CONSUELO MACK | WEALTHTRACK

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Why has this top ranked strategist and fund manager completely changed his portfolio positions?
Richard Bernstein makes the case for faster economic growth and reflation.

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CONSUELO MACK: This week on WEALTHTRACK investing in a new era. Star investment strategist turned fund manager Richard Bernstein explains why the financial climate of the last 8 years has changed dramatically and how to invest in it. Next, on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. The investment climate is changing. The speed of the economy is picking up, interest rates have risen, and around the world inflation is edging higher.

The Federal Reserve has caught on. In a unanimous decision, its policy making arm, the federal open market committee, hiked its benchmark short term interest rate, the Federal funds rate for the first time this year and only the second time since its record breaking string of interest rate cuts since the great recession. Citing "confidence" in the "progress the economy has made" and that it is expected to make,

The Fed indicated it might raise interest rates another three quarters of a percentage point in three stages in 2017, if the data warrants it. This is the opening of a fissure in what has become the consensus assumption among financial professionals: that economic growth, inflation and interest rates would be lower for longer.

There were however a few early dissenters from this lower for longer creed. One of them joins us this week. He is Richard Bernstein, a WEALTHTRACK regular since the beginning. He is founder, chief executive and chief investment officer of Richard Bernstein Advisors, an independent investment advisory firm which focuses on longer-term strategies combining top-down macro-economic analysis and quantitative portfolio construction.

Bernstein manages multiple portfolios including some mutual funds. His flagship, Eaton Vance Richard Bernstein Equity Strategy Fund is rated 4-star by Morningstar and has outperformed its world stock category and market benchmark, with less than market risk since its 2010 inception. Bernstein who was an early bull coming out of the financial crisis remains positive on the stock market, but has re-positioned his portfolio to reflect what he sees as a seismic shift in the big picture. He believes the global stagnation and deflation we have been living with for the last eight years ended in February of 2016. I asked him why.

RICHARD BERNSTEIN: It's a little uncertain why it ended. I think what's beginning to happen is that we're finally working off the excesses of the global credit bubble, and it took seven, eight years to work them off, but I think what began to happen was that people thought that those excesses and those deflationary pressures were going to be permanent, and we were never going to work them off. It appears this year, 2016 that we finally have begun to work them off. Now it's certainly not over, but things are slowly changing and I would argue changing for the positive.

CONSUELO MACK: What's changing? Where are you seeing the evidence?

RICHARD BERNSTEIN: It's a little bit ironic that if you go back five, six years ago, nobody was talking about lower for longer. I'm sure you remember the story was that central banks were printing money, and it was a fiat currency, and we were going to have massive inflation. Of course what people forgot was we were in the deflation of a credit bubble, and credit is the lifeblood of inflation. When you don't have credit, you don't have inflation, and so what we ended up with was a lot of excess capacity and deflationary forces around the world. Well, it appears that people finally caught on to that this summer when they started using the words lower for longer. So then they attached some permanence, and the irony to that was that right as they were attaching permanence to this lower for longer theme, inflation expectations began to go up in the United States. Inflation expectations troughed in the United States back in February, not that they're ripping. Whenever you say inflation, people automatically think of the 1970s.

CONSUELO MACK: Yes, or Volcker later.

RICHARD BERNSTEIN: Exactly, but they're gradually beginning to increase now, and the interesting thing is not only are they increasing in the United States. They're increasing in the U.K. They're increasing in Germany, and even in Japan they've stopped going down. So there's some kind of change going on in the world right here right when people finally believed that it was going to be lower for longer in interest rates.

CONSUELO MACK: So how long is it going to take for this ship to turn? So when inflation expectations start to change, are we actually seeing real signs, evidence of prices going higher?

RICHARD BERNSTEIN: Well, you have seen a little bit. The headline consumer price index certainly is higher than it was a year ago or two years ago but nobody cares because it's about one and a half or two percent.

CONSUELO MACK: Still under the Fed's target of two percent for instance.

RICHARD BERNSTEIN: Correct, but markets move on change. Markets don't move on the absolute values, one and a half, two, two and a half. Markets care if things are getting better or worse, stronger or weaker, and what's happening is inflation is rising through time, and that's why you're starting to see some of the reactions in the stock market, reactions in the bond market that you're seeing.

CONSUELO MACK: So how are you changing your positioning?

RICHARD BERNSTEIN: So going into the first quarter of this year – this year meaning 2016 – we were very defensively positioned. We thought profitability was slowing all around the world, and the textbook kind of says when profitability is slowing, you want to focus on quality, on larger caps, on defensive sectors, things that kind of survive in a Darwinistic environment if you will. So we had all those characteristics, but starting in the first quarter of 2016 we began to notice that profitability was beginning to recover. Now most people say, well, profits aren't booming. Well, of course they're not. You have to have a recovery before you get an expansion, an expansion before you get the boom. What we began to see was a troughing in the profit cycle, a recovering of corporate profits, and so what does the textbook say you do when that happens? You shift and you buy cyclicals. You buy lower quality.
So in the first Quarter we started overweighting energy and materials and financials and technology stocks and small caps and lower quality stocks, all those type of things on the equity side. So it was a huge reversal of positioning from where we were being very defensive to becoming very cyclical.

CONSUELO MACK: When you were here a year earlier and most people were bearish, you came on *WealthTrack* and said that the secular bull market was going to continue in the U.S. What's your view of it now?

RICHARD BERNSTEIN: I think the bull market is going to continue. I think that we are probably in let's say roughly the seventh inning still of that bull phase. Post-election, certainly the stock market has gone up. Certainly people are more enthusiastic about equities. You can see that in the flow data than they were prior to the election. That's fine. However, I don't think you're going to find that too many individual investors, too many pensions, endowments and foundations, too many hedge funds, I mean you can't find an investor class that is embracing cyclicality. That's the key thing. It's our guess that if we come back and you're kind enough to invite me back for year-end 2017, we're going to find that cyclical stocks will be the consensus. People will be much more bullish about the economy. They're going to be much more bullish on corporate profits, and it's that wave of enthusiasm that we're hoping to play in 2017.

CONSUELO MACK: So how long do these waves of enthusiasm last? Because when I think of cyclical stocks, I think that they can kind of turn on a dime, and so they can do really well in the up side, and then they can turn very quickly to the down side. How much more risky is being in cyclical stocks than being in defensive stocks?

RICHARD BERNSTEIN: Anything becomes very risky if carried out to an extreme. We've seen that with some of the income-producing strategies that have been out there where people say, "Well, investing for income is safe." Well, it's safe until everybody wants to do it.

CONSUELO MACK: Until it's expensive.

RICHARD BERNSTEIN: Until it's expensive and it's not safe anymore, but how do you hold cyclicals? That's a difficult question to answer, and the reason why is because the time horizon depends on how big the economic boom is. The stronger the boom, the shorter the period that you're going to hold cyclicals. What's very interesting, and you think have to think like an investor, not a politician or an economist, and what an investor doesn't like is a boom because a boom means that there's over enthusiasm. A boom means that companies are doing foolish things and expanding capacity and taking on debt. Think about the housing bubbles and all the things that went on. That's very normal. What you'd rather see is gradual growth that puts in too much uncertainty so that you don't get these excesses. So if the economy turns out to be very, very strong over the next year, year and a half, we're likely to see those excesses build. We're likely to see inflation grow very, very rapidly, in which case the Federal Reserve would have to respond to that and would probably end up choking off the recovery. They'd have to because inflation would be going so strongly. However, if we find that the acceleration is very muted, this could go on for two, three, four years.

CONSUELO MACK: What do you think it's going to be? A lot of the noise out there is that the reason that we're having this stock market surge is because of the Trump presidency and that he's coming in with a very stimulative fiscal program with tax cuts and with infrastructure spending and rolling back regulation. I mean how much of this is the Trump effect? It sounds like you think that it was starting before Trump was really even on the scene.

RICHARD BERNSTEIN: In fairness it's a little bit of both. Certainly any politician is going to take credit for anything good that happens but, as I said, inflation expectations and corporate profitability really troughed in the first quarter, and what we were seeing was cyclical leadership in the stock market through the end of the first quarter, all the second quarter, through the third quarter and pretty much this quarter to date. What's happened is the suggestion that the president-elect is going to initiate what would be the biggest fiscal stimulus package probably since the depression...

CONSUELO MACK: Which is phenomenal. Huge.

RICHARD BERNSTEIN: Which is huge if I can use that word. It's huge but the difference is this time, you're having a fiscal stimulus package suggested when we're not in a recession.

CONSUELO MACK: Explain why that is significant.

RICHARD BERNSTEIN: It's very, very important. You've had many times where you've had fiscal spending and stimulus packages put in, but normally there's tremendous excesses in the economy. Unemployment rate might be seven, eight, nine percent, six percent, something like that. Now we're in an economy that although it's been growing slowly, it's still not in recession. The unemployment rate is 4.9 percent. Now I'm sure some of your viewers are going to say, "Well, it's not really 4.9 percent." Okay, who cares? Maybe it's five, 5.1, whatever.

CONSUELO MACK: Still it's low.

RICHARD BERNSTEIN: It's low and one could argue that the quality of jobs is bad. I get that too, but if you start pumping up the economy, yes, people will leave poor-quality jobs and go to good-quality jobs, but then who fills the poor-quality jobs? Those jobs are going to have to offer higher wages to try and convince people to stay in the lower-quality jobs. This is a very different environment from when you normally get a big fiscal stimulus package. That's the reason why the stock market is now accelerating upwards because we're basically putting a lot of gasoline on a small fire. That's the reason inflation expectations are going up because of what I just described with wages. So you can see what's happening here. It will be very interesting to see over the next six to eight months what package actually comes forward, and how the Federal Reserve responds to the rise in inflation expectations.

CONSUELO MACK: But is it possible that this accelerant could mean that the recovery could end sooner and that the bull market could end sooner?

RICHARD BERNSTEIN: It could. The way you're hearing Washington economists talk about it is they talk a lot about productivity and how they think that this will improve productivity, because an improvement in productivity will stymie inflation. That's kind of underneath what people are talking about. That's the key question. Can you get a tremendous amount of stimulus in an economy that doesn't have a lot of flack, excess capacity around it? Can you get that improvement in growth without acceleration in inflation? That's the ten cent question. That's the question that's out there. I don't have an answer for people right now because you don't know how big the package is going to be.

CONSUELO MACK: So you are a global investor in your flagship fund. You've got 280 stocks. It's invested all over the globe. How does the U.S. look as a market? Where are you finding the opportunities versus the rest of the world?

RICHARD BERNSTEIN: The U.S., we are substantially overweight the United States.

CONSUELO MACK: Still.

RICHARD BERNSTEIN: Still. We have been and we continue to be.

CONSUELO MACK: Why?

RICHARD BERNSTEIN: The profitability in the United States appears to be the strongest right now. It is the healthiest. Now that may change as we go through 2017, but for the time being U.S. corporate profits appear to be the healthiest. As I said, we're very cyclically positioned. We're overweight energy and materials and financials and technology and small caps, trying to get sensitivity to that cyclical upturn in earnings. In the developed markets outside the United States, really the only kind of exciting thing that we can find is U.K.

multinationals. U.K. multinationals are benefiting from the weakness of the pound. It's just a simple translation story. As the pound weakens, you get more pounds back from every dollar, every yen, everything else you sell. So that's helping U.K. multinational profits. Japan we can't get excited about. I know a lot of people are very excited about Japan.

CONSUELO MACK: They are.

RICHARD BERNSTEIN: They say it's very cheap. What people are kind of missing here is that this is a pure currency story right now. Corporate profits are really not very good in Japan, and if you translate Japanese stocks performance back into U.S. dollars, it's done nothing this year.

CONSUELO MACK: Oh, interesting.

RICHARD BERNSTEIN: It's literally...

CONSUELO MACK: Local currency story.

RICHARD BERNSTEIN: It's a local currency story. So if you're hedging the currency, that's fine, but if you're not it's not quite as exciting. Emerging markets.

CONSUELO MACK: Emerging markets.

RICHARD BERNSTEIN: Emerging markets.

CONSUELO MACK: They have sold off big time.

RICHARD BERNSTEIN: We are very overweight in emerging markets.

CONSUELO MACK: Being overweight means what kind of a positioning?

RICHARD BERNSTEIN: In our benchmark I think emerging markets are about eight to ten percent. We're probably somewhere between 12 and 15 percent depending on the portfolio that we run, but why would that be the case? Well, the global economy is getting stronger. There is a lot of evidence that shows that. As I said, when you're an optimistic, if you believe things are getting better, you go down in quality. What are basically the lowest quality stocks in the world? They are the emerging markets. I mean I know every emerging market fan says, "Well, there are lots of high-quality stocks in the emerging markets." It's a little bit of an oxymoron that you're in emerging but you're high quality. That doesn't quite make sense, but there's huge cyclicality in the emerging markets, and that's what we're trying to take advantage of.

CONSUELO MACK: One of the interesting positions that I noticed, was gold. So it's gold stocks, or are you investing in gold or gold stocks?

RICHARD BERNSTEIN: In the funds we have gold miners. We have small capitalization global gold miners.

CONSUELO MACK: So talk about cyclicality. Right?

RICHARD BERNSTEIN: There's tons of it. Tons of it.

CONSUELO MACK: Is that why?

RICHARD BERNSTEIN: That is not an area for the faint of heart. We are there because we think we can manage the risk within the context of our overall portfolio, and our funds do tend to have lower volatility than their benchmark, so I'm not just saying that. That is a real consideration for us. But what it allows us to do because the sensitivity to gold, the sensitivity to inflation is so high among these companies, we can have a smaller position in the portfolio. In other words, if you have more sensitivity, you can have a smaller position, and that allows us to diversify the portfolio a little more and go elsewhere. I think we have, depending on the portfolio, anywhere between about three and a half, three and six percent let's say in either gold or gold miners, but if ...

CONSUELO MACK: I mean that's actually a big position given what the market cap of gold miners is relative to the market.

RICHARD BERNSTEIN: It is. Very much so, but what it allows us to do is to play around with that sensitivity to have a smaller position to allow us to diversify more.

CONSUELO MACK: Let me ask you about a couple of the other holdings. Again, what I have might not be up to date, but I know you've got some of the FANGs. You've got Facebook. You've got Amazon. You've got Google. What's the theory there with those types of stocks?

RICHARD BERNSTEIN: Incredibly boring. I hate to say it, but it's incredibly boring. What happens is that we are a macro firm, and so we like to take very big macro bets, but one of the ways to limit the risk of a portfolio is to negate the effects of the top ten or 20 stocks. So what you'll find is people always look at our holdings and say, "Oh, gee. You have all these stocks there." The answer is because they're the biggest stocks in the index, they're the biggest stocks in our portfolio, and we basically hold them in index weight. What that allows us to do is to go and take risk elsewhere in the portfolio.

CONSUELO MACK: Oh, interesting.

RICHARD BERNSTEIN: So we can negate the risk of the largest parts of the index, and then we can use our risk budget to go do sexy things.

CONSUELO MACK: The other thing you said, your management style allows you to actually take on less risk than the market? Explain that especially in a very cyclical type of positioning.

RICHARD BERNSTEIN: I actually think that diversification is one of the least understood concepts. We all talk about it, but I don't think people really understand it. What diversification really requires you to do is hold things in your portfolio that you don't like.

CONSUELO MACK: Absolutely.

RICHARD BERNSTEIN: Right? You're supposed to have a balance going on, but what people usually do is they just hold things they like, and then they can't figure out why their portfolio goes up and down all the time. We're very conscious of that, and especially in our multi-asset portfolios. If you think of diversification as a see-saw, we try very hard to make sure that we have assets on both sides of the see-saw. Obviously we want to make a bet on one side of the see-saw or the other, but we're going to have something as a ballast on the other side. That allows us to actively lower the volatility of the portfolio, and I'm not going to say all of our portfolios but certainly most of our portfolios have through time had lower volatility than their benchmarks, even lower volatility than some of their peers.

CONSUELO MACK: What don't you like that would be in one of your portfolios?

RICHARD BERNSTEIN: What don't we like? We still have a little bit of Treasuries. The Treasuries are short duration, but we still have them and not a huge fan of Treasuries given what I said about the economy improving and inflation may be revving up, but certainly we have some still in there.

CONSUELO MACK: They're a non-correlated asset. That's for sure.

RICHARD BERNSTEIN: Exactly. You've got to balance out the portfolio.

CONSUELO MACK: Speaking of Treasuries, because one of the things that you've written about as well is that it's kind of when everybody piles into an asset it usually represents the peak. You were saying looking at the bond market as an asset class is that it's the equivalent to you as if it's March 2000 in the technology sector.

RICHARD BERNSTEIN: Absolutely.

CONSUELO MACK: So it's that toppy? It's that dangerous? It's that overpriced?

RICHARD BERNSTEIN: I really think it is. I think what you saw this summer with this whole lower for longer enthusiasm was you saw historically large flows into bond mutual funds and bond ETFs. I mean just off the charts. You've never seen anything like it before. As I said before, that didn't happen five years ago. That's happened today or recently, and it turns out that when we had those big flows, the overall duration or interest rate sensitivity of the bond market was the highest ever in history. The total bond market was the highest ever in history. What that says is that the flows into bonds arrived at the riskiest point. So if you think about the technology bubble in March 2000, when were the biggest flows into tech stocks? They were March of 2000, the riskiest they possibly could have been.

CONSUELO MACK: At the end.

RICHARD BERNSTEIN: Exactly. What you found was in April of 2000, NASDAQ I think was down about 15, 16 percent on the month. Well, if you look at November in the fixed income market, long-term zeros, the riskiest of the risky were down about 12 or 13 or 14 percent in a month.

CONSUELO MACK: Treasury strips.

RICHARD BERNSTEIN: Exactly. So it's not that different.

CONSUELO MACK: No. So your advice to investors who were part of that flow into bond funds which up until recently were a good place to be. What's your advice to investors who were...?

RICHARD BERNSTEIN: My advice is several-fold. Number one is don't become income myopic. Everybody says, "Oh, I need income." No. The way we manage money, we always manage for total return. Sometimes we turn up the volume on capital appreciation. Sometimes we turn up the volume for income, but you have to remember that income investing is no safer than investing for capital appreciation. If you do it at the wrong time, they're just as risky. So what you have to do is kind of go back and forth between the two, and always look for that happy medium, but don't go to one extreme or the other. So March of 2000, everybody was hyped about capital appreciation. Nobody wanted those stinking dividends back then. Think about this summer. All anybody wanted was dividends, and so we went 180-degree difference, and I think number one is don't become income myopic. Number two is to realize that a true diversified portfolio is not going to all have the same goal. If all your stocks, all your bonds, everything is income-oriented, there's a lot of risk in that portfolio. So my guess is as we go through 2017 and people see the potential performance of stocks relative to bonds: that will begin to shift. I just think most investors should try and be in front of that.

CONSUELO MACK: So one investment for a long-term diversified portfolio. What would you have us all own some of?

RICHARD BERNSTEIN: It's almost always my favorite. I think, Consuelo, almost every time I've been on your show I probably have almost said the same thing. It's small cap value. Whether you choose an ETF or a fund, I don't really care, and the reason why is that if you believe as we do that corporate profits are troughing, that things are going to get better, the real optimistic play are the junkiest stocks you can find, because junk does very well when things get better. I mean high quality works in a survival of the fittest type mode. It's Darwin. Who's going to survive? But when things are getting better, the companies have a lot of financial leverage. They have a lot of operating leverage. I mean they basically have one foot out the door, but they get pulled back in. They don't do badly, and that's where you can actually make a lot of money through time. I think if you're a very young investor, one of the things I've always said that if you've got an IRA or a 401(k) or something and you're in your 20s, well, you should invest in small cap value through time because if you're the least bit bullish on the long-term prospects for the U.S. economy, the returns to small cap value are going to be very, very good because the probability goes down over the longer term that companies actually go bankrupt.

CONSUELO MACK: It's an asset class that a lot of people don't like right now. (Laughs)

RICHARD BERNSTEIN: Absolutely.

CONSUELO MACK: Rich Bernstein, always a treat to have you on *WealthTrack*. Thank so much.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week we want to pick up on Rich Bernstein's comment that you are not truly diversified until you own something you don't like, which most often means it's very unpopular. So our action point is: **make sure you are diversified and own something you don't like.**

The late great risk expert Peter Bernstein used to recommend, "…Owning something you are uncomfortable with." What's uncomfortable and unpopular right now? At the top of the list are U.S. treasury securities and emerging market stocks and bonds. Both asset classes have had big declines and been recently recommended by several savvy WEALTHTRACK guests.

Next week as we close out 2016, we are addressing a major challenge we will face again in 2017. We are revisiting solutions to the retirement crisis with Harvard's Brigitte Madrian and State Street Global Advisors' Fredrik Axsater.

In the meantime to find out how rich Bernstein proves economic theories through real life experiences go to the extra feature on our website. And for those of you active on social media, please continue to connect with us on Facebook and Twitter.

We also want to take this opportunity to thank you for taking the time to visit with us over the past year, and sharing your many insightful and valuable comments and suggestions. They are truly appreciated.

We wish you all the merriest of Christmases and the happiest of Hanukkahs with your loved ones. Have a great weekend and make the week ahead a profitable and a productive one.