Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights | September 2019

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.

Invest like a chameleon: Change your colors as the environment changes

RBA's portfolios are sometimes included in alternative asset allocations because of our "go anywhere" macro strategy. However, we differ greatly from traditional alternative managers in that our fees are typically much lower and investors' liquidity is on demand.

The potential for a multi-year or secular increase in market volatility has increasingly influenced our portfolio positioning. However, most asset allocators don't realize how an extended period of financial market volatility could affect the performance of alternative assets. The environment seems to be changing, and investors need to invest like a chameleon and change their colors.

Decreasing liquidity could propel secularly higher volatility

The primary factor influencing financial market volatility is liquidity. Many investors seek to buy when a market dips, but few ever ask why investors generally don't buy when there is a significant bear market. Of course, there are psychological factors that can impede disciplined investment processes, but that explanation overlooks that investors often simply can't buy at the market low because they don't have the liquidity to do so.

Chart 1 shows the relationship between the effects of Federal Reserve policy (depicted here as the slope of the yield curve) and equity market volatility. Although not a perfect relationship, there has historically been a strong link between liquidity and equity market implied volatility. The effects of monetary policy on financial market volatility can have significant lags because the Fed can't force financial institutions to start or to stop lending.

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We were very bullish 9 years ago partly because of the relationship between monetary policy and financial market volatility. Central banks around the world were desperately trying to add liquidity to the financial system in response to the global financial crisis, and we posited that US equity market volatility would be lower than was expected for a very long time because of the historically unprecedented liquidity injection.

That same relationship though is now causing us to re-evaluate our views on volatility. The gradual tightening of monetary policy has yet to work through the financial sector, but the inverted yield curve is suggesting that volatility could be on the rise.

This is not simply a US event. Chart 2 shows the proportion of global yield curves that are flat and inverted (i.e., 10-year to 2-year spread less than or equal to 100 bp). The sharp rise in this indicator suggests that global liquidity has been drying up, which implies that global financial markets are likely to become more volatile.

CHART 1:
Slope of the Yield Curve vs. Volatility
(Dec. 1986 – Aug. 2019)

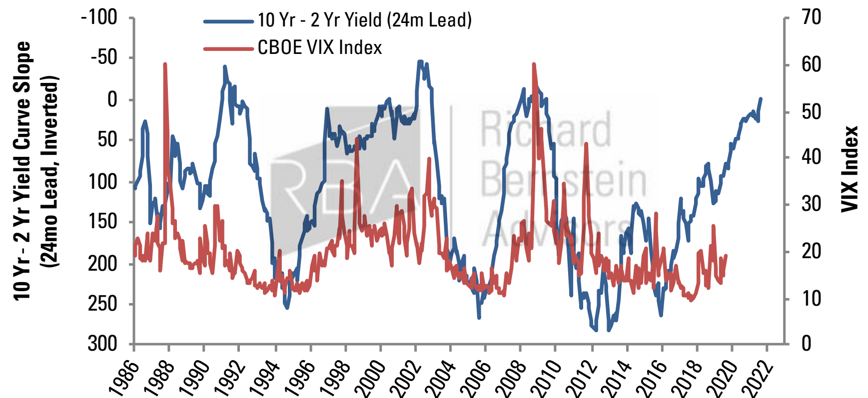
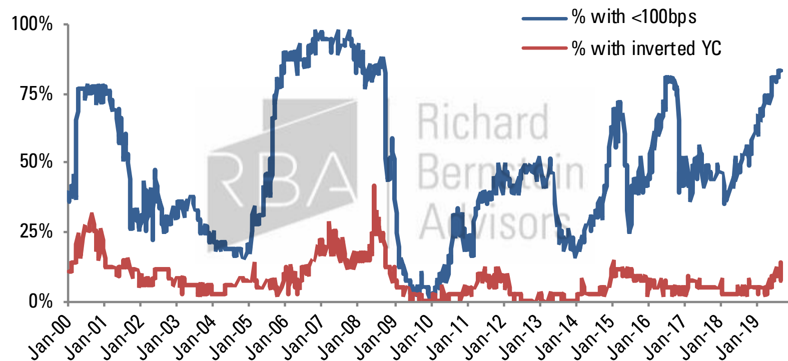


CHART 2:
Percent of ACWI® Countries with 10 Yr - 2 Yr Yield Curve Slopes < 100bps
(Jan. 2000 – Aug. 2019)



Source: Bloomberg Finance L.P.

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Popularity breeds underperformance

Perhaps the most important axiom of investing is that **return on investment is highest when capital is scarce**. Simple supply and demand suggest that the supplier of scarce capital should get higher returns through time. The lone bank in a town of 1000 borrowers will likely get a very high return on investment.

At the opposite extreme of a scarcity of capital, there have been enormous flows over the past decade into asset classes such as private equity and venture capital. Empirical Research Partners has estimated that investment flows into private equity and venture capital are bigger than the flows into US equity funds that corresponded to the Technology Bubble in the late-1990s[1].

Simple supply and demand imply the consensus expected returns for private equity and venture capital are much too high. Private equity and venture capital managers have been extending the time periods of their funds (i.e., from 5 years to 10 years or from 10 years to 15 years) recognizing the difficulty of investing when too much money chases too few ideas. Reminiscent of past bubbles, investors appear increasingly willing to pay managers' fees on capital that isn't being invested and might not be invested for years to come.

Some hedge funds might be a better choice than PE and VC (yes, that's us writing)

We've been very critical of "absolute return" hedge funds. Their fees are very high, their benchmarks are often inappropriate, their correlations to equities are higher than advertised, and their lock-ups are strict. In exchange for onerous terms, investors' absolute return hedge funds' returns have been inferior to those of short-term treasuries (i.e., more volatile and underperforming. See Chart 3).

[1] Empirical Research Partners *Portfolio Strategy June 2019*, June 27, 2019.

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CHART 3:

Absolute Return Hedge Funds vs. Short-Term Treasuries
(Weekly, Sep. 04, 2009 – Sep. 05, 2019)

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

However, an extended period of elevated market volatility might present opportunities for a few categories of hedge funds. Table 1 shows the correlation of various hedge funds strategies' returns with the VIX Index when volatility is increasing. A positive correlation suggests that a category's returns tend to be positive as volatility increases.

There are several conclusions from this table:

1. Contrary to popular belief, traditional asset allocation can provide better hedges against equity market volatility than can most hedge fund categories. Both gold and bond returns have positive correlation to upward trending volatility.
2. To hedge funds' partial credit, most hedge fund categories provide more protection against equity market volatility than the stock market itself. Yet, this is hardly remarkable because we are measuring S&P 500® returns versus S&P 500® implied volatility.
3. Although hedge funds in general do provide protection against volatility on a relative basis versus the S&P 500®, very few do so on an absolute basis. Only currency-related hedge funds have had positive correlation to equity volatility.
4. Hedge funds tend not to provide a true hedge against equity market volatility despite their ability to short assets.

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TABLE 1:
Hedge Funds vs CBOE Volatility (VIX): 10-Yr Correlation to Rising Volatility

Index	10-Yr Correlation
HFRI Macro Currency Index	0.16
Gold	0.11
Bloomberg Barclays US Agg Index	0.04
HFRI Relative Value Fixed Income-Asset Backed	-0.14
HFRI Macro Systematic Diversified Index	-0.21
Hedge Fund Research HFRI Macro Active Trading	-0.28
HFRI Macro Commodity Index	-0.31
HFRI Macro Total Index	-0.31
HFRI ED Credit Arbitrage Index	-0.36
HFRI Macro Discretionary Thematic Index	-0.36
HFRI Macro Multi-Strategy Index	-0.45
HFRI Relative Value Fixed Income Sovereign Ind	-0.46
HFRI Relative Value Yield Alternatives Index	-0.47
HFRI Relative Value Fixed Income-Corporate Ind	-0.48
HFRI Credit Index	-0.49
HFRI Relative Value Fixed Income-Convertible A	-0.50
HFRI ED Multi-Strategy Index	-0.51
HFRI ED Merger Arbitrage Index	-0.51
HFRI EH Equity Market Neutral Index	-0.52
HFRI ED Distressed/Restructuring Index	-0.52
HFRI Relative Value Volatility Index	-0.53
HFRI World Index	-0.54
HFRI Relative Value Total Index	-0.54
HFRI Relative Value Multi-Strategy Index	-0.54
HFRI Asset Weighted Composite Index	-0.56
HFRI ED Activist Index	-0.58
HFRI Event-Driven Total Index	-0.59
HFRI Event-Driven Special Situation Index	-0.60
HFRI Fund Weighted Composite Index	-0.67
HFRI EH Multi-Strategy Index	-0.67
HFRI Equity Hedge Total Index	-0.67
S&P 500® Index	**-0.69**
HFRI EH Quantitative Directional Index	-0.71

Source: Bloomberg Finance L.P. For Index descriptors, see “Index Descriptions” at end of document. ** Excludes FoF, Sector, Regional, FX Hedged, and Thematic indices. Correlations between monthly % change in index, monthly change in VIX.

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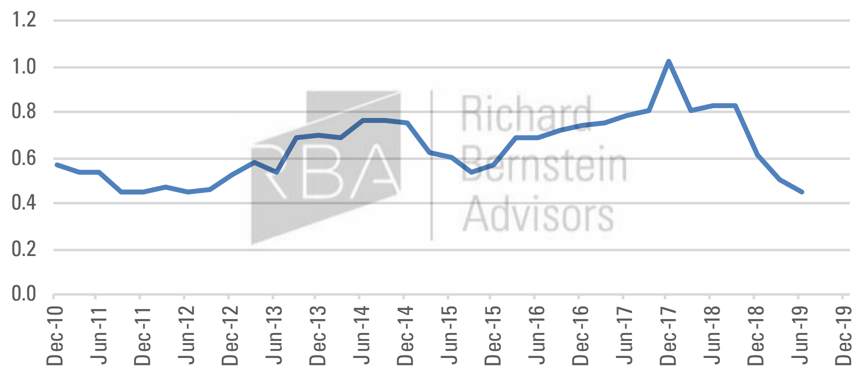
RBA's current positioning

Except for an occasional currency hedge, RBA does not take short positions in its currently available multi-asset portfolios. Positioning for a potential period of increased volatility, therefore, requires old-fashioned asset allocation. (See *"Asset Allocation 2.0™"* **http://www.rbadvisors.com/images/pdfs/Asset_Allocation_2.0.pdf**). We have been gradually increasing our fixed-income and gold allocations as the table above might suggest one should and have been lowering the beta to our equity benchmark as well. Investors often forget that equity market sensitivity is a function of both the equity weight and the beta to the equity benchmark when assets other than equities are included (i.e., equity-sensitive asset classes such as credit).

Charts 4 and 5 show our flagship portfolio's equity beta and volatility beta. The portfolio's sensitivity to the equity market across asset classes is currently the lowest in the past 9 years. The sensitivity to volatility is the highest its been because we have positioned the portfolio to benefit from increased volatility.

CHART 4:

RBA Global Risk-Balanced Moderate ETF Strategy: Beta to MSCI ACWI®
(Dec. 2010 – Jun. 2019)



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

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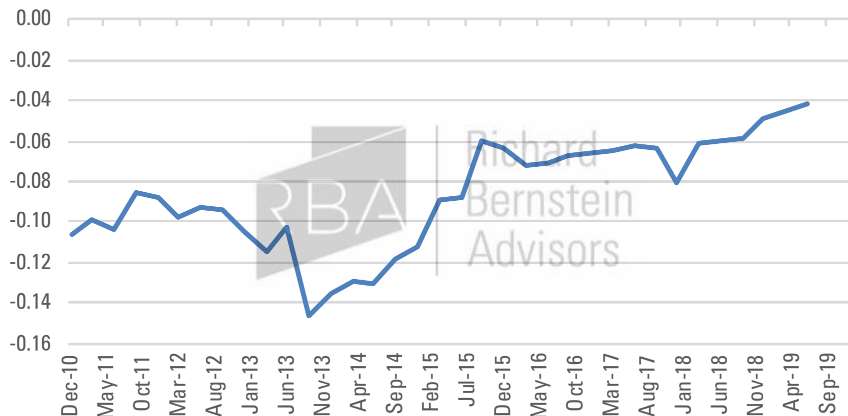
CHART 5:

RBA Global Risk-Balanced Moderate ETF Strategy: Beta to CBOE Volatility Index (Dec. 2010 – Jun. 2019)



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

Invest like a chameleon

The investing environment might be changing, and we see an extended period of higher volatility than that which investors have grown accustomed. Accordingly, investment positioning should change as well. A period of rising volatility could hurt the returns of today's most popular asset classes (private equity and venture capital), might benefit certain hedge fund categories, and could favor traditional asset classes like gold and high-quality bonds.

Invest like a chameleon.
Change your colors as the environment changes.

Don't miss out on future RBA Insights, subscribe today: ***jump.rbadvisors.com/subscribe****.*

To learn more about RBA's disciplined approach to macro investing, please contact your local RBA representative. ***rbadvisors.com/images/pdfs/Portfolio_Specialist_Map.pdf***

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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.**

Absolute Return Hedge Funds: The Hedge Fund Research HFRX Absolute Return Hedge Fund Index is designed to be representative of the overall composition of the hedge fund universe. It is comprised of all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage, and relative value arbitrage. As a component of the optimization process, the index selects constituents which characteristically exhibit lower volatilities and lower correlations to standard directional benchmarks of equity market and hedge fund industry performance. Hedge Fund Research, Inc. (HFR) utilizes a UCITSIII compliant methodology to construct the HFRX Hedge Fund Indices. The methodology is based on defined and predetermined rules and objective criteria to select and rebalance components to maximize representation of the Hedge Fund Universe. HFRX Indices utilize state-of-the-art quantitative techniques and analysis; multi-level screening, cluster analysis, Monte-Carlo simulations and optimization techniques ensure that each Index is a pure representation of its corresponding investment focus.

Short-Term Treasuries: The Bloomberg Barclays 1-3 Yr Gov Total Return Index Value Unhedged USD is a broad-based benchmark that measures the non-securitized 1-3 yr component of the US Aggregate Index. It includes investment grade, US dollar-denominated, fixed-rate Treasuries, and government-related securities.

Gold: The London PM Gold Price. The LBMA Gold Price will replace the Gold Fixing Price and ICE Benchmark Administration Limited ("IBA") will become the administrator from March 20, 2015. Under the administration of IBA, the methodology underpinning the LBMA Gold Price is as follows:* Independently administrated and tradable auction process* Electronic and physically settled auction* Aggregated and anonymous bids and offers published on-screen and in real-time* Auction conducted in US DollarsThe IBA auction process is an electronic auction, with the imbalance calculated, and the price adjusted in rounds (45 seconds in duration). The auction will run twice daily at 10:30am and 3:00pm London time. The round duration will be continuously monitored for suitability. If it is necessary to adjust the duration, this will be advised to all direct participants with not less than one week's notice. For more information please see https://www.theice.com/iba/lbma-gold-price.

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CBOE Volatility Index (VIX): The Chicago Board Options Exchange (CBOE) Volatility Index reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of strikes. 1st & 2nd month expirations are used until 8 days from expiration, then the 2nd and 3rd are used.

MSCI ACWI® Index: The MSCI ACWI® Index is a widely recognized, free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets.

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.

The Bloomberg Barclays US Aggregate: The Bloomberg Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency).

HFRI® Indices: HFRI® Indices are designed to capture the breadth of hedge fund industry performance trends across all strategies and regions. All single-manager HFRI Index constituents are included in the HFRI Fund Weighted Composite Index® while all funds of hedge funds are included in the HFRI Fund of Funds Composite Index®. Most HFRI Indices are equally-weighted (annual rebalance) while the constituent funds of the HFRI Asset Weighted indices are weighted according to the AUM reported by each fund for the prior month.

To be eligible for inclusion in the HFRI Indices a hedge fund must: 1) Report monthly returns, 2) Report Net of All Fees Returns, 3) Report assets in USD, 4) Have at least $50 Million under management or have been actively trading for at least twelve (12) months, 5) Open to new investment, and 6) Available in a fund structure.

For additional detail on HFRI® Indices, see http://www.hedgefundresearch.com/family-indices/hfri

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About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager. RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $9.1 billion collectively under management and advisement as of August 31st, 2019. 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. 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**.

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