“Change is the law of life. And those who look only to the past are certain to miss the future.”
- John F. Kennedy

“Let us not look back in anger, nor forward in fear, but around in awareness.”
- James Thurber

Pretend for a moment that it’s 2001, and that you are reading this report in the midst of the deflation of the Technology bubble. It is likely that the most important investment question on your mind is, “When will technology stocks rebound?” You are also probably quite content to continue your strategy of buying and holding US stocks because you have read so much about how those stocks will outperform for the “long run”.

Continuing along these lines, it is also quite likely that you are not interested in investing in emerging-market stocks, Treasuries, non-US bonds, gold, or commodities. These assets are significantly out-of-favor and considered by most investors to be very risky.

In retrospect, these investment opinions formed in 2001 were very backward-looking and did not attempt to identify the next wave of secular investment themes. Rather, they were based simply on the hope that the prior stock market winners would resurge. Such backward-focused investment strategies have likely been major contributors to the destruction of retirement savings in the US.

Despite all the legal forewarnings that “past performance is not indicative of future returns”, past performance is perhaps the prime factor influencing individuals’ investment decisions. Rather than searching for investments based on sound financial theory, investors tend to look at upward-sloping price charts and decide, “I’m missing out; I need some of that in my portfolio.”

Don’t chase past performance

Investors today seem to be again looking backward at past performance to gauge the global equity markets. Sub-par returns in US stocks during the past decade have shaken some investors’ willingness to invest in the US, and the outperformance of emerging markets is now driving record money-flows to emerging markets funds (see Chart 1). Chasing past performance has led to disappointment time and time again, but investors seem to believe that this cycle will somehow be vastly different.
Looking backward continues to meaningfully cramp investors’ portfolio performance, and appears now to be causing them once again to overlook a significant change in stock market leadership. Investors have been funneling huge sums into BRIC (Brazil, Russia, India, and China)-related funds, yet US small cap stocks have been outperforming the BRIC countries for nearly three years! Small cap US companies have outperformed China by more than 30 percentage points since the end of 2007 (see Chart 2).

Chart 1:

EM vs. US: Cumulative Equity Fund Flows
(12/31/03 - 9/15/10)

Source: Richard Bernstein Advisors LLC, EPFR Global

Chart 2:

Stock Index Total Return
(12/31/07 to 9/22/10)

Source: Richard Bernstein Advisors LLC, Bloomberg
Volatility signals opportunity, not risk

Investors often react with fear to periods of volatility, but volatility actually signals opportunity. Financial market volatility occurs when a significant change occurs in the underlying economy (for example, the end of the credit bubble). The best-performing stocks prior to a change in the economy were those stocks that were best suited for that earlier economic backdrop. It is only natural that the stock markets’ leaders should change when the contours of the economy change. The challenge to investors is to recognize why volatility occurs and to uncover the budding stock-market leaders most suited to the new environment.

Because of this link between volatility and the underlying economy, the best-performing strategies during one period do not tend to repeat during the immediately subsequent period. Table 1 shows the five-year performance over 25 years of eight different equity categories. Each group is color-coded so that one can easily visualize the lack of consistency among market leaders.

The best-performing segment of the global equity markets during one five-year period was never the best-performing segment during any subsequent period. In fact, there were five different leadership groups for the five different periods. Japan led during the late 1980s, Emerging Markets from 1990 to 1994, Growth stocks from 1995 to 1999, Small Cap stocks during the early 2000s, and BRIC from 2005 to 2009.

Note that even the top three market leaders rarely repeat among the top three in any subsequent period, and most often the top three for one period actually underperform in the immediately subsequent period. This shows, once again, that formulating investment strategies based on past performance can result in inferior portfolio returns.

If history is any guide, the odds are low that the BRIC markets will repeat any time soon as the best-performing segment of the global equity markets. Yet BRIC-related mutual funds continue to have very sizeable inflows. It seems likely that investors enamored of the BRIC countries (especially China) today will be disappointed in the years ahead, much as were Technology investors after 2001. Looking backward was not a constructive equity strategy in 2001, and we doubt it is today.

Table 1:

<table>
<thead>
<tr>
<th>5-Year Equity Performance</th>
<th>(Annualized total returns)</th>
<th>85-89</th>
<th>90-94</th>
<th>95-99</th>
<th>00-04</th>
<th>05-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td></td>
<td>41%</td>
<td>21%</td>
<td>34%</td>
<td>7%</td>
<td>23%</td>
</tr>
<tr>
<td>Growth</td>
<td></td>
<td>32%</td>
<td>10%</td>
<td>29%</td>
<td>6%</td>
<td>16%</td>
</tr>
<tr>
<td>Value</td>
<td></td>
<td>20%</td>
<td>9%</td>
<td>23%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Small Cap</td>
<td></td>
<td>20%</td>
<td>9%</td>
<td>23%</td>
<td>2%</td>
<td>2%</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td>20%</td>
<td>8%</td>
<td>17%</td>
<td>0%</td>
<td>1%</td>
</tr>
<tr>
<td>Europe</td>
<td></td>
<td>13%</td>
<td>7%</td>
<td>6%</td>
<td>-2%</td>
<td>0%</td>
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<tr>
<td>EM</td>
<td></td>
<td>na</td>
<td>-3%</td>
<td>2%</td>
<td>-6%</td>
<td>-1%</td>
</tr>
<tr>
<td>BRIC</td>
<td></td>
<td>na</td>
<td>na</td>
<td>2%</td>
<td>-7%</td>
<td>-1%</td>
</tr>
</tbody>
</table>

Key:
- US
- Growth
- Value
- Small Cap
- Japan
- Europe
- EM
- BRIC

Source: Richard Bernstein Advisors LLC, MSCI, Bloomberg
Buy-and-hold isn’t dead

Most investors agree that longer investment time horizons are critical to successful investing, but they are nonetheless lured toward short-term trading by both its entertainment value and by the growing belief that buy-and-hold strategies provide inferior returns to trading strategies. However, performance data clearly show that buy-and-hold strategies have actually done very well over the last decade.

Investors need to differentiate between the success (or not) of buy-and-hold strategies and the decision as to which assets to buy and hold. Many have claimed that buy-and-hold strategies are no longer successful because of the underperformance of the S&P 500 during the past decade. However, if one had bought emerging-market stocks, gold, or Treasury bonds and held them for ten years, one would have concluded that buy-and-hold was a powerful approach. Emerging-market stocks appreciated 198% over the past decade, Treasury bonds appreciated 124%, and gold appreciated 349%. Poor asset selection, and not the general failure of buy-and-hold strategies, has misled disappointed investors to believe that buy-and-hold is an antiquated investment philosophy.

Chart 3 highlights that investing with a longer time horizon has historically been very beneficial (and accordingly, that short-term trading has been detrimental) to building wealth. In addition, it demonstrates that the US equity market’s negative return over the past ten years is atypical. The chart shows the historical probability, over more than an 80-year period, of the S&P 500’s providing a negative return by investment time horizon. Day-trading is like flipping a coin (i.e., it has roughly a 50/50 outcome), but longer time horizons are more likely to provide positive returns. Note that the probability of the S&P 500’s providing a negative return over a ten-year period is only about 11%, which suggests that a repeat of the past decade’s returns seems unlikely.

Despite the fact that, according to the data, long-term investment decisions are more likely to be successful (i.e., the probability of losing money becomes progressively lower, the farther out one goes), most investors believe the opposite – that they will be more successful trading with shorter time horizons, when decisions have to be made more frequently and the probability of success is commensurately lower.

Chart 3:

![Probability of a Loss for the S&P 500](source: Richard Bernstein Advisors LLC, Bloomberg)
Looking forward for opportunity

Investors have been understandably rattled by the equity markets’ volatility over the past several years, and by the long-term underperformance of their core US equity positions. However, using past performance to divine future investment themes has rarely been a good strategy.

At the turn of the millennium, investors based their strategies on the 1990s’ outperformers, buying Technology shares and S&P 500 index funds. Over the decade that followed, this proved to be a disappointing strategy, with significantly negative implications for maintaining, much less building, wealth. One must recall that it was virtually inconceivable to investors in 2001 that emerging markets, commodities, or gold would become the dominant investment themes.

Relying on the winners of the 2000s, like the popular BRIC markets, to form portfolios for the next ten years is likely to be similarly disappointing. Our current strategies are concentrated in equity-market themes that are largely off today’s investment radar screens (such as US small cap value) and present attractive and unexploited opportunities.

Richard Bernstein is chief executive officer of Richard Bernstein Advisors LLC.

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