VOLATILITY

Managing risk
with a range of strategies

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JULY 2015 TIMELY THINKING

The black widow returns

Eaton Vance Richard Bernstein **All Asset Strategy** Fund	(A) **EARAX** (I) **EIRAX**
Eaton Vance Richard Bernstein **Equity Strategy** Fund	(A) **ERBAX** (I) **ERBIX**
Eaton Vance Richard Bernstein **Market Opportunities** Fund	(A) **ERMAX** (I) **ERMIX**

In 1989, I wrote a report titled “Dividends: The Black Widow of Valuation.” The report demonstrated that investing for high income can sometimes be extremely risky despite the irresistibility of higher dividend yield. Certainly, income-oriented equity portfolios tend to have lower long-term betas than do portfolios focused on capital appreciation. However, strategies based on stretching for yield have a long history of surprising investors with unanticipated risks.

Investors today seem to be as myopic toward the risks of income investing as they were in 1989. MLPs, REITs, emerging-market debt and other income categories all seem to have risks that investors today are largely ignoring. One must remember that excess returns in the financial markets are always accompanied by excess risk. Yields that are abnormally high typically carry abnormally high risks as well, and a proper assessment of those risks should never be taken for granted.

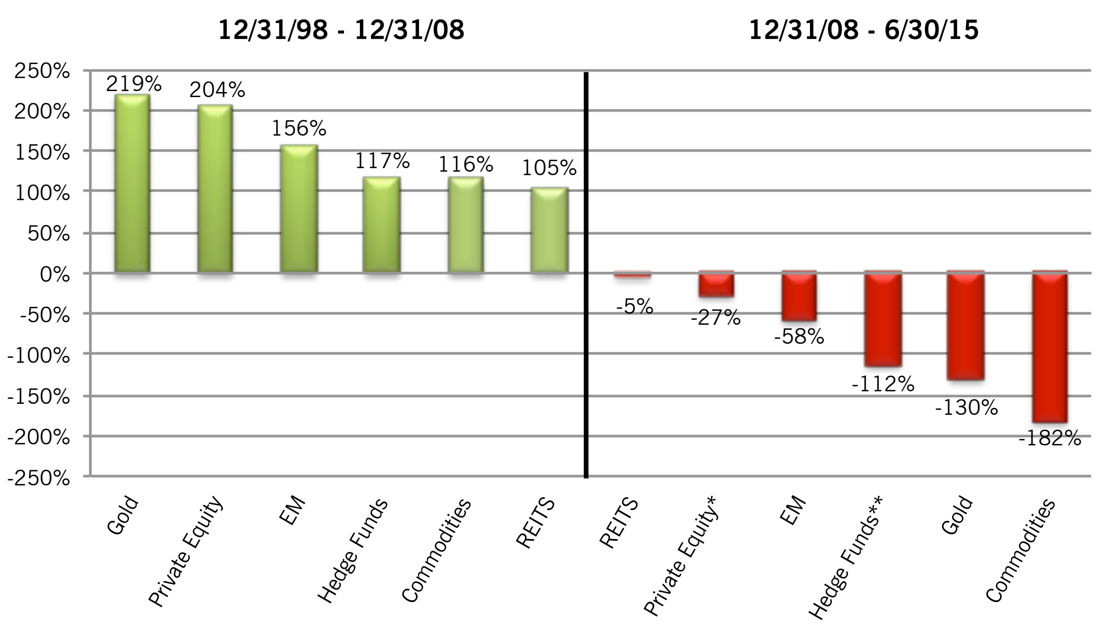
The deflation of the global credit bubble remains our primary investment focus. The problems related to oil, Greece, Puerto Rico, China, Brazil, gold and other investments should not be a surprise given the secular deflation of the global credit bubble. Yet, investors' unwillingness to accept the end of the1998-2008 credit paradigm has caused considerable financial market volatility.

Credit-related assets continue to underperform

Credit-related asset classes continue to underperform. This seems perfectly normal as the global credit bubble deflates and as credit conditions return to something more normal than that seen from 1998 to 2008. Exhibit A compares the relative performance versus the S&P 500 of credit-related asset classes from 1998 to 2008 with their relative performance from 2008 to present. Credit-related asset classes outperformed old-fashioned stocks handily as the credit bubble was inflating. However, they have underperformed stocks as the credit bubble has deflated.

This makes perfect sense to us and, as mentioned, this is the central tenet of our portfolios. However, it does not appear as though most investors share our concern. In fact, some credit-related asset classes are still considered "safe" or "opportunistic" by many investors.

Exhibit A **Credit-related asset class performance relative to the S&P 500**



*Private Equity performance available through 12/31/14.
**Hedge Fund performance available through 5/31/15.
Sources: Richard Bernstein Advisors LLC, MSCI, Standard & Poors, BofA Merrill Lynch, Bloomberg Cambridge Associates, HFRI. For Index descriptors, see "Index Descriptions" at end of document.

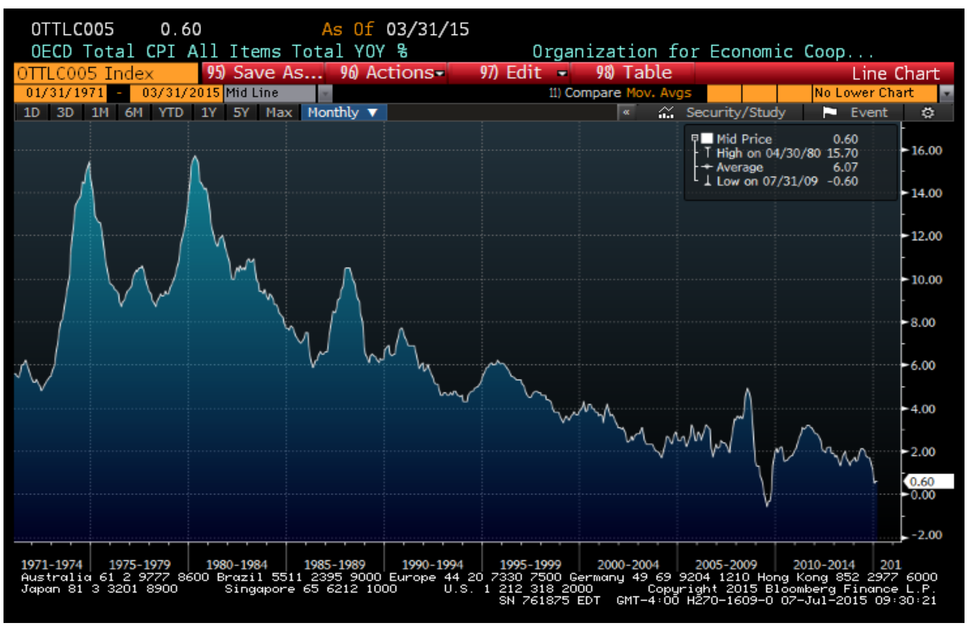
Credit DEFLATION, not inflation

Monetary theory states that credit, not printing money, is the life blood of inflation. Chuck Clough, the former chief investment strategist at Merrill Lynch and one of my mentors, once said that it is impossible to get abnormal inflation without it being preceded by abnormal credit creation. Accordingly, the credit bubble produced the highest rate of inflation in the U.S. in nearly 20 years. (U.S. CPI hit 5.6% in July 2008 versus 6.3% in October 1990).

Exhibit B demonstrates how difficult it is to get inflation during the deflation of a global credit bubble. The chart portrays the overall OECD inflation rate. The recent readings are the second lowest since 1971.

It should be no surprise that debt-related problems are cropping up around the world, given this deflationary backdrop. Inflation can "cure" debt problems in that borrowing entities can pay back loans with cheaper currencies and inventory profits. However, deflation typically exacerbates debt problems. So, why are investors surprised by Greece or Puerto Rico?

Exhibit B **Global CPI: Second lowest reading since 1971**



Source: Bloomberg LP.

Anything for yield

Investors have been surprised by debt problems around the world because they have continually ignored the ramifications of the deflating global credit bubble. Investors seem to have been lulled into a false sense of security by higher yields and/or promises of capital appreciation from distressed prices. High yield is generally attractive when nominal growth is accelerating (nominal growth equals the sum of real growth and inflation). In the absence of both accelerating real growth and inflation, marginal credits tend to have higher default probabilities.

Among equities, MLPs seem to fit this description. We pointed out in earlier reports* that investors' belief that MLPs are defensive income investments does not seem to match the industry's fundamentals. The industry is highly correlated to oil prices (commodities are a credit-related asset class), industry cash flows are tied to contracts that seem suspect as counterparty risk increases and the overall industry is cash flow negative. Exhibit C points out that MLPs (represented by the S&P MLP Index) are in a bear market, but most MLP investors don't yet seem concerned.

Exhibit C **MLPs are now in a bear market**

Source: Bloomberg LP.

*Earlier reports:
http://www.rbadvisors.com/images/pdfs/Special_Note_Are_MLP_returns_correlated_to_Oil_Prices_I.pdf
http://www.rbadvisors.com/images/pdfs/2015_Year_Ahead_Continuing_to_deflate_the_global_credit_bubble.pdf
http://www.rbadvisors.com/images/pdfs/CommodityCaution.pdf,

The recent performance of high-dividend-yielding stocks around the world already qualifies as a correction, and a full-blown bear market should probably not be ruled out. Exhibit D shows the performance of the MSCI World High Dividend Yield Index. The index's history shows that higher-yielding stocks tend to be much more cyclical than most investors might expect. In the last 20 years, the index has declined 29% and 64% during bear markets. The index is down a bit more than 10% over the past year or so.

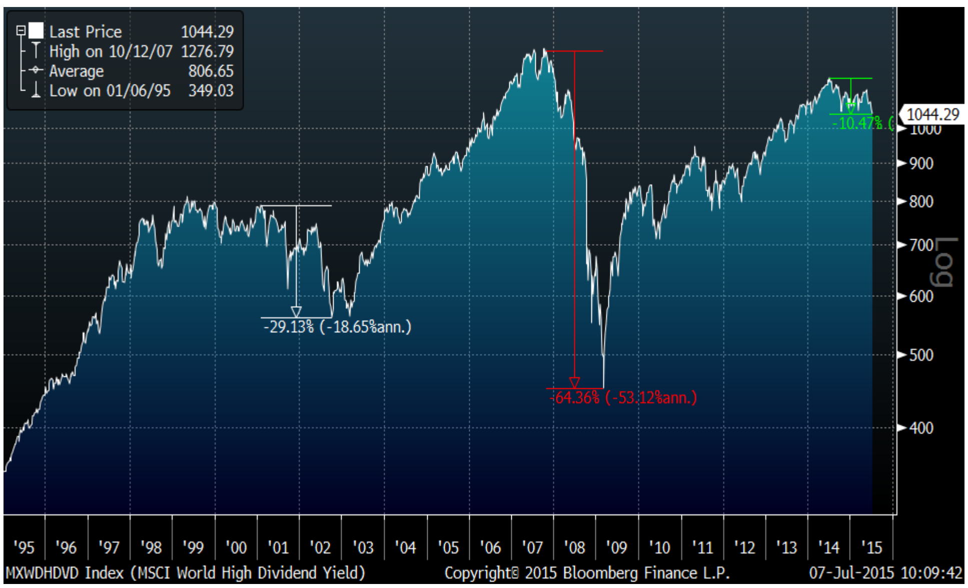
Few have questioned higher-yielding stocks' ability to maintain dividends during a period of global debt deflation. One would think that investors might question nominal cash flow growth during this period, but so far that doesn't seem to be happening. Higher-yield equity strategies remain immensely popular despite the risks associated with such strategies.

It's sustainability, not yield, that's important

We think blindly investing for yield carries considerable risks in the present deflationary environment, and we prefer to focus on the sustainability of dividends rather than the absolute yield. Yields can sometimes be abnormally high because the market price is anticipating a future dividend cut. We try to avoid such situations by looking at fundamentals that suggest a high probability of continued payment. We don't want to get bitten by the alluring Black Widow.

Our portfolios are structured accordingly.

Exhibit D **Global high-dividend-yield equities are now in a bear market**



Source: Bloomberg LP.

Index Definitions

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 indexes. 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. Indexes are not actively managed and investors cannot invest directly in the indexes.

U.S. Dollar: InterContinentalExchange (ICE) US Dollar Index (DXY). 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.

Gold: Gold Spot USD/oz Bloomberg GOLDS Commodity. The Gold Spot price is quoted as U.S. dollars per troy ounce.

U.S. Dollar: InterContinentalExchange (ICE) US Dollar Index (DXY). 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.

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.

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 12-month track record of active performance. The Index includes both domestic (U.S.) and offshore funds, and does not include any funds of funds.

Private Equity: The Cambridge Associates LLC U.S. Private Equity Index. The Cambridge Associates LLC U.S. Private Equity Index is an end-to-end calculation based on data compiled from 986 U.S. private equity funds (buyout, growth equity, private equity energy and mezzanine funds), including fully liquidated partnerships, formed between 1986 and 2012. Pooled end-to-end return, net of fees, expenses and carried interest. Historic quarterly returns are updated in each year-end report to adjust for changes in the index sampl**e.**

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 U.S. economy through changes in the aggregate market value of 500 stocks representing all major industries.

MLPs: The S&P MLP Index: The S&P MLP Index provides investors with exposure to the leading partnerships that trade on the NYSE and NASDAQ and includes both Master Limited Partnerships (MLPs) and publicly traded LLCs, which have a similar legal structure to MLPs and share the same tax benefits.

Global High Dividend Yield: The MSCI World High Dividend Yield Index: The MSCI World High Dividend Yield Index is a free float market capitalization-weighted index that includes only securities that offer a meaningfully higher-than-average dividend yield relative to the MSCI World Index and that pass dividend sustainability screens.

About Risk

Equity investing is subject to stock market volatility. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, established companies. Investments in foreign instruments or currencies can involve greater risk and volatility than U.S. investments because of adverse market, economic, political, regulatory, geopolitical or other conditions. In emerging or frontier countries, these risks may be more significant. Smaller companies are generally subject to greater price fluctuations, limited liquidity, higher transaction costs and higher investment risk than larger, established companies. Investing involves risks including possible loss of principal.

Investing is an inherently risky activity, and investors must always be prepared to potentially lose some or all of an investment's value. Past performance is, of course, no guarantee of future results.

Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance of any fund.

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Before investing, investors should consider carefully the investment objectives, risks, charges and expenses of a mutual fund. This and other important information is contained in the prospectus and summary prospectus, which can be obtained from a financial advisor. Prospective investors should read the prospectus carefully before investing.

About Eaton Vance

Eaton Vance Corp. is one of the oldest investment management firms in the United States, with a history dating to 1924. Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information, visit eatonvance.com.

Richard Bernstein Advisors LLC serves as subadvisor to three Eaton Vance mutual funds.

Richard Bernstein is chief executive officer of Richard Bernstein Advisors LLC, a registered investment advisor.

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