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Investment Commentary

May 18, 2010

Richard Bernstein

Keeping Focused Despite the Volatility

Volatility has recently increased within the global equity markets. The VIX Index (an indicator of expectations of future equity market volatility) jumped to a high of over 40 in early-May from about 15 in mid-April. Many observers had discussed the possibility of a stock market correction, but investors should not lose sight of the broader macroeconomic fundamentals.

There are several factors that we think investors should keep in mind during this period of heightened volatility.

Sentiment Remains Attractive

Short-term, tactical sentiment indicators are really of little value. In my previous position at Merrill Lynch, we studied the efficacy of most of the widely-accepted sentiment indicators. In every case, these indicators had no statistically significant stock market forecasting ability for time horizons varying from one month to one year. Even the indicators' extreme readings gave about as many good readings as bad.

We prefer to use longer-term sentiment measures, which look at structural levels of sentiment rather than tactical. These measures are much more effective in predicting future stock market returns than are shorter-term tactical measures. Longer-term structural sentiment indicators move much more slowly than do shorter-term indicators and are, therefore, much more useful when constructing asset allocation strategies.

Currently, structural sentiment is about where it should be for this part of the economic and market cycles. Investors are not as bearish as they were a year or so ago, but they are hardly euphoric. By our reckoning, investors haven't even reached "normal" historical bullishness.

The US Dollar Troughed 2 Years Ago!

The US dollar, as measured by the DXY Index basket of six currencies, is not solely a falling-Euro story. In fact, the US dollar troughed in value more than two years ago, long before anyone questioned the future of the Euro. The situation in Greece is just another factor that has contributed to the multi-year appreciation of the US dollar.

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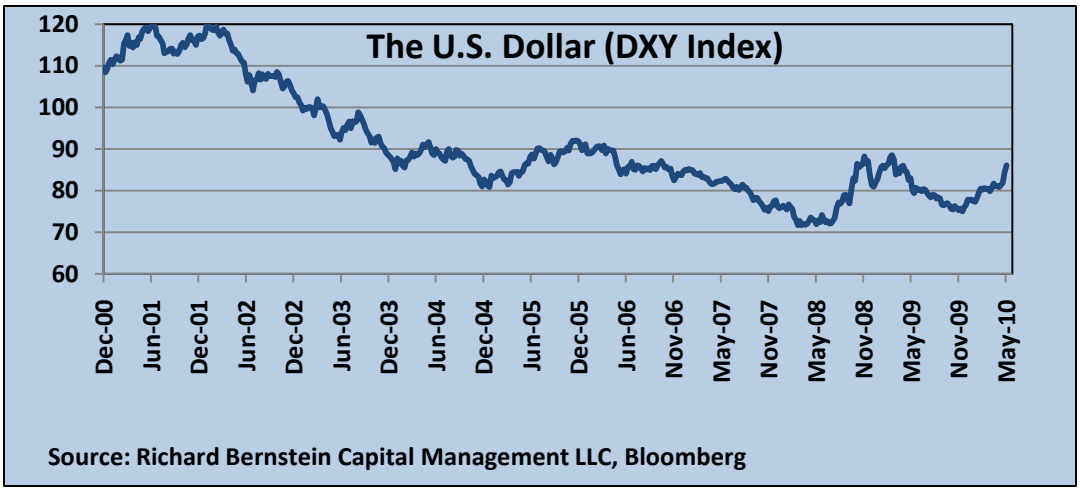
We expect the US dollar to continue to appreciate as investors come to understand that the credit problems the US experienced over the past several years are now being felt in other parts of the world. Non-US economies have often lagged the US economy, and it increasingly seems as though this cycle will fit that historical norm. Credit problems could surface in other smaller developed and emerging markets.

Accordingly, non-US investors seem increasingly likely to view US assets as being attractive. Both the appreciation of the US dollar and the continued growth of the US economy could contribute to funds flowing into both US equity and debt.



Treasuries – Flight to Quality Stimulates the Economy

We have repeatedly suggested that Treasuries should be an important part of a portfolio because they are the only major asset class whose returns are negatively correlated to stocks'. Hedge funds, non-US stocks, small cap stocks (our favorites, read on), commodities, gold, and now even muni bonds have very high correlations to the S&P 500 or have rapidly rising correlations.

Treasuries remain today's "alternative asset class". Similar to investors' views regarding private equity and hedge funds 15 years ago, a broad array of investors deem Treasuries too risky despite the bonds' uncorrelated, and often superior, returns.

Admittedly, if the US economy continues to expand as we expect, Treasuries are unlikely to outperform equities. However, diversification is not about amassing a portfolio of assets that all rise together. Rather, it is about allocating to assets that appreciate through time, but do so independently of each other.

Most important, lower long-term US Treasury interest rates resulting from the Greece-related flight to quality is a positive for the US economy. So long as the US economy moves from recovery to expansion, lower long-term interest rates resulting from global flights to quality will likely lower US lending rates that are benchmarked to the 10-year note.

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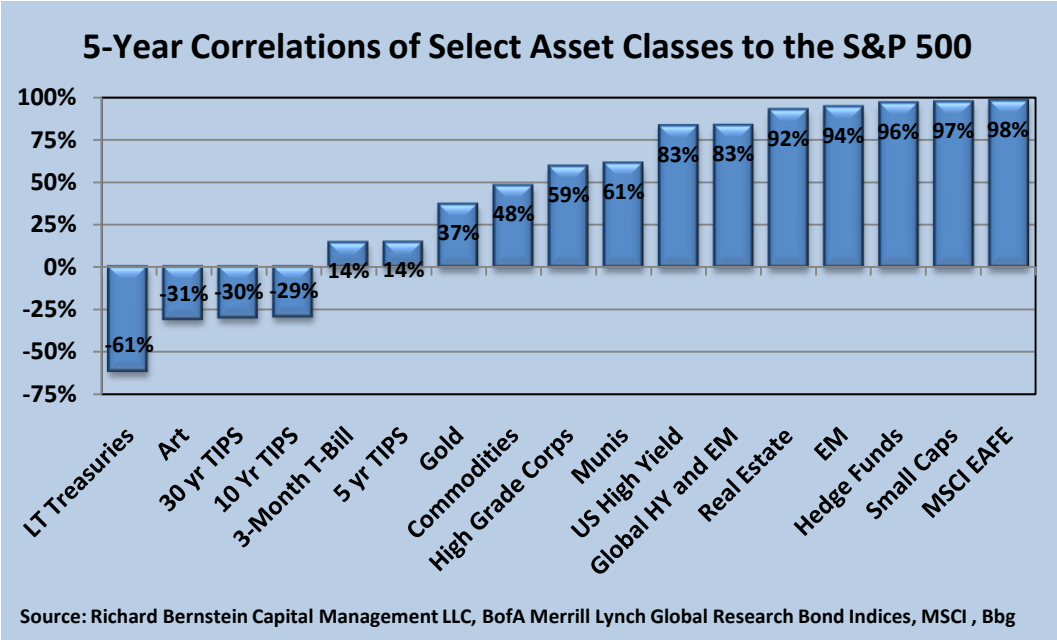

Gold: Starting to Tarnish?

For most of the past ten years, our theme on gold has been that a "small proportion of a portfolio should be in gold and/or gold shares" (depending on the relative valuation between the two). However, the more recent price movements in gold seem to suggest that the gold story might be getting toward its later chapters.

First, although many suggest that gold is a "traditional safe haven", nothing could be farther from the truth. An analysis of gold returns over long periods of time clearly shows that gold provides negative and inferior long-term returns far more frequently than do other asset classes. It is worrisome that few investors seem to know that fact, but quote marketing lines about "fiat currencies" and "long-term store of value." Sentiment towards gold seems overly bullish to us.

Second, US investors should be losing interest in gold, but are not. The dollar, which as mentioned troughed more than two years ago, is hardly the peso, and US inflation expectations are stable to falling. Thus, two of the main reasons for US investors to hold gold seem to be losing strength.

The momentum story for gold continues. However, US investors should realize the risks that accompany a rally that is neither fundamentally based (dollar up and inflation down) nor out-of-consensus (as I write this, there is a commercial on television for gold coins).

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Potential Secular Leadership: Small Cap Value

Small cap value continues to be our favorite size/style category. Here are several bullet points behind our views:

1. Small cap value may be the one area of the global financial markets that is starved for capital.

2. Washington is more likely to favor small financial companies ("community banks") to large financial companies ("Wall Street"). Financials are a large proportion of the small cap value universe.

3. Small cap value is the most domestically-oriented segment of US size and style. If the US dollar continues to appreciate and an increasing number of non-US economies have credit/debt problems, then larger multi-nationals' earnings growth projections will likely be reduced.

4. Small cap value has been outperforming China for more than two years, but few seem to recognize this leadership shift. In addition, small cap value is more conservatively valued than is China and is projected to have stronger earnings growth.

5. Nearly all investors are underweight small cap value.

Admittedly, small cap value is highly cyclical, and will probably underperform if the US economy does not expand. Nonetheless, we find these assets to be significantly undervalued and under-appreciated, and seem to have the characteristics of a long-term secular investment theme.

Valuation/Growth Snapshot as of 5/17/10

	Trailing P/E	Price/Book	Price/Sales	Est. EPS Growth	Div. Yld	Total Return 12/28/07 - 05/17/10
Small Cap Value	44	**1.5**	**0.7**	**84%**	1.3%	**-2%**
Shanghai Composite Index	**19**	2.5	1.6	27%	**1.6%**	-50%

Source: Richard Bernstein Capital Management LLC, Bloomberg

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Volatility is always scary to investors. However, volatility has historically signaled a change in stock market leadership, and therefore, presented investors with opportunities. This cycle appears no different to us. Leadership is again shifting within the financial markets.

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Our focus on longer-term investment strategies that have sound fundamental and contrarian support leads us to US assets and specifically to small cap value strategies. Despite the outperformance of small cap value, it continues to have the contrarian and fundamental characteristics that we find attractive. Thus, small cap value could still be in the early stages of secular outperformance.

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