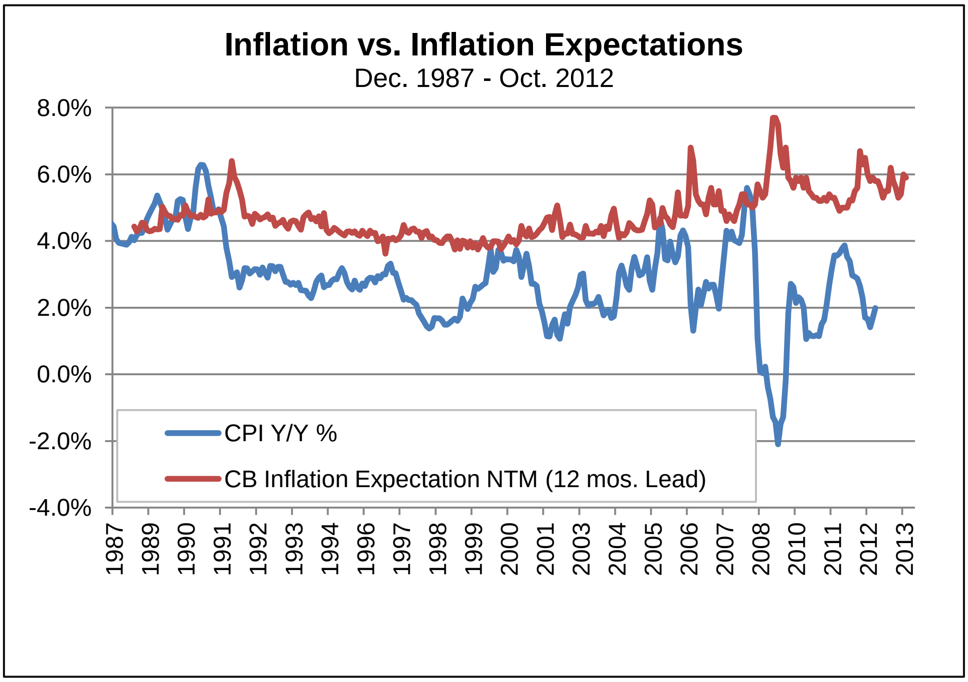
28th Floor
New York, NY 10022
212-692-4000

www.rbadvisors.com

Chart 5:



Over-estimating the risks within the US

We continue to have a bullish view of the US equity market because investors seem to be overestimating the risks within the US economy and for US corporate profits. The wall of worry can be a high one, and these indicators lead us to think that the bull market is likely to continue for longer than investors currently expect.

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28th Floor
New York, NY 10022
212-692-4000

www.rbadvisors.com

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.

Consumer Price Index (CPI): The CPI is a measure of the average change in prices over time of goods and services purchased by households. The CPI is based on prices of food, clothing, shelter, and fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living. Source: Bureau of Labor Statistics

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