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# 2011: The U.S. Year

January 2012

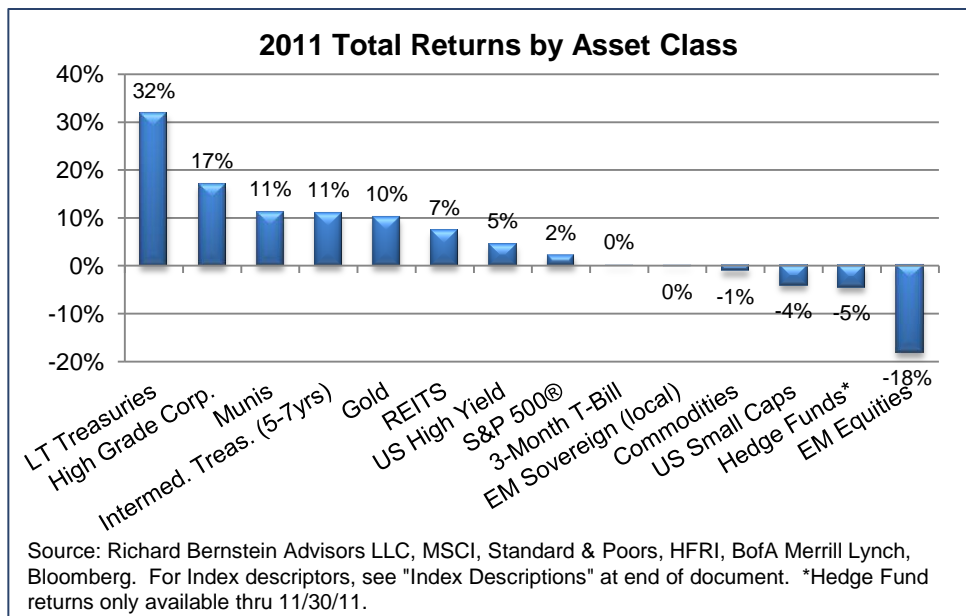
The market generally proves the consensus wrong, and 2011 certainly adhered to that historical precedent because the consensus “must owns” at the beginning of 2011 generally underperformed during the year. What is somewhat startling to us, however, is that conviction has yet to be shaken. The consensus continues to favor commodities, emerging markets, and “any-bond-but-treasuries”.

Our view continues to be that the US markets are in the early stages of a decade of outperformance. US stocks have now outperformed BRIC (Brazil, Russia, India, and China) for more than four years, and the US dollar (as measured by the DXY) troughed in 2008. Long-term US treasury bonds were 2011’s best performing major asset class, and they continued to exhibit our three defining characteristics of an alternative asset class. Unlike when investing in typical alternative investments, however, investing in treasuries doesn’t require the investor to accept high fees and illiquidity.

It’s déjà vu all over again. Investors during the early-2000s were waiting for technology shares to rebound, and ignored the asset classes that were outperforming, such as emerging markets, commodities, gold and REITs. Today, investors are waiting for emerging markets and commodities to rebound, and are generally ignoring the asset classes that are outperforming, such as US stocks and bonds.

We continue to favor US assets as the core of our strategies.

**Chart 1:**



**PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS**

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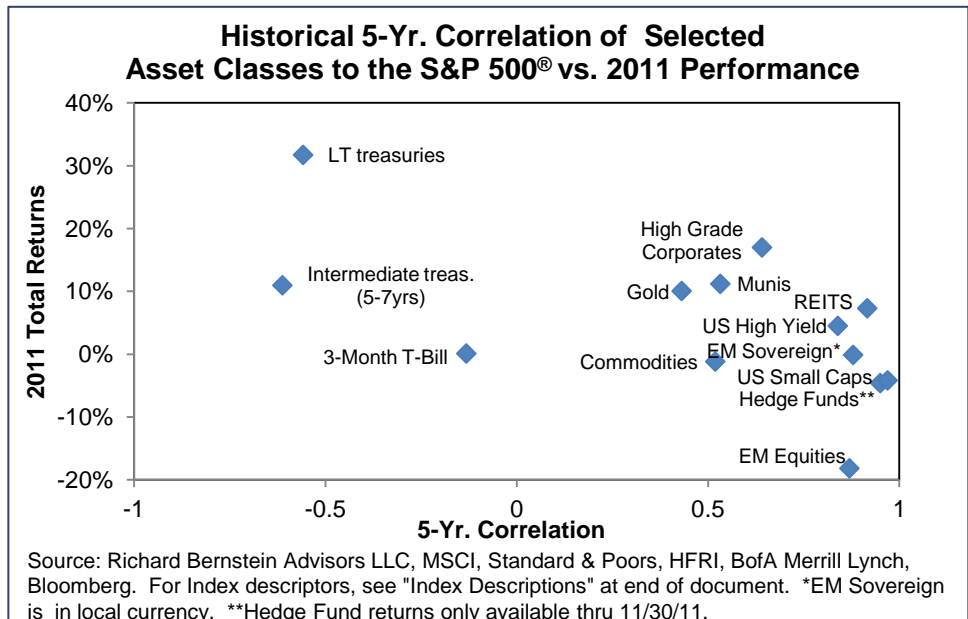
### Long-term treasuries

Long-term US treasuries have been perhaps the most hated asset class for several years, yet their performance has been outstanding. During 2011, long-term US treasuries were the best performing major asset class in the world (see Chart 1). This should not be too surprising because quality investments generally outperformed around the world, and US t-bonds are the world's highest quality asset.

We continue to believe that investors' portfolios are severely under-diversified because they generally refuse to hold treasuries. It is nearly impossible today to form a diversified portfolio without including treasuries because most other asset classes are so highly correlated. Chart 2 shows the 2011 performance of selected asset classes versus those asset classes' correlations to the S&P 500. Treasuries stand out both in terms of 2011 performance and in terms of diversification potential.

Again, our favoring treasuries is not a directional belief that long-term interest rates must fall. Rather, we favor holding treasuries for diversification purposes. We remain very surprised that investors have not gravitated to treasuries despite their outperformance AND their currently unique diversification properties.

Chart 2:





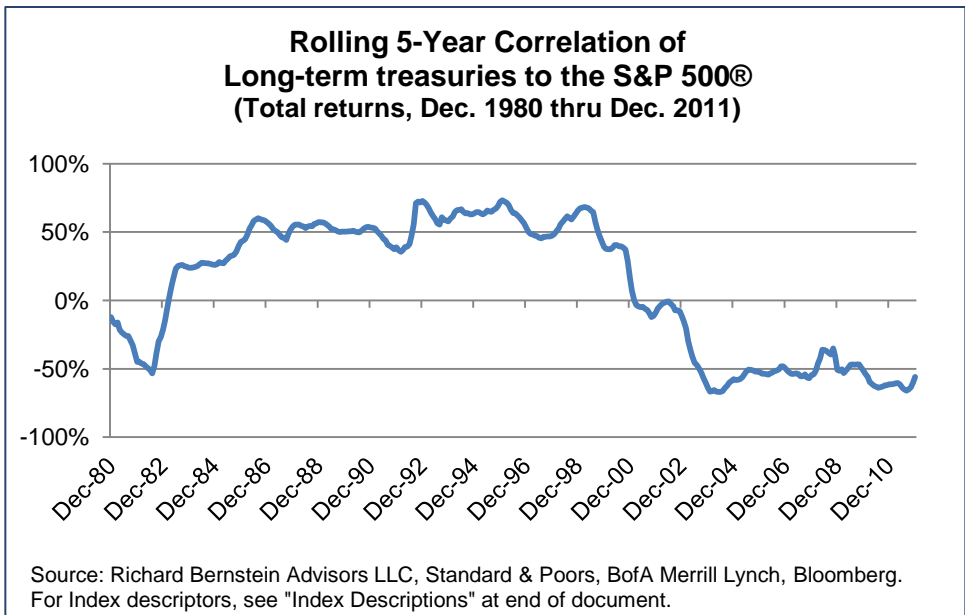
### Treasuries may be the new “alternative” investment

In a Financial Times article in 2009 we first outlined our view that treasuries are the new “alternative” investment. (You can read the article here: <http://www.ft.com/intl/cms/s/0/a8ad8980-d481-11de-a935-00144feabdc0.html#axzz1iWdiAAAnN> ) Alternative investments tend to have several characteristics: 1) they provide superior returns; 2) they are uncorrelated or negatively correlated to other asset classes and, in particular, to equities; and 3) they are generally considered overly risky by investors because they are the “alternative” to the generally accepted investment strategy. Treasuries appeared to have these three characteristics, whereas traditional alternative investments (hedge funds, private equity, commodities, etc.) no longer did. Traditional alternatives were underperforming, alternatives’ correlations had risen substantially, and risk premiums were low because investors were flooding the asset sub-classes with funds. Our observations in 2009 still seem appropriate today.

The economic and financial conditions that made traditional alternative investments attractive have significantly changed. Typical alternative assets were particularly attractive when treasuries had a positive correlation to equities (and, therefore, provided little or no diversification to an equity portfolio), and when credit was cheap and widely available.

Through much of the 1980s and 1990s, old-fashioned stock/bond/cash asset allocation did not work well because the stock market was in an interest rate-driven/PE-driven phase. The stock market rose when bond prices rose, and the stock market fell when bond prices fell. Because stock and bond returns were positively correlated, investors had to search for investments that had low or negative correlation to stocks in order to diversify their portfolios. Today, stock and bond returns are generally negatively correlated (see Chart 3), and old-fashioned asset allocation has again been working. At the same time, the returns of nearly all alternative asset classes have become highly correlated to equities.

Chart 3:





In addition, most alternative asset classes are credit-based. The extended period of cheap and easy credit helped fuel the performance of alternative investments. Since the deflation of the credit bubble, however, such financing has become considerably harder to obtain. The fees associated with investing in treasuries are much lower than in traditional alternatives, and the treasury bond market is the most liquid market in the world. There are no lock-ups, side pockets, or gates and investors don't need to ask permission to get their capital returned when investing in treasuries.

Thus, the conditions that favored investing in alternative assets no longer seem to exist. Bonds are negatively correlated to equities and alternatives are positively correlated. Credit conditions have tightened significantly making the leverage associated with alternative investments more difficult to obtain and more expensive. Traditional asset allocation now seems much more attractive to us. Treasuries may be the new "alternative" asset.

### **US stocks continued to outperform BRIC**

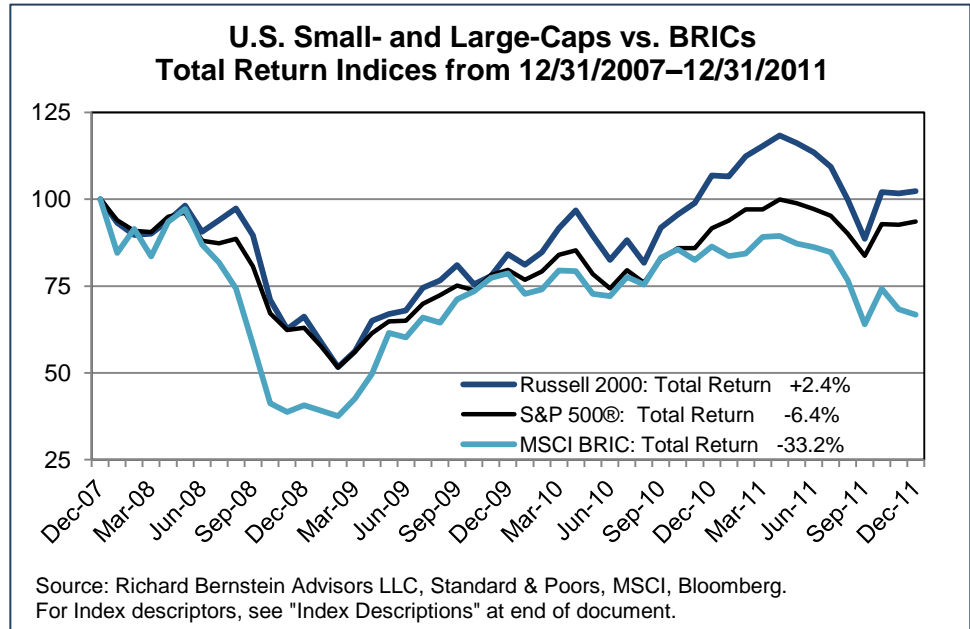
History shows well that periods of extreme equity market volatility are typically followed by a change in leadership. The growth stories going into a period of volatility are rarely the growth stories coming out. Volatility is a signal to investors that the underlying economic fundamentals are changing. Stock market leadership going into a period of volatility is typically geared to a specific economic environment. As the environment changes, old leaders correct, new leaders begin to emerge, and the markets become quite volatile because of the related uncertainty.

This cycle has been no different. 2008's bear market was a signal to investors that the economic environment was moving away from the credit-driven growth of the prior decade. As we pointed out last month in our "2012" report, the result has been that nearly all credit-related investments (i.e., such things as housing, commodities, emerging markets, financial stocks, etc.) have been underperforming since 2008. The biggest beneficiaries of the credit bubble are now largely the biggest underperformers.

Perhaps the most striking example is that US stocks have now outperformed BRIC stocks since late-2007, i.e., for more than four years (see Chart 4). Even European stocks outperformed BRIC stocks during 2011 despite Europe's myriad of financial problems. The world's stock markets seem to be sensing that the global credit bubble's deflation is worse for the emerging markets than it is for developed regions.



Chart 4:



### Munis outperformed gold and EM debt!

Going into 2011, the consensus was that the US municipalities were in dire straits. Investors were worried that many municipal defaults were looming. At the same time the growing consensus was that gold should be a core holding. The markets again surprised investors, and municipal bonds actually outperformed gold during 2011 (11.2% versus 10.1%). Despite the thought that US credit conditions were deteriorating whereas those in the emerging markets were improving, Munis also outperformed local-currency emerging market debt (11.2% versus 7.7%).

### The US's year. More to come?

Whether one looks at the stock markets, the government bond markets, or even the municipal market, 2011 was certainly the US's year. Interestingly, though, investors still seem mesmerized by non-US markets despite that the economic and financial fundamentals associated with the deflation of the global credit bubble increasingly seem to favor investing in the US.

As we discussed in detail in our "2012" report, we continue to believe that the greatest opportunities for investment are mainly in the United States.



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**PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS**



## 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.

**BRICs: MSCI BRIC Index.** The MSCI BRIC Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of the following four emerging-market country indices: Brazil, Russia, India and China.

**EM Equity: MSCI Emerging Markets (EM) Index.** The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of emerging markets.

**U.S. Small Caps: Russell 2000 Index.** The Russell 2000 Index is an unmanaged, capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

**Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity.** The Gold Spot price is quoted as US Dollars per Troy Ounce.

**DXY Index: InterContinentalExchange (ICE) US Dollar Index.** The ICE US Dollar Index, indicating the general international value of the USD, averages the exchange rates between the USD and six major world currencies, using rates supplied by some 500 banks.

**Commodities: S&P GSCI® Index.** The S&P GSCI® seeks to provide investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index. The index is calculated primarily on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

**Hedge Fund Index: HFRI Fund Weighted Composite Index.** The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to the HFR (Hedge Fund Research) database. Constituent funds report monthly net-of-all-fees performance in USD and have a minimum of \$50 million under management or a twelve (12)-month track record of active performance. The Index includes both domestic (US) and offshore funds, and does not include any funds of funds.

**REITS: THE FTSE NAREIT Composite Index.** The FTSE NAREIT Composite Index is a free-float-adjusted, market-capitalization-weighted index that includes all tax qualified REITs listed in the NYSE, AMEX, and NASDAQ National Market.

**3-Mo T-Bills: BofA Merrill Lynch 3-Month US Treasury Bill Index.** The BofA Merrill Lynch 3-Month US Treasury Bill Index is comprised of a single issue purchased at the beginning of the month and held for a full month. The Index is rebalanced monthly and the issue selected is the outstanding Treasury Bill that matures closest to, but not beyond, three months from the rebalancing date.



## INDEX DESCRIPTIONS: cont'd

**Long-term Treasury Index: BofA Merrill Lynch 15+ Year US Treasury Index.** The BofA Merrill Lynch 15+ Year US Treasury Index is an unmanaged index comprised of US Treasury securities, other than inflation-protected securities and STRIPS, with at least \$1 billion in outstanding face value and a remaining term to final maturity of at least 15 years.

**Intermediate Treasuries (5-7 Yrs): The BofA Merrill Lynch 5-7 Year US Treasury Index**  
The BofA Merrill Lynch 5-7 Year US Treasury Index is a subset of The BofA Merrill Lynch US Treasury Index (an unmanaged Index which tracks the performance of US dollar denominated sovereign debt publicly issued by the US government in its domestic market). Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and a minimum amount outstanding of \$1 billion, including all securities with a remaining term to final maturity greater than or equal to 5 years and less than 7 years.

**Municipals: BofA Merrill Lynch US Municipal Securities Index.** The BofA Merrill Lynch US Municipal Securities Index tracks the performance of USD-denominated, investment-grade rated, tax-exempt debt publicly issued by US states and territories (and their political subdivisions) in the US domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule, and an investment-grade rating (based on an average of Moody's, S&P and Fitch). Minimum size requirements vary based on the initial term to final maturity at the time of issuance.

**High Grade Corporates: BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index.** The BofA Merrill Lynch 15+ Year AAA-AA US Corporate Index is a subset of the BofA Merrill Lynch US Corporate Index (an unmanaged index comprised of USD-denominated, investment-grade, fixed-rate corporate debt securities publicly issued in the US domestic market with at least one year remaining term to final maturity and at least \$250 million outstanding) including all securities with a remaining term to final maturity of at least 15 years and rated AAA through AA3, inclusive.

**U.S. High Yield: BofA Merrill Lynch US Cash Pay High Yield Index.** The BofA Merrill Lynch US Cash Pay High Yield Index tracks the performance of USD-denominated, below-investment-grade-rated corporate debt, currently in a coupon-paying period, that is publicly issued in the US domestic market. Qualifying securities must have a below-investment-grade rating (based on an average of Moody's, S&P and Fitch) and an investment-grade-rated country of risk (based on an average of Moody's, S&P and Fitch foreign currency long-term sovereign debt ratings), at least one year remaining term to final maturity, a fixed coupon schedule, and a minimum amount outstanding of \$100 million.

### **EM Sovereign: The BofA Merrill Lynch Local Debt Markets Plus Index**

The BofA Merrill Lynch Local Debt Markets Plus Index is designed to track the performance of sovereign debt publicly issued and denominated in the issuer's own domestic market and currency other than the more established top-tier sovereign markets. In order to be included in the Index, a country (i) must have at least \$10 billion (USD equivalent) outstanding face value of Index qualifying debt (i.e., after imposing constituent level filters on amount outstanding, remaining term to maturity, etc.); and (ii) must have at least one readily available, transparent price source for its securities. In addition, the following countries are specifically excluded from the index: G10 countries, Euro members; all countries with a foreign currency long-term sovereign debt rating of AA3 or higher (based on an average of Moody's, S&P and Fitch). Qualification with respect to country size criteria is determined annually based on information as of September 30th, but does not take effect until December 31st. Conversion of local currency outstanding face value into USD terms is based on the average of the previous 12 month-end exchange rates up to and including the September 30<sup>th</sup> evaluation date. To be excluded on the basis of Euro membership, entry into the European Monetary Union must be announced on or before the country qualification date (September 30) and must take effect on or before January 1 of the upcoming year.