Richard Bernstein

13 for ’13

13 for ’13 **December 10, 2012**

Each December we publish a list of investment themes that we feel are critical to the coming year.

We continue to believe that US equities are in the midst of a major bull market that could ultimately rival 1982’s bull market. It is hard to be bearish when one considers the following:

> **Sentiment** - Continued outflows from US equity funds; Wall Street Strategists’ recommending the most bearish equity asset allocation in nearly 30 years.
>
> **Valuation** – According to our models, the US equity market is presently discounting 5%-6% inflation for the next 12 months, which seems very extreme to us.
>
> **Liquidity** – The Fed has told investors that they will continue to provide liquidity and will be slow or late to tighten.

With that bullish view toward equities, here are our “13 for ’13.”

1) US stocks outperform Emerging Markets, yet again.
Rationale: US corporate profits continue to be the healthiest in the world. EM profits are likely to improve, but the profits rebound might be more muted than many investors currently expect.

2) Inflation remains benign. Gold and commodities underperform.
Rationale: China has tremendous excess capacity, and continues to build more. Although slack in the global economy may be reduced in 2013, the global economy is unlikely to experience either the credit creation or the bottlenecks that are traditionally necessary to fuel a late-cycle inflationary environment that typically fosters commodity or gold outperformance.

3) The Japanese Yen weakens substantially.
Rationale: Japan just recorded their first current account deficit. ¥100/dollar should not be summarily ruled out if that current account deficit expands.

4) A cash-financed M&A wave begins in the US.
Rationale: By hoarding cash, larger US companies have under-invested for future growth. They may start buying growth in 2013 if the economy continues to improve. Small or Mid-cap stocks appear undervalued (based on EV/EBITDA) relative to their larger cap counterparts in seven of ten sectors.

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5) Consensus warms to European stocks in the second half of the year.

Rationale: Relatively easy profit comparisons lie ahead for European companies, and every new cycle begins with easy comparisons. Unfortunately, despite attractive valuations, European corporate fundamentals still appear to be deteriorating.

6) Long-term treasury rates continue to fall.

Rationale: The long-duration “wall of worry” remains very high. Bond portfolios have been consistently short duration relative to benchmark for seven years despite that the 10-year treasury rate has fallen from above 5% to below 2%. Inflows are incredibly strong to short-duration funds. Such overwhelming negative sentiment toward the long-end of the curve argues that long-duration assets are likely to outperform.

7) Non-dollar debt underperforms.

Rationale: Stronger USD might hurt non-dollar returns, and credit spreads might widen as investors realize they have underestimated the risks associated with investing in emerging markets.

8) Hedge funds continue to experience outflows to traditional asset allocation funds.

Rationale: Hedge funds’ combination of high fees, regulatory headlines, and correlated *under*performance make traditional asset allocation funds increasingly tough competition.

9) Volatility begins to increase late in 2013.

Rationale: Perhaps the most important factor influencing the long-term trend in equity market volatility is central bank liquidity. Thus, it has not been surprising to us that the VIX has stayed so low because of the huge amount of liquidity the Fed has provided. Our work is starting to suggest that the VIX might begin to increase toward 2014.

10) The American Industrial Renaissance continues

Rationale: Small and mid-cap US-centric industrial and manufacturing stocks are likely to outperform as the companies continue to gain market share because of the combination of closing wage disparities, lower energy and transportation costs, and political stability.

11) Small US banks

Rationale: Smaller US bank stocks are likely to outperform because of the combination of improving household cash flow, continued improvement in housing and construction, improving asset values, and virtually no exposure to the deflation of non-US credit bubbles.

12) The opportunity cost of not owning equities becomes too great for investors to not participate.

Rationale: Equities have outperformed most short-duration fixed-income returns, but the opportunity costs have evidently not been high enough to get investors to move into equities. Given our bullish stance on the equity market, we think that opportunity cost will continue to expand, and investors will finally start to chase equity performance.

13) Short-duration is not a panacea

Rationale: Investors have flooded into short-duration bond funds believing that these funds offer both high yield AND safety. The basic tenets of investing say that risk and return go hand-in-hand, which means that high yield typically comes only with added risks. It is our guess that investors are quite unaware of the risks imbedded into short-duration funds. Trouble could lie ahead.

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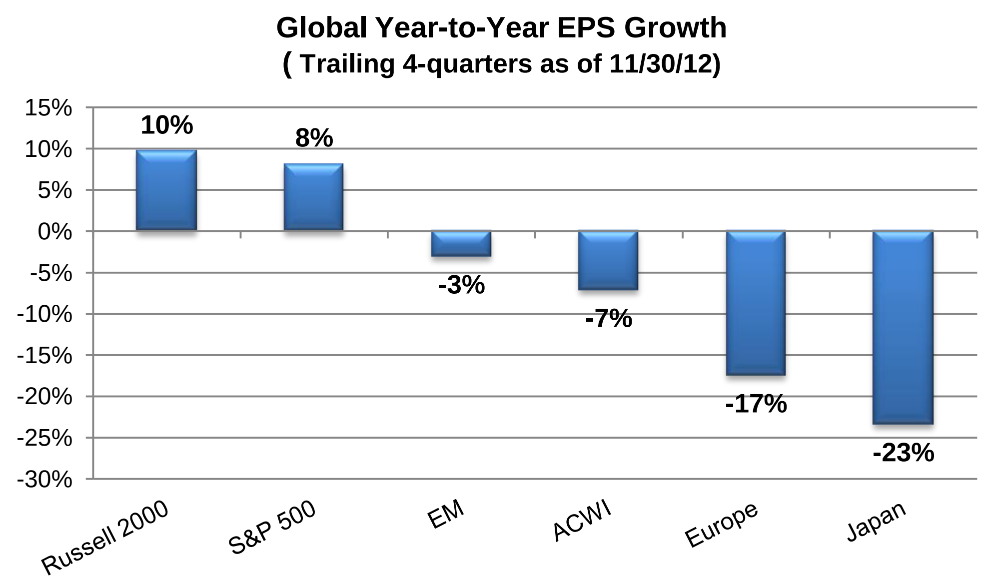
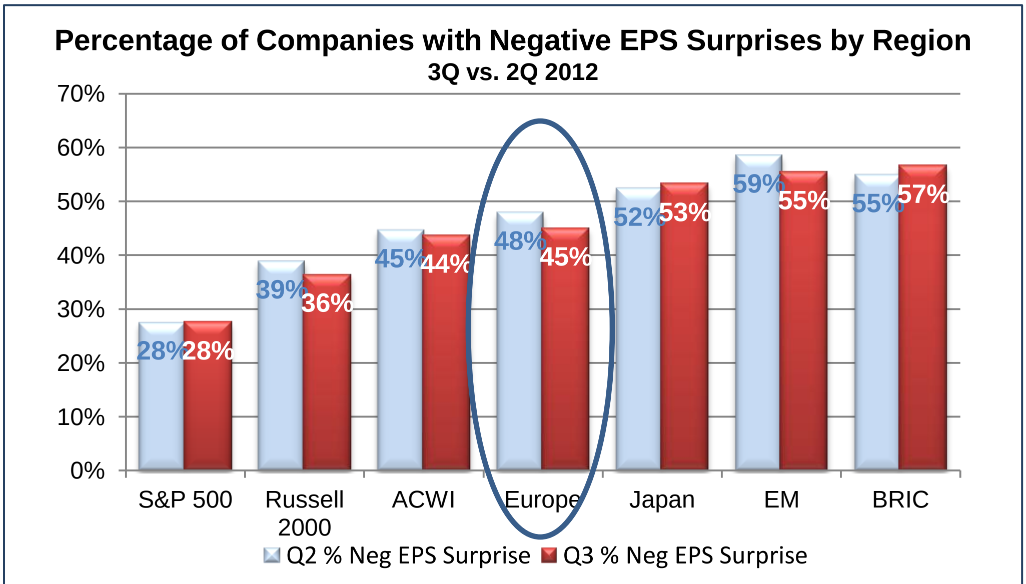
Chart 1: US corporate profits lead the rest of the world.



Source: Richard Bernstein Advisors LLC, Bloomberg, MSCI

Chart 2: Europe –easy comparisons in 2013, but still has weak fundamentals



Source: Richard Bernstein Advisors LLC, Bloomberg, MSCI

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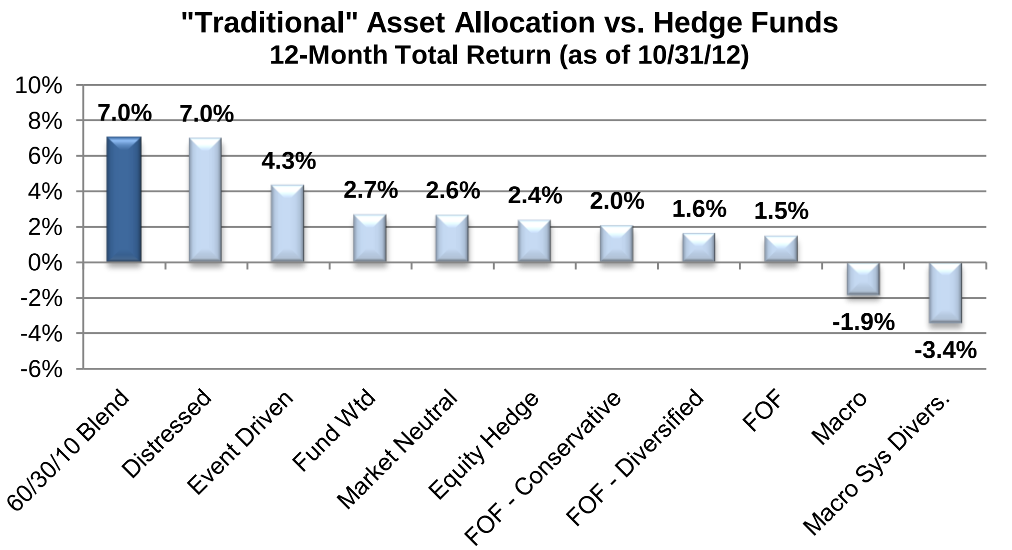
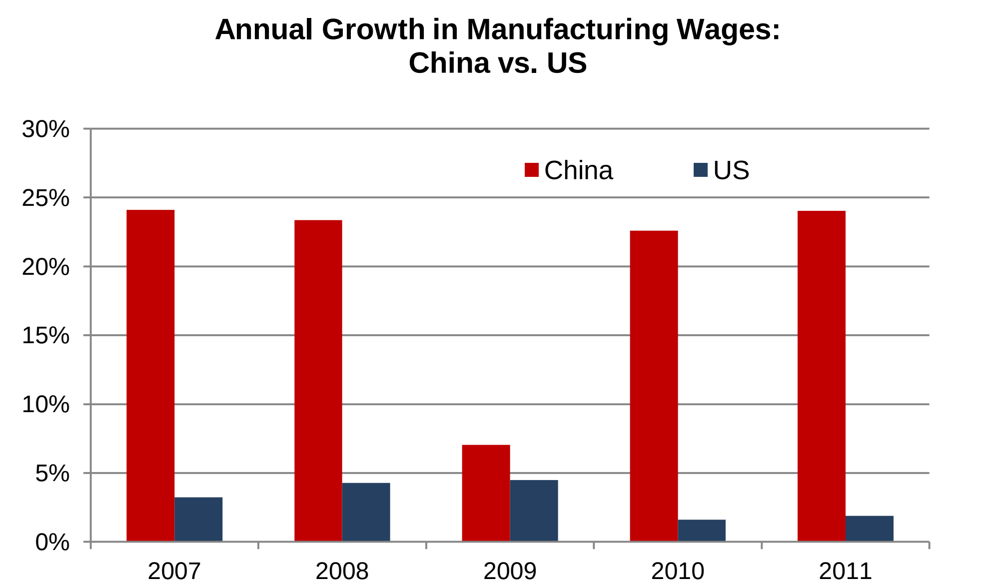
Chart 3: "Traditional" asset allocation has outperformed Hedge Funds.



Source: Richard Bernstein Advisors LLC, Bloomberg, HFRI. 10/31/12 is latest available hedge fund performance. Blended Benchmark of "Traditional" 60/30/10 Stock/Bond/Cash Allocation. Equities = MSCI All Country World Index (ACWI), Bonds = Barclays US Aggregate, Cash = 3-month T-Bills

Chart 4: Incrementally, wage disparities are shrinking



Source: Richard Bernstein Advisors LLC., U.S. Dept. of Labor, U.S. Bureau of Labor Statistics, Bloomberg, CEC

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PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS

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Chart 5: Gold seems quite expensive given inflation

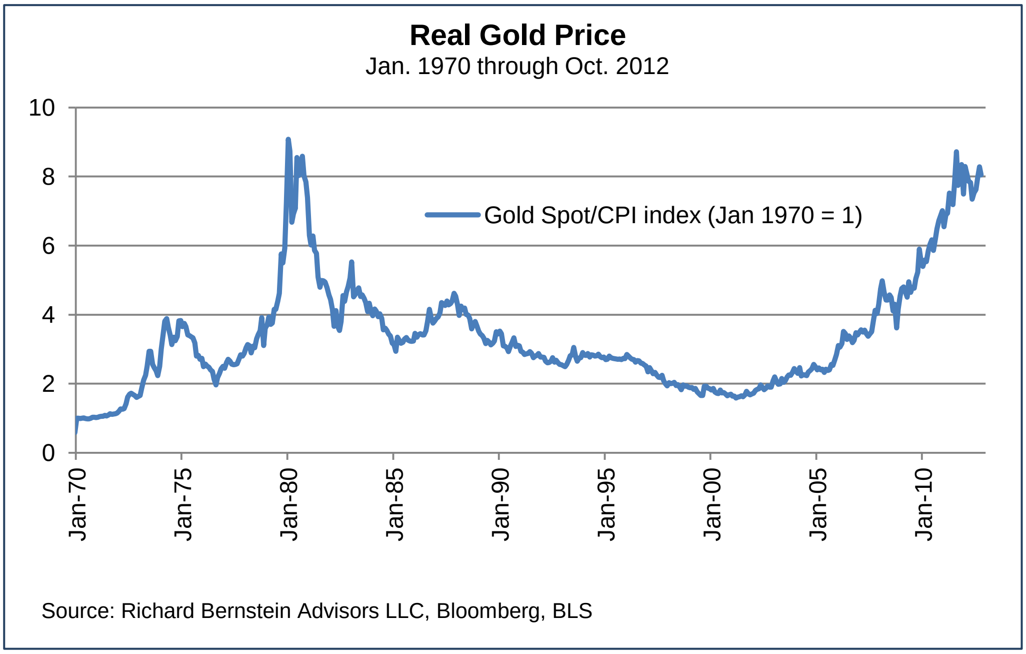
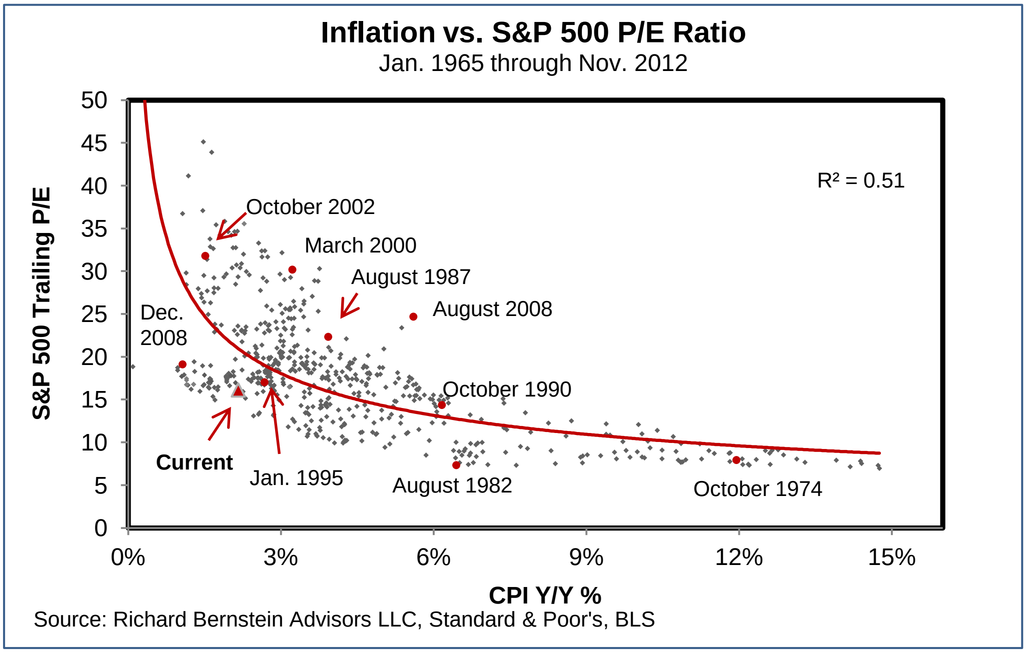


Chart 6: However Equities appear quite inexpensive



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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.**

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.

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.

Russell 2000: Russell 2000 Index. The Russell 2000 Index is an unmanaged, market-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.

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

MSCI 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.

MSCI EM: 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.

MSCI Europe: MSCI Europe Index. The MSCI Europe Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of developed European markets.

MSCI Japan: MSCI Japan Index. The MSCI Japan Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity-market performance of Japan.

Hedge Funds: 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.

Hedge Funds: HFRI Equity Hedge (Total): Equity Hedge strategies maintain positions both long and short in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity Hedge managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities, both long and short .

Hedge Funds: HFRI Event-Driven (Total): Investment Managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event Driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

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Hedge Funds: HFRI Equity Market Neutral . Equity Market Neutral strategies employ sophisticated quantitative techniques of analyzing price data to ascertain information about future price movement and relationships between securities, select securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices. Equity Market Neutral Strategies typically maintain characteristic net equity market exposure no greater than 10% long or short .

Hedge Funds: HFRI Distressed/Restructuring: Strategies which employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance or obliged (par value) at maturity as a result of either formal bankruptcy proceeding or financial market perception of near term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors' committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms; in most cases portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but in general for which a reasonable public market exists. In contrast to Special Situations, Distressed Strategies employ primarily debt (greater than 60%) but also may maintain related equity exposure.

Hedge Funds: HFRI Macro (Total): Macro Investment Managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ RV techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both Macro and equity hedge managers may hold equity securities, the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposes to EH, in which the fundamental characteristics on the company are the most significant and integral to investment thesis.

Hedge Funds: HFRI Macro Systematic Diversified : Macro Systematic Diversified strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ counter trend models, strategies benefit most from an environment characterized by persistent, discernable trending behavior. Systematic Diversified strategies typically would expect to have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

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Hedge Funds: HFRI Fund of Funds (Total): Fund of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The minimum investment in a Fund of Funds may be lower than an investment in an individual hedge fund or managed account. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers.

Hedge Funds: HFRI Fund of Funds Conservative: FOF - Conservative: FOFs classified as "Conservative" exhibit one or more of the following characteristics: seeks consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as Equity Market Neutral, Fixed Income Arbitrage, and Convertible Arbitrage; exhibits a lower historical annual standard deviation than the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Conservative Index shows generally consistent performance regardless of market conditions.

Hedge Funds: HFRI Fund of Funds Diversified: FOF - Diversified: FOFs classified as "Diversified" exhibit one or more of the following characteristics: invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets.

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