Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

September 2023

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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Investors' shift from fear to greed presents historic opportunities

We started RBA in 2009 primarily because we thought the US stock market was entering one of the biggest bull markets of our careers. Simply put, if one was going to start a firm, it seemed like a good time to do so.

However, most investors did not agree with our bullishness. The Global Financial Crisis and the ensuing bear market damaged investor psychology and investors were extremely wary of US equities. The widespread consensus was one should invest in emerging markets for growth and investing in the US was imprudent.

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The risk-averse consensus rebuked us for our bullish views of US equities.

- Many investors summarily dismissed even meeting with us because they felt we were too bullish on the US.
- A major fund research firm refused to classify our global equity fund as a global fund because they believed our active exposure to the US equity market was too large.
- Marketing pitches necessarily incorporated a description of "fire extinguishers" or strategies we could employ to protect the portfolio in case our bullishness proved foolhardy.
- Investors questioned why our multi-asset portfolios weren't heavily weighted in fixed-income and dividend-oriented stocks.
- There were even *ad hominem* attacks regarding our motivation, our backgrounds, and other irrelevant issues.

Fourteen years later investors' extreme risk aversion has become extreme risk taking. Today we are viewed by many as not being bullish enough and the *ad hominem* attacks have returned.

Admittedly, the S&P 500® Index is up about 17% year-to-date, but that has largely been driven by 7 megacap stocks (termed the "Magnificent 7" by many observers). The Magnificent 7 are up over 90% and have contributed over 70% of the S&P 500®'s year-to-date return. For comparison, the equal-weighted S&P 500® Index is up only 5% and the equal-weighted ACWI® Index is up only 3.3%.

Risk aversion seems a thing of the past. Investors have largely started to chase the equity market's narrow leadership and are often shunning diversified portfolios to gain greater exposure to the Magnificent 7.

The investment opportunity in those 7 stocks seems very limited. Their valuations are lofty, and their profits growth is generally not superior. But we do think the menu of investment opportunities outside those 7 stocks both within the US and in the global markets could be historically broad and historically attractive.

Extremes in sentiment typically present significant investment opportunities. Fourteen years ago, investors' extreme fear implied a bull market was forming. Today, investors' extreme greed and narrow focus suggests a broad portfolio of US and non-US stocks might substantially outperform.

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Portfolio total equity exposure

There are two components to a portfolio's overall equity exposure: equity allocation and equity beta. The equity allocation is the proportion of the portfolio invested in equities. The beta represents the market-related risk of an equity portfolio. A higher beta implies greater upside and downside volatility. (Of course, volatility isn't always symmetric, but beta is nonetheless a reasonable risk measure.)

Allocation times beta represents a portfolio's overall equity exposure. A large equity allocation could be invested in low beta stocks, whereas a small equity allocation could be in high beta stocks. Neither equity allocation nor equity beta alone identifies the total equity risk of a portfolio.

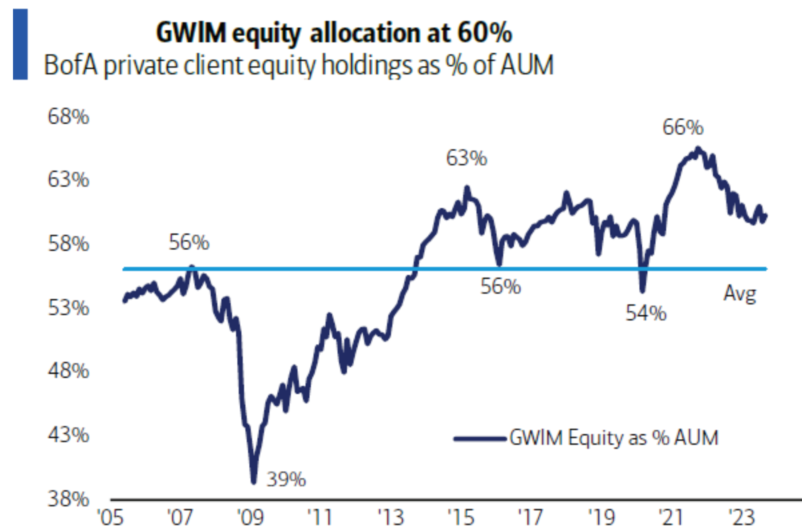
Other investments, such as high yield bonds, have equity sensitivity as well. In our internal analyses, we account for such sensitivity, but a discussion of the equity sensitivity of non-equity assets is beyond the scope of this report.

Investors' total equity exposure has increased significantly over the past 10-15 years. An increase in both equity allocation and in equity beta reflects a dramatic change in risk preference. Portfolios used to have low equity allocations invested in low beta stocks, but investors now have high equity allocations that incorporate high beta stocks.

Equity allocations have increased

Investors increase in equity allocation reflects their shift from risk aversion to risk taking. Chart 1 (courtesy of BofA Global Strategy) shows individual investors' equity allocation was only 39% at the beginning of the bull market in 2009. Today, after 14 years of a bull market, their equity allocation is 60%.

CHART 1
BofA Private Client Equity Allocation
(Dec. 2005 – Aug. 2023)



Source: BofA Global investment Strategy

BofA GLOBAL RESEARCH

Source: BofA Global Research

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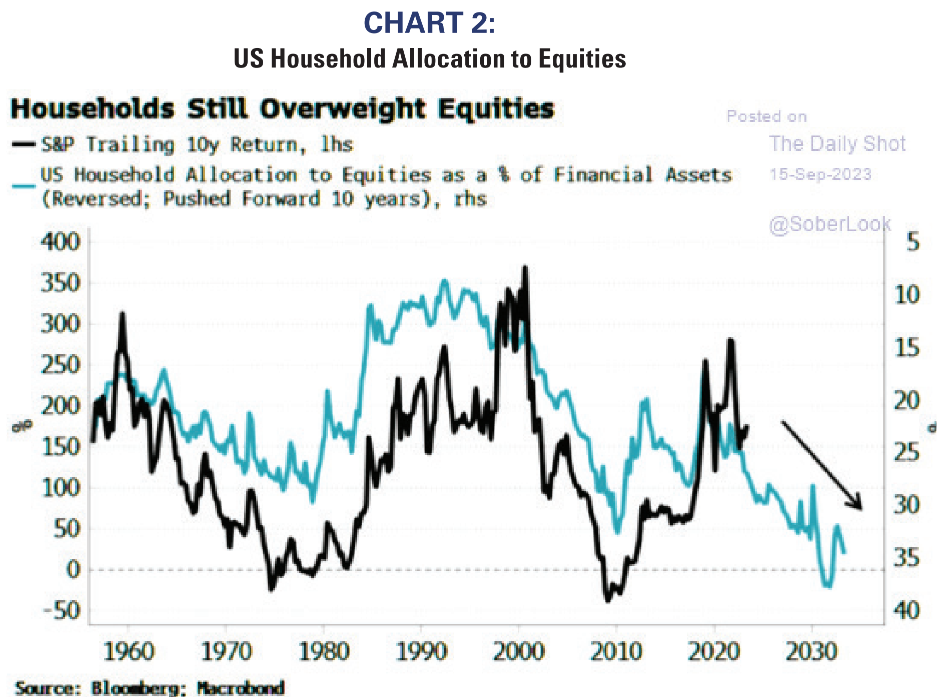
Chart 2 (courtesy of The Daily Shot and MacroBond) shows a broader measure of the asset allocation of the entire household sector's financial assets. This version includes retirement accounts, employee stock purchase plans, and other accounts not necessarily captured in Chart 1.

The analysis compares household sector equity allocations to future long-term equity returns. The chart shows that household equity allocations have historically been a contrary indicator, i.e., subsequent long-term equity returns tend to be higher when household equity allocations are lower and vice versa.

The last time households were so bullish on equities, the subsequent decade's equity returns were poor and the period was called the "lost decade in equities." The author's inference is that today's high equity allocations indicate the long-term outlook for US equities might mimic those of the Lost Decade.

CHART 2:
US Household Allocation to Equities



Source: Bloomberg, Macrobond

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Equity asset class returns are currently very dependent on the performance of the 7 stocks. As mentioned, they have contributed roughly 70% of year-to-date S&P 500 returns. Equities as an asset class might do poorly but as was the case during the lost decade, a rotation away from the old leadership (today just 7 stocks!) could provide tremendous opportunity.

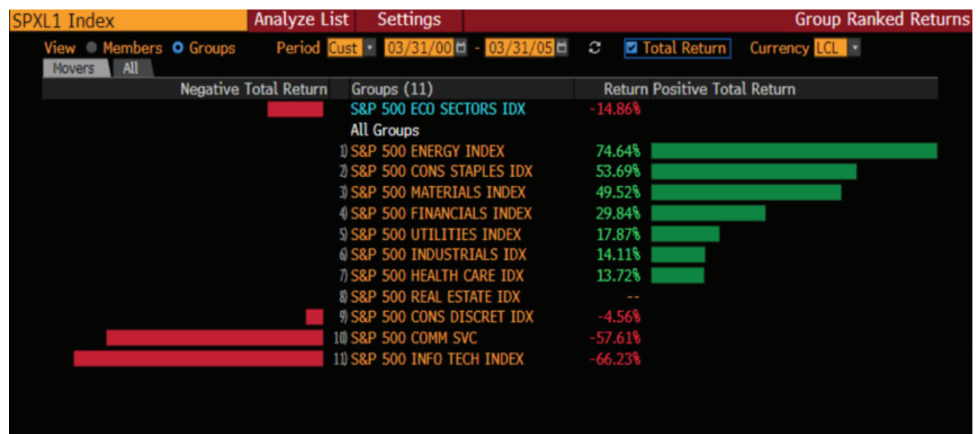
Chart 3 shows S&P 500® sector performance during the five years after the peak of the Technology Bubble. The S&P 500® and the three leading sectors during the bubble had significant negative returns once the bubble deflated, yet most sectors had large positive returns. In addition, non-US stocks significantly outperformed US stocks.

A huge gap between the performance of the equity asset class and the underlying sectors occurred during the lost decade. Today's Magnificent 7, and accordingly equities as an asset class, might perform poorly, but the range of attractive investment opportunities both in the US and in the global markets could be extremely broad.

CHART 3:

S&P 500® Sector Performance

(Mar. 2000 – Mar. 2005)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P. For index descriptions see Index Descriptions at end of document.

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Equity beta remains aggressive

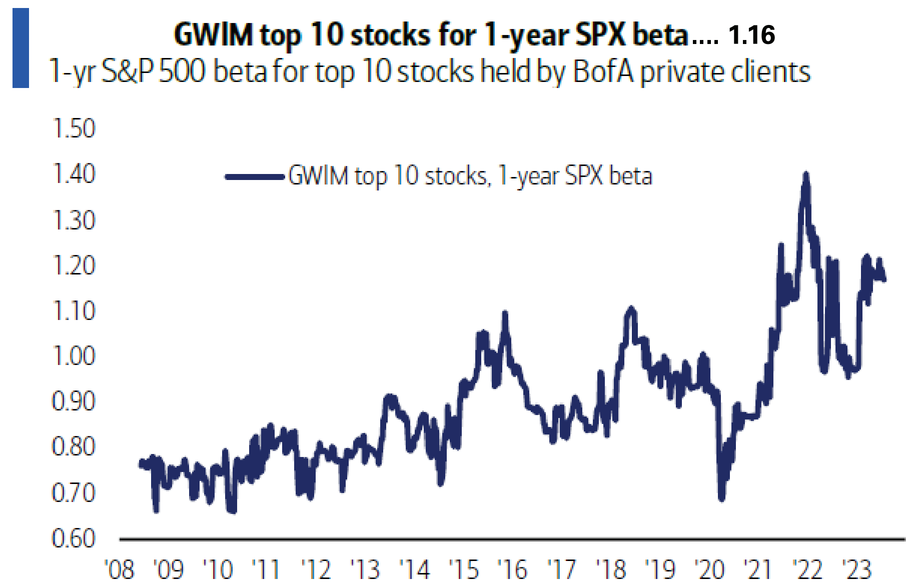
Investors have clearly shifted their asset allocations toward equities, but that wouldn't necessarily signal undue risk taking if their equity beta was reduced through time. In other words, overall equity exposure might not have changed if they lowered beta while increasing allocation.

That is not the case. Rather, investors have increased equity beta as they've increased equity allocation, thus significantly increasing the effective equity exposure within their portfolios.

Chart 4 (courtesy of BofA Global Strategy) highlights that the equity beta of the top 10 stock holdings by BofA private clients has significantly increased. Investors' equity beta was roughly 0.75 at the beginning of the bull market, but rose to a very aggressive 1.40 in 2022. Today, it is still 1.16

So overall equity exposure rose from 29% (0.75 x 39%) in 2009 to 70% today (1.16 x 60%). This simple measure does not reflect true total portfolio equity risk, but we consider it a realistic proxy. Risk aversion has clearly turned into risk taking. Fear has turned to greed.

CHART 4:
BofA Private Client: Beta for Top 10 stock holdings
(Dec. 2008 - Aug. 2023)



Source: BofA Global Research

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RBA's role in diversifying portfolios

Diversification is primarily a risk-reduction tool and not a return-enhancement tool. It's unfortunate that diversification is often marketed as both enhancing returns AND reducing risk because that combination rarely happens.

A well-diversified portfolio will have asset classes that have low correlation and prepare the portfolio for a broad range of unknown outcomes. Most investors have a view of the global economy and microeconomic opportunities, but what if those assessments prove incorrect? Diversification is the primary tool to protect against being wrong.

The unfortunate reality is portfolios tend to be grossly under-diversified simply because people don't want unattractive investments. Investors typically have a specific view and holding any investment antithetical to that view implies reducing returns. Under-diversification works well so long as the view proves correct, but portfolios tend to disappoint and have greater volatility when the incorporated view proves incorrect.

Our portfolios have typically acted as an out-of-consensus diversifier. In 2009 when investors were very risk averse, RBA's added equity risk to investors' portfolios. Today, when investors are taking significant risks, RBA is investing in opportunities that are generally being ignored by investors' narrow focus on the Magnificent 7.

Despite that some investors describe us as bearish because we don't find the Magnificent 7 attractive, we are not so pessimistic as to believe there are only 7 growth opportunities in the entire global equity market.

We are optimists and think opportunity is abundant. Just not in everyone's 7 favorite stocks.

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®: 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.

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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 $16.2 billion collectively under management and advisement as of June 30, 2023. 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**.

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