First Quarter 2015

CAPITAL MARKETS OUTLOOK

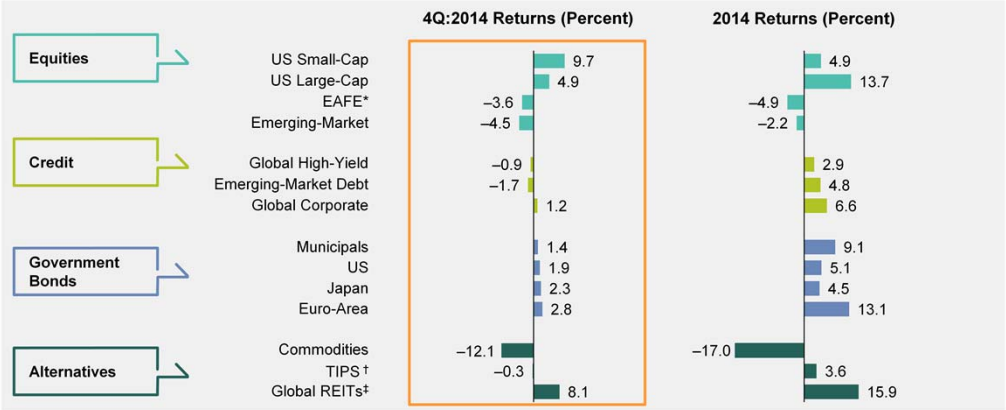
NAVIGATING DIVERGENCE IN GLOBAL MARKETS AND ECONOMIES

First Name Last Name Position—Department/Product Area

First Name Last Name Position—Department/Product Area

A Strong Year Overall from Global Capital Markets

Returns in US Dollars



Past performance does not guarantee future results.
As of December 31, 2014
Global high yield, global corporates, and Japan and euro-area government bonds in hedged USD terms. All other non-US returns in unhedged USD terms. An investor cannot invest directly in an index and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
*Europe, Australasia and the Far East. †Treasury Inflation-Protected Securities. ‡Real Estate Investment Trusts
Source: Barclays, FactSet, FTSE, MSCI, S&P Dow Jones and AB

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Many of the themes that we saw develop during the year held true in return patterns.

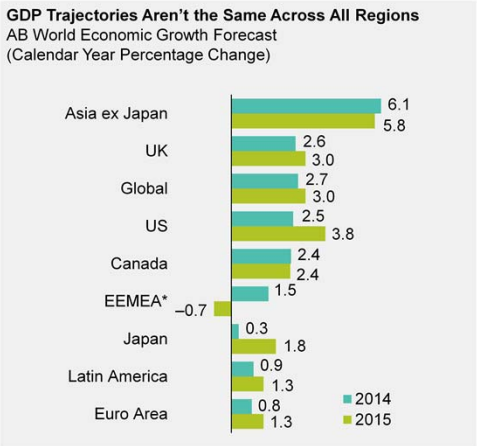
Equity markets endured a very volatile year, particularly in the fourth quarter, but ended up finishing strong. US stocks rose almost 14% for the year, including nearly 5% in the fourth quarter—that's based on the S&P 500 Index. That aligns with the story of stronger US growth. Other developed market equities and emerging market stocks delivered modest returns for the year in local currency terms, but the impact of a strengthening US dollar resulted in negative returns in US dollar terms.

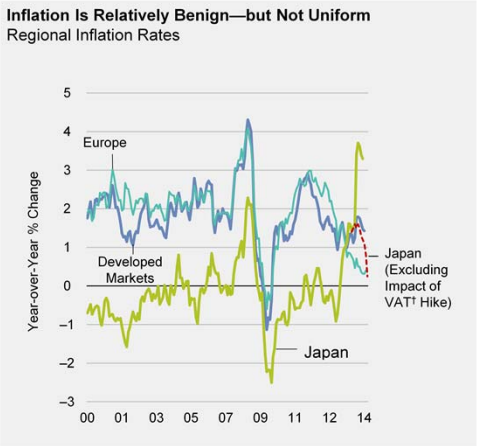
Most fixed-income sectors also finished the year positive. The Barclays Global Aggregate Index total return was about 7%. Government bonds rallied globally as interest rates continued to trend downward, and most non-government debt also posted positive returns, although corporate bonds finished slightly behind government bonds after adjusting for interest-rate sensitivity. From a credit standpoint, high-quality corporate bonds outpaced high-yield bonds.

With oil prices plummeting and commodity prices down, commodities trailed most other market segments and were substantially negative for both the quarter and year. TIPS produced modestly positive returns, as the drag of falling inflation expectations was more than offset by the benefit of falling rates.

So, it was a strong year overall, with significant divergence among sector and asset class returns. Where else are we seeing divergence today?

Growth and Inflation Patterns Becoming More Diverse





Historical analysis and current forecasts do not guarantee future results.
Left display as of January 2, 2015; right display through October 31, 2014
*Emerging Europe, Middle East and Africa (the forecast aggregate includes Hungary, Poland, Turkey, Russia and South Africa)
†Value-Added Tax
Source: Haver Analytics, Office for National Statistics, US Bureau of Labor Statistics and AB

Based on our forecasts in the left display, we expect global economic growth to continue at a moderate pace, with gross domestic product (GDP) finishing 2014 up by 2.7%, picking up to 3.0% growth in 2015. But the patterns of regional economic growth haven't been uniform, and we expect that will continue.

The US growth cycle seems to be firmly entrenched. The public sector, which has lagged behind, is now growing modestly. And we expect private sector strength to continue, with business and consumer fundamentals supporting the case for further expansion. In Europe, growth is much slower overall: we expect euro area GDP to expand by only a little over 1% in 2015. In the UK, however, we see GDP grow reaching 3%. In Japan, we expect growth to pick up from 0.3% in 2014 to 1.8% in 2015.

The uneven pace of global economic growth is even more apparent in the regions and countries of the emerging world. Overall emerging market growth has been faster than that of developed markets for some time, although the gap has been shrinking in recent years. Regionally, growth continues to slow in Latin America, and global sanctions have dealt a hard blow to the Russian economy and its neighboring countries in Eastern Europe. In Asia, economic growth remains the strongest among regions. It's dominated by China, but the region has several other fast-growing economies.

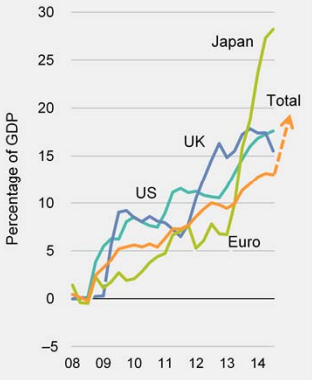
The sharp decline in crude oil prices that we've seen since the summer should create even more divergence in GDP growth. Since a July peak of about $100 per barrel, prices had fallen to the mid-$60 range by early December. This amounts to a massive wealth transfer from oil-exporting economies to oil-importing economies.

Inflation rates are also beginning to diverge globally, although the overall inflation picture is still relatively benign. On the right, you can see the differing patterns: developed economies on the whole versus two economies in the midst of concerted efforts to generate inflation and/or fight deflation. Inflation in Europe is very low and declining—in fact, price levels are pretty close to stagnant in the region. In Japan, inflation has picked up substantially, though largely as a result of the April 2014 value-added tax hike. Excluding the tax hike, inflation has stalled below the level targeted by Japanese policymakers. In other developed economies, deflationary fears have largely disappeared—however, inflation is modest by historical comparison.

Growth and inflation are both an influence on and a result of monetary policy, so it's not surprising that we're also beginning to see bigger distinctions among monetary policy approaches globally.

Policy Generally Accommodative, but with Differences Appearing

Differences in Monetary Policies…
G4 Aggregate Change in Base Money Since 2008 as a Percentage of GDP



…and Variations in Official Rates…
Short-Term Policy Rates

	Current	2015F
UK	0.50	1.00
US	0.13	1.50
Canada	1.00	1.50
Mexico	3.00	3.50
Euro Area	0.10	0.10
Japan	0.10	0.10
Brazil	11.75	11.75
Australia	2.50	2.00
China	3.00	2.50
India	8.00	7.75
Korea	2.00	1.75

….Lead to Divergent Currency Moves
Spot Return: G10 Currencies vs. USD

Current analysis does not guarantee future results.
Left display through September 30, 2014; middle display as of December 1, 2014; right display represents year-to-date returns as of December 31, 2014
Source: Bloomberg; Cabinet Office; Government of Japan; CEIC Data; Eurostat; Haver Analytics; Ministry of Internal Affairs and Communications Japan; Thomson Reuters Datastream and AB

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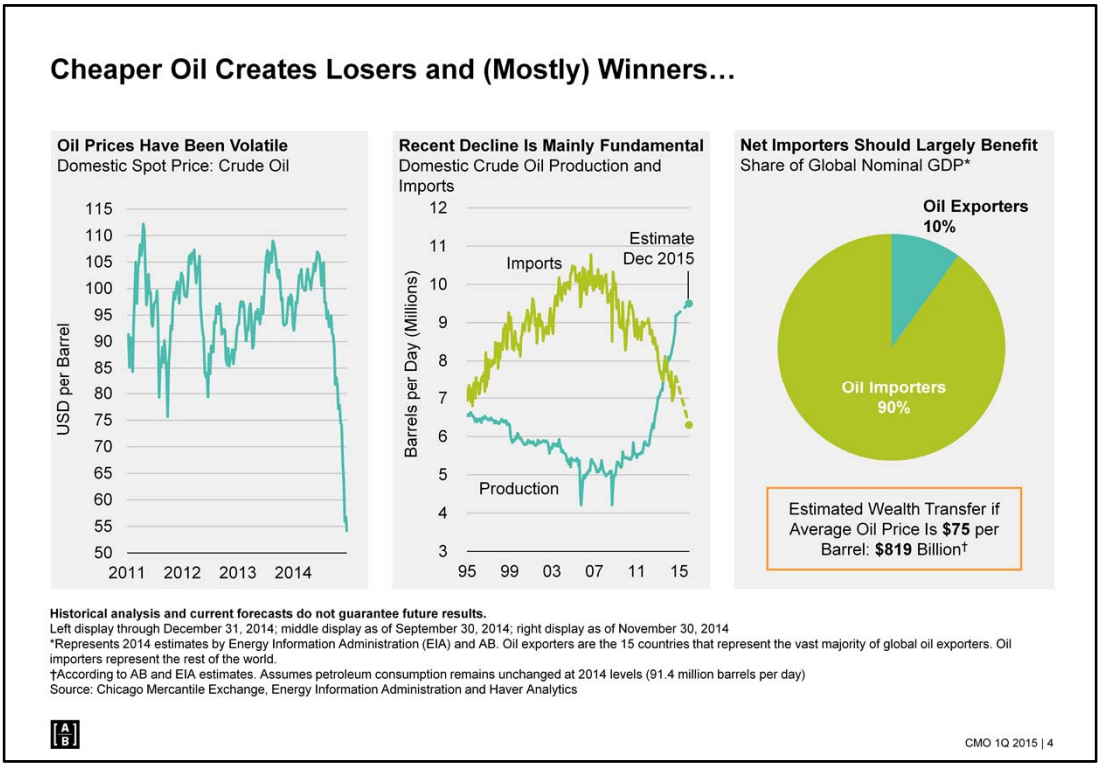
The overall global policy stance still leans heavily toward accommodation, but as you can see on the left, differences are beginning to emerge.

We're looking at the lay of the land for global liquidity in terms of base-money growth in major developed regions and countries. The US has recently concluded tapering, and you can see the impact in the flattening of the green growth line for US base money. However, the end of the Fed's asset purchase program is not tightening; the Fed's overall stance is still a highly accommodative liquidity picture—for the moment. As for the euro area, liquidity has declined in the last two or three years, but there are plans to add potentially one trillion euro to the money supply to raise it back to previous levels. Japan continues to stimulate, and as 2014 came to a close, it introduced more monetary stimulus measures.

Official interest rates are another key policy lever, and central banks aren't following the same script in this area, either. The middle display shows policy rates for major global economies both as they were at the end of 2014 and where we expect them to be at the end of 2015. The UK, US, Canada and Mexico are among the larger economies expected to hike rates; the euro area, Japan and Brazil are expected to hold steady; and we expect China, India, Australia, and Korea to cut rates in 2015.

Actual and expected open-market operations and official interest rates are big influences on currency movements. Because the Fed is the first major central bank in developed countries to start withdrawing monetary accommodation and tighten rates, the US dollar strengthened against other G10 currencies last year. As we show on the right, the returns of various currencies in 2014 versus a strengthening US dollar have been fairly diverse. For example, the pound sterling depreciated the least, while the Swedish and Norwegian krone fell substantially.

As I mentioned a moment ago, these divergences are likely to be magnified by the impact of sharply lower oil prices globally.



Volatile oil prices aren't a new development, as you can see from the left hand display. Historically, there has been a series of big swings in crude prices. In many cases, the typical dynamics of supply and demand have been upstaged by major shocks, including the 1973 and 1979 OPEC disruptions and, more recently, geopolitical events such as the Ukraine crisis and various Middle East concerns or conflicts. This time around, we think supply and demand changes are largely responsible.

Global energy demand has weakened along with global growth, while supply has surged. At the center of this shift is the US. We've seen a relentless rise in US oil production from shale-oil fields. You can see the impact on US production the last few years in the green line in the center display. It amounts to about four million additional barrels of global supply per day. The blue line shows a corresponding decline in US demand for imported oil. In addition to better US productivity, Saudi Arabia kept its production up, Libyan supply miraculously recovered amid a three-way civil war and Nigerian production recovered unexpectedly.

Most countries stand to be winners from cheap oil, as we show in the right-hand pie chart. In terms of relative shares of global GDP, the oil "takers," or net importers, vastly outnumber oil "makers," or net exporters. With cheaper oil, exporters lose and importers win. This creates a massive wealth transfer on the order of $800 billion, benefiting oil importers and consumers. That number assumes oil prices of $75 per barrel, our average price assumption for 2015.

Over the long run, oil isn't likely to stay this low. We see it eventually moving higher from 2104 year-end levels, although trying to predict short-term price movements is difficult. In the meantime, who else wins or loses from cheap oil? The impact across economies, asset classes and sectors is wide-ranging.

…with the Line Drawn Between Consumers and Producers. The Big Winner? The Global Economy

A 10% Change in Oil Is Associated with a 0.2% Change in Global GDP (IMF)

Losers

Net Oil Exporters

+ Russia
+ Venezuela
+ Iran
+ Iraq
+ Nigeria

High-Cost Oil Producers

+ US Independent E&P
+ Canada Tar Sands

Other Energy

+ Natural Gas
+ Alternative Energy

Central Banks Fighting De/Disinflation

+ ECB
+ BOJ

Winners

Net Oil Importers

+ US
+ China
+ Japan
+ India
+ South Korea

Energy/Energy Intensive Industries

+ Refiners
+ Pipelines
+ Petrochemical Users
+ Agriculture
+ Transportation
  + Airlines
  + Lodging/Destinations

Oil Subsidizers

+ Indonesia
+ Brazil

Consumer Goods/Services

"if oil prices stay between $75–$95 a barrel, we would see the kind of stimulus package that the Federal Reserve or Congress could never do." Douglas R. Oberhelman, CEO, Caterpillar (*The New York Times*, Nov. 13, 2014)

Current analysis does not guarantee future results.
As of December 31, 2014
Source: *The New York Times* and AB

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The basic rule of thumb: oil producers get hurt and oil users benefit.
Among the specific losers:

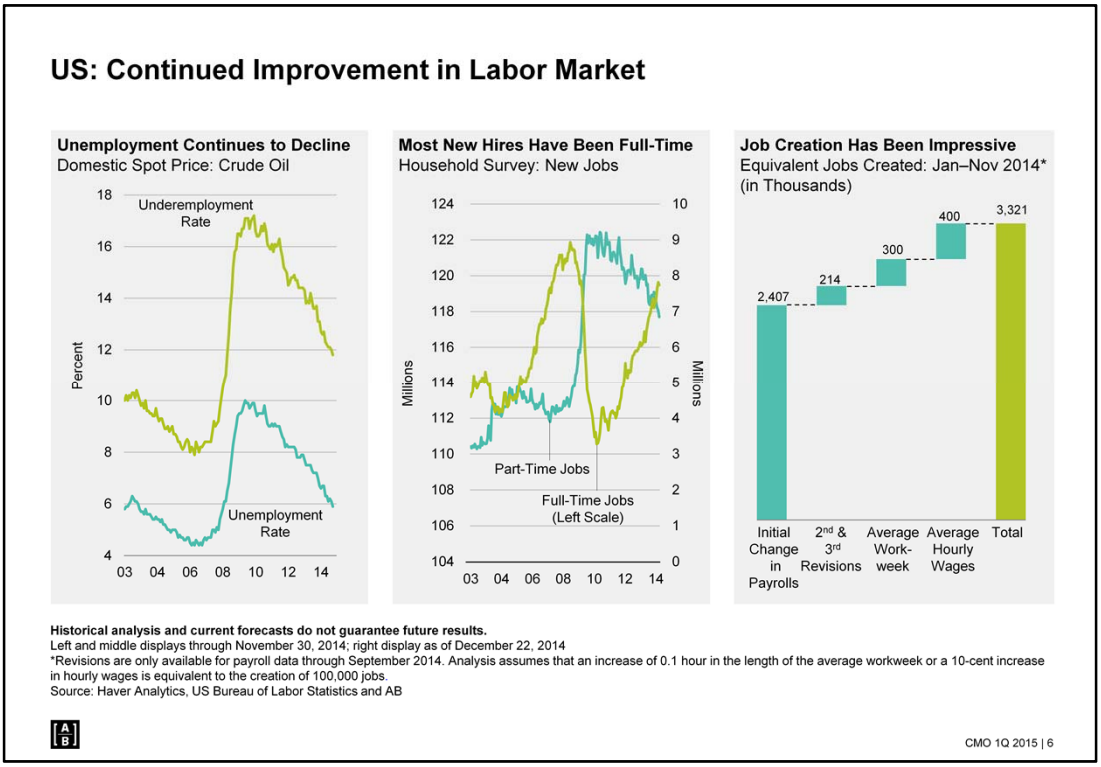
+ Net Oil Importers: Russia, Venezuela, Iran, Iraq and Nigeria
+ High Cost Oil Producers: US Independent exploration & production firms and Canada tar sands producers
+ Other Energy Types: Natural Gas, Alternative Energy
+ Central Banks Fighting De/Disinflation: ECB and Bank of Japan

Among the specific winners:

+ Net Oil Exporters: US, China, Japan, India, South Korea
+ Oil Subsidizers: Indonesia and Brazil
+ Energy/Energy-Intensive Industries: Refiners, Pipelines, Petrochemical Users, Agriculture, Transportation, Airlines, Lodging/Destinations
+ Consumer Goods/Services

Bear in mind that scale of the wealth transfer is tremendous, with the global economy and consumers as the main winners. According to the IMF, a 10% change in oil prices is associated with a 0.2% change in global GDP. This quote from the Caterpillar CEO puts it in perspective: "If Oil Prices Stay Between $75-$95 a Barrel, We Would See the Kind of Stimulus Package that the Federal Reserve or Congress Could Never Do."

The boost provided by cheap oil prices adds to an already strong US economy. Let's start by looking at an improving jobs picture first.



The US unemployment rate has been steadily trending downward over the past five years—that's the green line in the left display. Today, unemployment is just under 6%. Just as supportive is the improvement in the underemployment rate (blue line), a broader measure that includes not only people who don't have jobs, but also those with part-time jobs that want to work full-time, as well as discouraged workers who have stopped looking for work altogether..

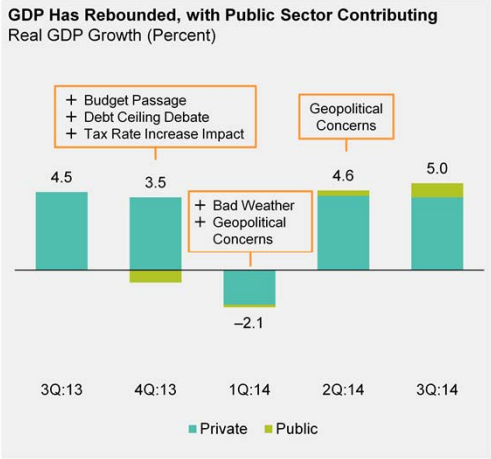
There's more good news in the changing composition of new jobs. In the center display, we're showing changes in the level of part-time and full-time jobs. You'll notice that long-term jobs are increasing while part-time job growth is tailing off. This speaks to better quality in the composition of jobs being created.

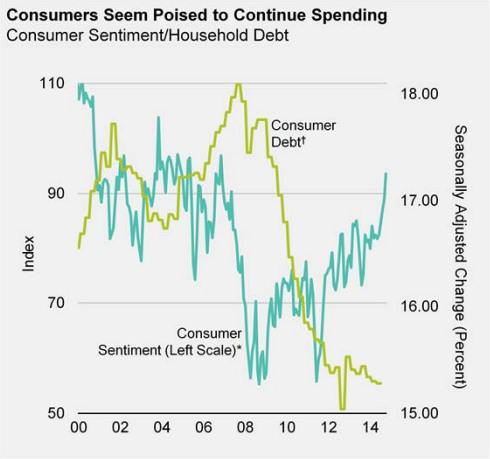
Let's look at job growth another way. If we piece together payroll data with other labor characteristics, as we do in the right display, it builds a stronger picture of job growth than top-line job numbers might indicate.

From January through November of 2014, initial payroll survey data showed about 2.4 million new jobs were added in the US. But those initial numbers have consistently been revised upward by another 214,000. Workers have also been putting in longer work weeks, and that's the equivalent of another 300,000 jobs in terms of additional income. In other words, longer work weeks are adding to overall consumer strength, Even though they aren't new jobs, the extra income is very real. And finally, workers in aggregate have received an hourly pay raise that's the income equivalent of another 400,000 jobs. So, in "income-equivalent" terms, the US has actually picked up about 3.3 million jobs.

The improving jobs picture is an important dynamic of the US expansion, because it creates the potential for stronger household consumption. Also, the higher tax receipts generated by a robust labor market help create better balance in the public sector, particularly for state and local governments. This, in turn, drives an important reversal from the growth drag we experienced from the public sector over the last five years.

US: Growth Continues, with Consumers Stepping Up





Historical analysis and current forecasts do not guarantee future results.
Left display: Quarter-over-quarter annualized growth through December 31, 2014. Right display: consumer sentiment through December 31, 2014; consumer debt through September 30, 2014
*University of Michigan Consumer Sentiment Index. †Household Financial Obligation Ratio.
Source: Bureau of Economic Analysis, Haver Analytics, University of Michigan, US Federal Reserve and AB

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In the left display, we look at the improving public-private balance in terms of GDP. This is quarter-by-quarter annualized GDP growth separated into the public sector contribution in grey and the private sector contribution in green.

You can see the public sector drag, which was present after the financial crisis, continued in the fourth quarter of 2013 and the first quarter of 2014. We've been discussing this relationship in a number of previous CMOs. You can also see the poor overall first quarter of 2014, which suffered from a stretch of bad weather and geopolitical concerns. However, later GDP revisions showed that the dip wasn't as severe as was initially thought.

Now, look at the growth rebound in the second quarter of 2014, with a 4.6% growth rate based on the most recent revision. Also, the public sector drag has turned around, becoming a modest positive contribution and a boost to GDP. Based on the most recently available data, third-quarter growth was revised up to 5%, the highest rate in over a decade. For the full year 2014, we think the final tally will end up at 2.5%, with growth increasing to 3.8% in 2015.

Strong consumption should play a big part in supporting economic growth. The improved jobs picture is translating into more income, and as we see on the right, consumers are feeling more optimistic about the future, evidenced by steady improvements in sentiment. Their household financial position is also much stronger today, judging by the steady decline in household financial obligations as a percentage of disposable income. Both trends support the potential for continued robust consumer spending.

On the corporate side, fundamentals are much-improved from the pre-financial-crisis period and should provide a good base for further business investment. We've discussed this issue in terms of the US for some time; we're expanding the discussion globally this quarter.

Corporate Fundamentals: Improved Globally, with US Stronger

	US		EAFE		Emerging Markets	
	Oct 31, 2007	Nov 30, 2014	Oct 31, 2007	Nov 30, 2014	Oct 31, 2007	Nov 30, 2014
Cash Flow per Share	$77.86	$181.66	$155.51	$181.56	$96.64	$121.66
Net Debt/Equity*	156%	41%	79%	58%	48%	50%
Return on Equity*	22%	22%	21%	15%	25%	18%
Free-Cash-Flow Yield*	3.5%	3.4%	4.2%	4.0%	2.9%	2.7%
Price to Forward Earnings	15.6x	16.7x	13.7x	14.1x	14.5x	10.8x

Better
Largely Unchanged
Worse

Historical analysis and current forecasts do not guarantee future results.
As of November 30, 2014
*Net debt/equity, return on equity and free-cash-flow yield are based on data from the AB US, International Developed, and Emerging Markets Large-Cap universes, capitalization weighted, excluding financials. Cash flow per share and price to forward earnings based on the S&P 500, MSCI EAFE and MSCI Emerging Markets indices. Price/forward earnings for next 12 months. An investor cannot invest directly in an index and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
Source: Bloomberg, Center for Research in Security Prices, MSCI, S&P Dow Jones and AB

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There are actually two important perspectives on corporate fundamentals if we look globally. One is the improvement we've seen in key metrics from before the crisis, and the other is the relative strength of US fundamentals versus other parts of the world.

In this display, we're looking at a few key indicators, both before the global financial crisis and today. We've added colored indicators that show whether that indicator is better, worse or largely unchanged today.

Cash flow per share has improved globally: in the US, other developed countries and emerging markets. The debt burden has been reduced dramatically in the US and significantly in other developed markets, while remaining roughly the same in emerging markets. Return on equity has held steady in the US while falling off elsewhere. The same trend holds true with free cash flow yield.

The relative strength of US fundamentals today is somewhat of a counterargument to the notion that equity valuations are a bit extended versus other regions. You can see the valuation profile in price to forward earnings ratios. US valuations aren't particularly cheap, but better quality argues for maintaining—or even overweighting—US stocks. On the flip side, fundamentals aren't as strong in other markets, but valuations are more attractive: effective research should enable active managers to uncover opportunities there as well.

Globally, strong fundamentals support both equities and fixed income corporate credit. However, as we've seen in other facets of the global economy and capital markets, investors will need to navigate divergences among regions, countries, sectors and individual securities.

Let's move away from the macro-level picture now and take a look at AB's perspective on individual asset classes. I'll start with fixed income.

US Rates: A Long Path to "Normal," as Market/Fed Debate Continues

Current analysis and forecasts do not guarantee future results.
As of December 31, 2014
*Longer-run expectations by the market are defined as expectations for the official rates on December 31, 2019.
†Yield curves projected based on historical analysis of Treasury yield curves and on applying the slope to the fed funds rate projections as implied by the forward market.
Source: Barclays, Bloomberg, US Federal Reserve and AB

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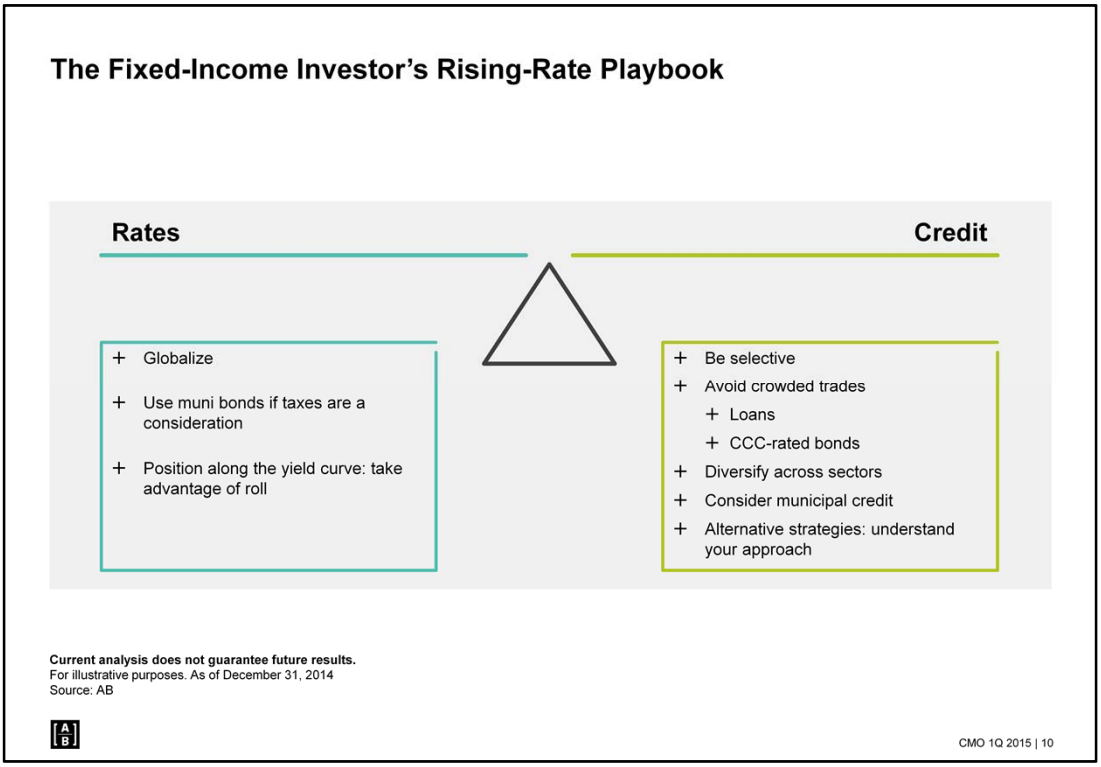
As the US economy continues to expand, the Federal Reserve has signaled its intent to begin raising policy rates this year to guard against overheating. Eventually, long-term rates will trend higher, too. Based on our assessment, the path to higher rates will be slow and steady, taking place over the next few years.

Let's take a look at the current policy rate projections from the Fed in the left display. This is the Fed's "Summary of Economic Projections," the so-called "dot plot." Each green dot represents the interest-rate projection of one member of the Federal Reserve Open Market Committee for policy rates at the end of each of the next three years. Opinions differ, but the general trend is upward, as we indicate with the larger blue dots—that's the median forecast.

Based on these numbers, short-term interest rates would rise from essentially zero right now to 1.5% by the end of 2015, and eventually to near 4% by the end of 2017. Based on yields observed in the bond market today (the red line), the market's view hasn't yet caught up to the Fed, and if the Fed's expected path holds, we'd expect some volatility as this adjustment takes place.

In either case, the path to higher rates is likely to be gradual, with the yield curve flattening: short-term rates should rise more than long-term rates. This is likely to support modest bond returns going forward: we don't think investors should be in fear of a major bond-market selloff like the ones in 1981 or 1994. The current adjustment is likely to take place over years.

In the meantime, bond markets should continue to provide investors with a reasonable source of income. In fact, as interest rates rise, there's also the opportunity to reinvest in even higher-yielding securities. Given these views, we're often asked how we would build a fixed-income portfolio today. Our answer is what we'd loosely call the "Fixed Income Investor's Rising-Rate Playbook".



The main focus of our suggested fixed income playbook is balance—specifically in terms of interest rates and credit. These two key factors drive fixed-income returns, and each represents both a source of opportunity and a risk factor that has to be managed and diversified effectively.

On the interest-rate side of the scale, we think going global can reduce exposure to single-country interest-rate risk. Interest-rate cycles of individual countries diverge from each other over time, providing diversification and the opportunity to add value from active management. If taxes are a consideration for US investors, muni bonds can help reduce the impact of rising Treasury rates. And positioning along the yield curve is critical to taking advantage of roll. Roll is the tendency of a bond's price to rise as it moves closer to maturity, assuming rates don't change. The steeper the yield curve, the more attractive the roll.

On the credit side of the scale we see pockets of opportunities, such as within subordinated financials or non-agency mortgages. But overall, it's important to be selective, because there aren't many areas of the market that are uniformly cheap today. Investors should avoid diving into crowded trades such as high-yield loans and CCC-rated high-yield bonds.

Alternative strategies can help diversify your fixed-income exposure, but it's important to do your homework on each individual strategy. Each one is distinctive, and they may carry unintended exposure to general interest rate or credit risk, or "beta," which could upset the balance in your portfolio design. Diversifying across credit sectors can expand the opportunity set in that segment while providing added diversification. Finally, credit seems particularly attractive in the muni space today.

Let's dig into each of these areas by taking a look at the case for going global in a core fixed-income strategy. This is another case where divergence in global economic and market patterns can create diversification and active-management opportunities.

Interest Rates: Policy Differences Create Active Opportunities in Global Bonds

Monetary Policy Influences Yields
Percent

	10-Year Bond Yield	Rating*
Australia	2.74	AAA
US	**2.17**	**AAA**
Canada	1.79	AAA
Germany	0.54	AAA
UK	1.76	AA+
France	0.82	AA+
New Zealand	3.68	AA+
Japan	0.32	A+
Spain	1.60	BBB
Italy	1.88	BBB
Portugal	2.65	BB

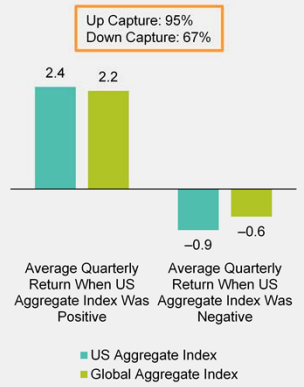
Yield Changes Drive Return Variances
Global Bond Returns Hedged to USD (Percent)†

2010	2011	2012	2013	2014
UK 7.2	UK 16.1	Euro Area 11.2	Euro Area 2.5	UK 14.2
US 5.9	US 9.8	UK 2.4	Japan 2.3	Euro Area 13.1
Canada 5.6	Australia 8.9	Japan 2.2	Australia –2.4	Australia 8.3
Japan 2.9	Canada 8.3	US 2.0	US –2.8	Canada 6.5
Euro Area 1.0	Japan 2.6	Australia 1.4	Canada –3.1	US 5.1
Australia 0.3	Euro Area 2.6	Canada 1.4	UK –4.4	Japan 4.7
6.9	13.5	9.8	6.8	9.5
Gap between best and worst				

Best Performer

Worst Performer

Global Bonds: Better Return Profile
Up vs. Down Capture (Percent)
Mar 1990–Dec 2014



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As of December 31, 2014
*Credit rating is a measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition. AAA is highest (best) and D is lowest (worst).
†Returns represented by Barclays government bond indices. An investor cannot invest directly in an index and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
Source: Barclays, Bloomberg and AB

The display on the left is what we refer to as our "league table." It compares 10-year government bond yields in different regions and countries.

We discussed earlier how short-term policy rates are beginning to diverge globally. These rates have some influence on longer-term bond yields, and distinctions have emerged among these maturities, too. While many investors consider 10-year US Treasury yields to be low, yields on government bonds in other countries such as Germany or Japan are even lower Joining the US at the other end of the spectrum are New Zealand and Australia. These different yield levels create ample opportunities for global investors.

Given the divergent monetary policies we expect, the yield trajectories of individual countries should offer quite a bit of variety globally. The US is expected to raise policy rates, for instance, while the euro area and Japan will likely become more accommodative—it's not hard to envision rates in those areas staying low or even falling further. Yields in the UK could rise, given comments from the Bank of England about possible rate hikes and the better quality of economic growth there.

Over time, yield levels and policy stances are major influences on country bond returns, which we show in the middle display in US dollar hedged terms. Historically, the world's bond markets haven't traveled in lockstep—instead, they trade leadership year to year. The US was near the top in 2010 and 2011 but finished in the middle of the pack in 2012 and 2013. In 2013, Japan was near the top of the "high-grade" country ranks, but last in 2014. In the euro area, strong performance in countries like Spain and Italy contributed to the region's stronger overall number. In 2014, despite strong US Treasury returns from falling yields, the US lags.

These variable return patterns underscore the importance of global fixed income investing, both as a risk diversifier and a potential source of alpha relative to investing in US government bonds alone. No single country wins all the time. And the big differences between the best and worst country returns in each year highlight the opportunities for active global bond managers.

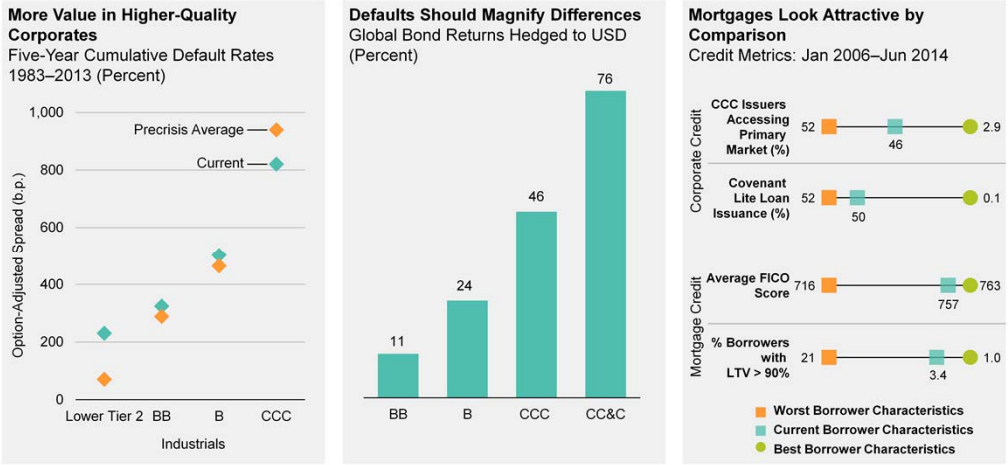
But it's important to hedge out currency exposure. Currency adds a lot of volatility to global bond returns without adding return over the long run. We think it's better to hedge foreign currency exposure to US dollars (or another home currency) and take very select and small currency positions backed by strong conviction and research. Adding such a hedged global bond strategy to a fixed-income portfolio has historically produced more attractive risk/return patterns for investors.

In the right display you'll see that, hedged global bonds have captured most of the upside from rising US bond markets while reducing the downside in selloffs. Going back to 1990, the average return for the Barclays US Aggregate Index in positive quarters has been 2.4%; global bonds nearly match that with a return of 2.2%. The average return for the US Aggregate in down quarters has been –0.9%, while global bonds have declined by only –0.6%.

So, how much global is enough? Our historical research shows that as investors add more hedged global bond exposure, returns have stayed relatively constant but volatility has declined substantially. As a result, any allocation to global has historically improved risk-adjusted returns. There is no particular "sweet spot," and an investor doesn't have to move to 100% hedged global to see results—even a 10%, 20% or 50% allocation has shown better risk-adjusted returns than a single-country allocation.

On the credit side of the scale, we still see credit as attractive and we see pockets of opportunities, but we think investors should be selective.

Credit: Still Attractive, but Investors Must Be Selective



Historical analysis does not guarantee future results.
Left display as of December 31, 2014. Precrisis average for BBs, Bs and CCCs is for the period September 30, 1995–December 31, 2007; precrisis average for Tier 2 is for the period January 31, 2001–December 31, 2007. A credit rating is a measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition. AAA is highest (best) and D is lowest (worst). Ratings are subject to change. Investment-grade securities are those rated BBB and above. Mortgage credit data reflects Freddie Mac averages for cohorts from 2006 to 2013 for loans with original loans to value of 60%–80% and excludes loans with mortgage insurance.
Source: Bank of America Merrill Lynch, Barclays, Freddie Mac, Moody's Analytics, Trepp and AB

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We see better value in higher-quality credits than in lower-quality issues. The corporate bond spreads in the left display tell the story. Yield spreads for financial bonds that are subordinated in the capital structure are somewhat inexpensive today compared with their pre-financial-crisis averages. BB-rated spreads are essentially in line with pre-crisis levels, and for B-rated bonds, spreads are somewhat tighter today.

Now look at CCC-rated bonds: yield spreads are much tighter today that they were before the crisis, so investors aren't receiving nearly as much compensation as they were for taking the greater risk of investing in lower-rated bonds.

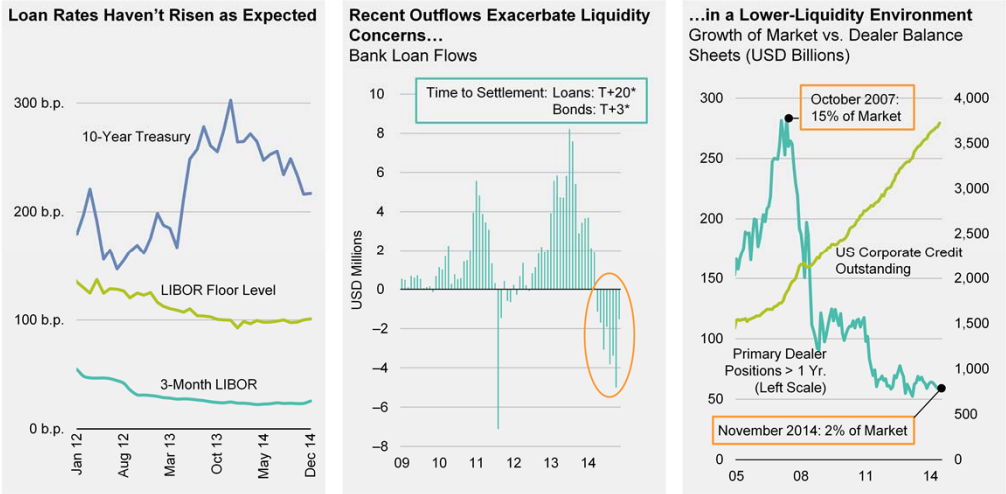
Not only are these bonds expensive, but we believe they're particularly overpriced compared with the higher default rates investors expect, which we show in the middle display. The historical cumulative five-year default rate for B-rated bonds is about 25%, but it's nearly 50% for CCC-rated bonds and 75% for bonds rated less than CCC. We don't believe that higher defaults should be a big concern for investors yet, but the low level of compensation for that type of risk should be viewed with caution, in our view.

Instead, investors should consider exploring opportunities in mortgage-related securities, which we think look attractive by comparison to lower-rated credit. Mortgage-lending standards are very tight: this is frustrating for borrowers, but it also means the loans that are made tend to be high-quality and to creditworthy borrowers. As we show on the right, several mortgage credit metrics—including the average FICO score and loan-to-value ratio—are at or near their best levels since 2005. The opposite is true when it comes to syndicated bank loans and high-yield bonds.

This makes sense, given that it's still relatively early in the housing recovery, even as bank loans and high-yield bonds are moving further into their credit cycle. In that part of the cycle, underwriting standards tend to weaken.

One area that we don't view as a big opportunity—contrary to previous heavy inflows—is the bank-loan space.

Credit: Bank Loans Still Seem Unattractive



Current analysis does not guarantee future results.
Left display through December 31, 2014; middle and right displays through November 30, 2014
*T=trade date
Source: Barclays, Bloomberg, Credit Suisse, Haver Analytics, J.P. Morgan, the Loan Syndications & Trading Association, US Federal Reserve and AB

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Many investors have looked to high-yield bank loans as a way to take part in a rising-rate environment through a floating-rate investment. But this is a big misconception, in our opinion.

Remember that "resets" in bank loan rates only happen when there's an increase in LIBOR, the London Interbank Offered Rate. And almost 100% of newly issued bank loans have an interest-rate floor (the light blue line in the left display) that's tied to three-month LIBOR rates (the green line). The rates on loans only reset (upward) if LIBOR climbs above that floor. But look what happened when 10-year Treasury yields (the dark blue line) spiked leading up to the end of 2013. LIBOR actually decreased modestly. As a result, loan-fund yields never came close to the floor rate—and investors never received higher yields.

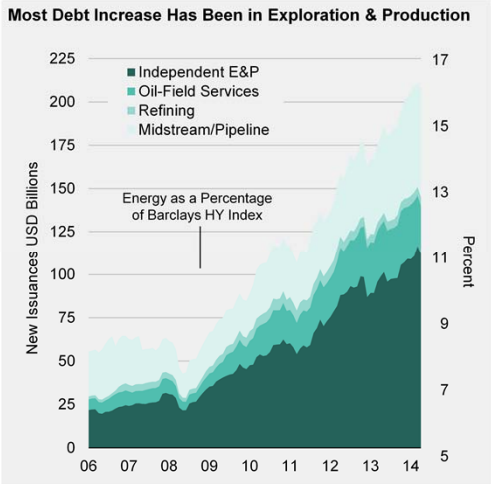
Recent outflows, which you can see in the middle display, have exacerbated liquidity concerns that already existed for bank loans because of their different transaction rules. Transactions for the average high-yield loan settle 20 business days after the date a trade is made. That's a long time for investors to wait to get their money after a trade, especially compared with the three-day settlement period for high-yield bonds.

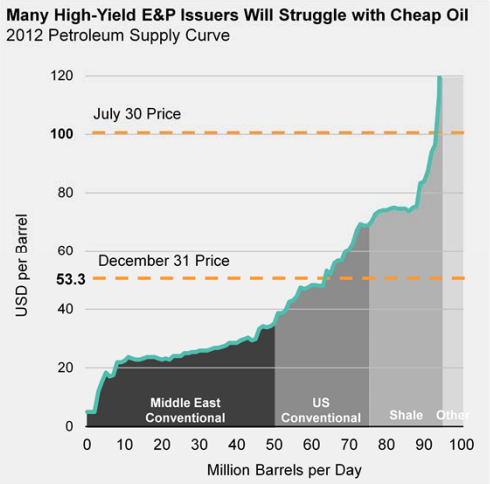
These liquidity concerns are compounded by an environment that already features reduced liquidity. The chart on the right shows that primary dealer's inventories, which are important in facilitating secondary market trading, have fallen dramatically since the global financial crisis. This has happened even as the credit market has continued to expand. So, the ratio of available liquidity to the size of the overall credit market has fallen significantly since the crisis.

Liquidity risk, like other risks, compensates investors who are able and willing to provide liquidity, or money and time, but liquidity risk has to be managed carefully. In addition to bank loans, we've seen illiquidity be an issue in other credit areas including CCC-rated bonds and the energy sector.

In the case of energy bonds, it's important to distinguish between issuers and segments of the industry that are more at risk and those other areas that may present opportunities.

Credit: Not All Energy Sectors Are Alike





Historical analysis does not guarantee future results.
Left display through October 31, 2014; right display as of December 3, 2014
For illustrative purposes only.
Source: Barclays, J.P. Morgan and S&P Leveraged Commentary & Data

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With crude oil prices collapsing, investors are worried about the implications for debt-heavy energy companies who are now facing much lower revenue streams, which makes it more difficult to service and manage that debt.

After rapid growth in debt over the past several years, energy is now one of the biggest sectors in the high-yield market, as you can see from its share of the Barclays High Yield Index—that's the blue line on the left display. There are concerns that debt problems or bankruptcies in that sector could ripple through the banking and financial system, hurting the broader economy.

But not all subsectors of the energy industry are cut from the same cloth. Also in the left-hand display, you can see that the biggest buildup in energy debt has been in the independent exploration and production space. That's the dark green shaded area in the left display, which shows the heavy cumulative debt issuance since about mid-2009. This presents a more focused view of where the real debt concentration is within energy. By contrast, areas such as pipelines and refiners have grown much less in debt—and they depend much more on volume, rather than prices, for their financial health.

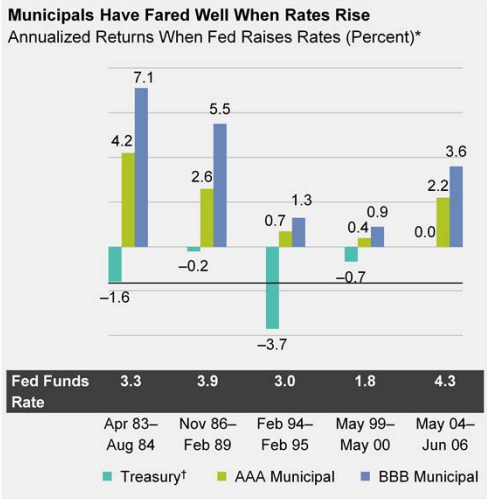
However, low oil prices will be a real challenge for independent E&P; we show why on the right. The grey area shows cumulative oil supply in millions of barrels per day at various price levels that makes economic sense. Lower-cost producers, such as Middle East conventional, are on the left, with higher-cost producers toward the right, including shale producers.

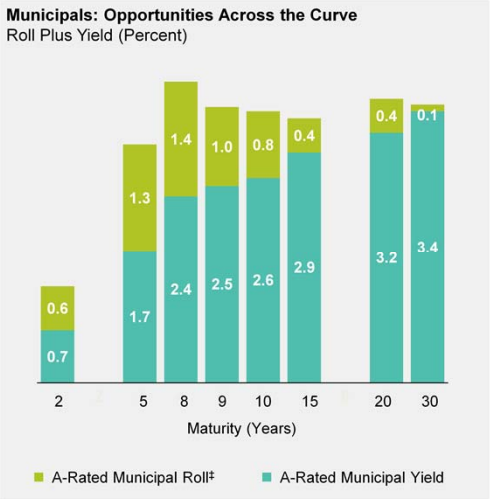
We've added two blue lines, one representing the $100 per barrel price on July 30, and the other showing the December 31 price of $53 per barrel. At a price of $53, almost every shale producer finds it uneconomical to produce, and even higher-cost conventional oil producers struggle. Again, we don't expect oil prices to stay this low indefinitely, and combinations of available capital and higher oil prices locked in through the futures market will likely put off significant challenges through much of 2015. However, from an economic standpoint, it could eventually cause significant pain for many independent oil producers.

Given the presence of some crowded areas and other risky segments within credit, we think investors need to be selective in their exposure, and investing across multiple high-income sectors is a good way to expand the universe of opportunities and diversify risk.

On the tax-exempt side of fixed-income markets, we think investors with taxable bond accounts should look at municipal bonds, which we feel offer attractive yields and credit potential, and can dampen the impact from rising rates.

Municipals: Strategies in a Rising-Rate Environment





Historical analysis does not guarantee future results.
Left display through May 30, 2014; right display as of December 31, 2014
*Bonds with five-year maturities. †After-tax returns. ‡Roll is the natural price gain that a bond experiences as it ages, assuming interest rates are unchanged.
Source: J.P. Morgan, Municipal Market Data, US Federal Reserve and AB

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With interest rates expected to rise, the characteristics of municipal bonds may provide insulation from the impact…and offer opportunities across the yield curve.

On the left, we're looking at the annualized returns of several bond segments in periods when the Federal Reserve raises short-term interest rates. Since we expect them to begin hiking this year, this is a particularly relevant analysis.

Treasury bonds, shown by the dark blue bars, underperformed or were flat in each of the periods shown. Generally, the underperformance was more pronounced when short-term rates were hiked substantially and quickly. Municipal bonds, because they tend to have a reduced sensitivity to changes in Treasury yields, actually posted positive returns in each period, as indicated by the green bars. If we add in the credit aspect by showing BBB-rated munis (the light blue line), the performance was even stronger when rates rose.

So, municipal bonds—particularly credit—have historically been a good play when the Fed has been raising short-term rates. We believe that the example of BBB munis illustrates the notion of balance from earlier: blend interest-rate and credit risk while taking advantage of more efficient types of rate risk (global hedged bonds and munis) and uncrowded or "smarter" types of credit risk (such as non-agency mortgages, subordinated financials, and muni credit).

There's one more interest-rate efficiency we've talked about previously, and that's investing in the smart part of the yield curve. On the right, we take a look at muni strategies to consider, including credit exposure, across the yield curve. We're showing yields plus roll for municipal bonds at different maturity ranges, grouped into short, intermediate and long-term.

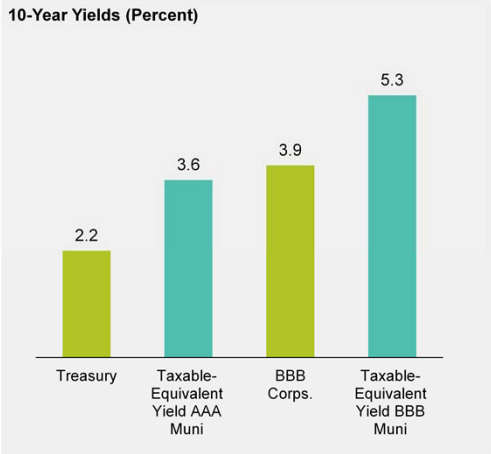
We think credit exposure makes sense at longer maturities, simply because investors essentially have to take on longer-term bonds to access much of the available credit supply. From a high-grade perspective though, we still see the "sweet spot" of the yield curve as intermediate to intermediate/long maturities, in terms of combined yield and roll potential.

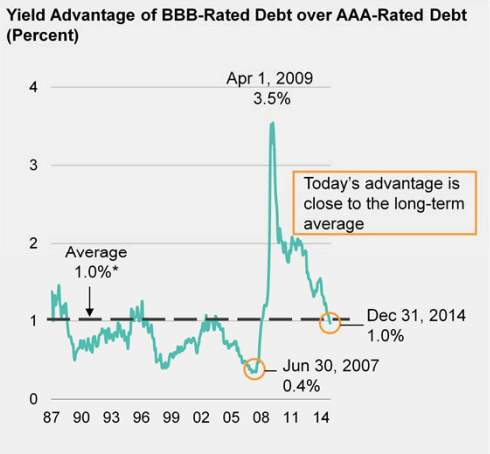
We've talked about the power of roll for some time. Roll is the natural price gain a bond experiences as it moves closer to maturity, assuming interest rates don't change. This display shows the combined potential of yield and roll. For a 10-year AA-rated muni bond, as shown by the green and blue bars in total, it was about 3.5% at the end of September.

Using roll may enhance returns, but there are risks associated with investing in bonds for a longer period of time, including interest-rate risk. Again, that's why we focus on the "smart" part of the curve in munis. For instance, yield plus roll is about the same for a 10-year bond as a 30-year bond, which carries significantly more interest rate risk and volatility!

At the short end of the municipal bond yield curve, there are challenges with a lack of municipal supply and resulting low bond yields. At this range, investors' tax brackets come into play, and in some cases taxable bonds may be a better—or at least equal—choice. We're showing 1–3 year maturity non-government bond yields on an after-tax basis here (at the highest tax bracket), and they're roughly the same as those of AA-rated municipal bonds.

Municipals: Attractive Yields and Credit Potential





Historical analysis does not guarantee future results.
Left display as of December 31, 2014; right display through December 31, 2014. Nominal yields. A credit rating is a measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition. AAA is highest (best) and D is lowest (worst). Ratings are subject to change. Investment-grade securities are those rated BBB and above. Barclays long indices are used for each respective rating category. Credit spreads shown are for 10-year municipal securities.
*The long-term average was measured from January 1, 1987 through September 30, 2014.
Source: Barclays, Municipal Market Data, US Department of the Treasury and AB

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The muni opportunity is highlighted by comparing muni bond yields with their taxable peers on the left display. The 10-year Treasury yield is 2.5% while the 10-year AAA municipal bond yield, after adjusting for the tax-advantaged nature of muni income, is very attractive at 3.8% (the middle blue bar), assuming the highest income-tax bracket.

Given the still-attractive level of muni credit spreads, we also compare the 10-year BBB rated corporate bond at a 3.9% yield to the tax-equivalent yield of the BBB-rated muni bond, which is much higher at 5.8%. So, if you look at the valuations, muni bonds—on a tax-equivalent basis—are attractive versus taxable bonds.

We put the muni credit premium into historical perspective in the right-hand display, which shows the yield spread of BBB municipal corporate bonds versus AAA rated municipals over time. Historically, this credit premium has averaged about 100 basis points.

The premium has dipped as low as 35 basis points in 2007, and it's risen as high as 3.5% in early 2009. Today, BBB municipals yield just over one percent more than AAA municipals—a level that's about average historically. So taking credit risk offers solid risk compensation.

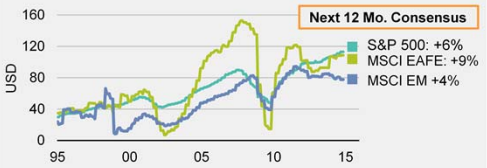
Now, let's turn to equity markets.

US Equity Market: Looking Back, Looking Forward

AB's Perspective at Beginning of 2014

- Strong corporate fundamentals
- Solid earnings growth
- Higher revenue growth if global GDP growth improves
- Margins high but sustainable
- Shareholder-friendly corporate actions will continue
- Valuations extended but sustainable
- Rising interest rates not a challenge for equity returns
- High-conviction active equity strategies can capture upside to market returns and/or provide downside protection

Earnings per Share (EPS) Have Continued to Rise*



Earnings Growth to Drive Stock Returns (Percent)

Past performance and current forecasts do not guarantee future results.
As of November 30, 2014
An investor cannot invest directly in an index and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
Columns may not sum due to rounding.
*Trailing 12-month EPS; next 12 months' consensus EPS growth is the next four quarters' consensus EPS versus the current trailing 12-month EPS.
†Five-year annualized expected return for US equities uses AB proprietary Capital Markets Engine forecasts. Chart reflects composition of expected US equity returns.
Source: Bloomberg, MSCI, S&P Dow Jones and AB

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We thought it would be interesting to look at how 2014 turned out for US equities compared with our own expectations at the beginning of the year, which we've shared in previous CMOs. At the beginning of 2014, we thought the widespread concern about overvaluation in the US equity market was overdone. Instead, we had a constructive outlook based on the following insights and observations:

- Continued strong corporate fundamentals
- Solid earnings growth
- Higher revenue growth, if global GDP growth improves
- High but sustainable margins
- Continued shareholder-friendly corporate actions, including dividends and buybacks
- Extended but sustainable valuations
- Rising interest rates shouldn't be a challenge for equity returns—in this case, we still believe that, and rising rates didn't actually turn up in 2014
- And finally, high-conviction active equity strategies can capture upside to market returns and/or provide downside protection

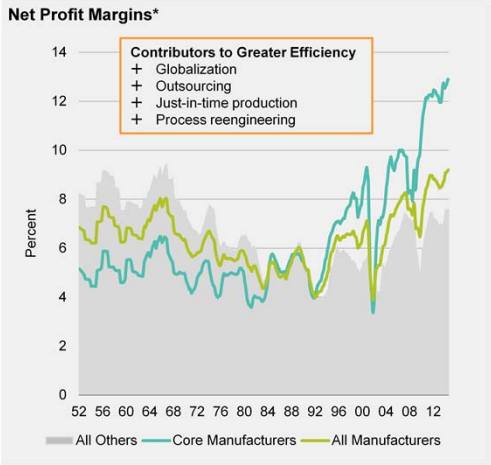
Happily for investors, this outlook largely played out in 2014, with a solid year for equities.

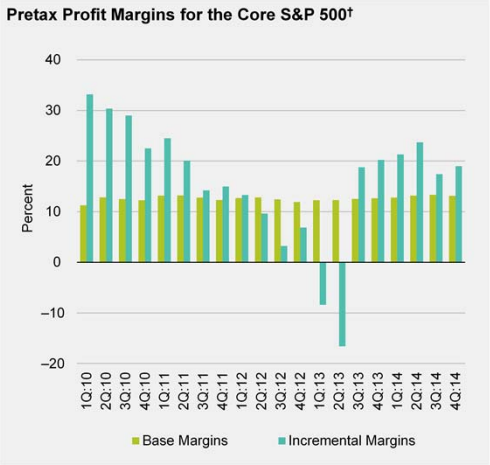
To start looking ahead, let's focus first on one of those bullet points: we did indeed see solid earnings growth in 2014, and we expect that to continue in 2015, as we show on the upper right. In 2015, the market consensus is for earnings to grow by 6% for US stocks, 9% for non-US stocks and 4% for emerging-market stocks. With valuations extended, we think this earnings growth will be the main driver of equity total returns, as you can see from the lower right chart detailing return sources.

The sources of equity returns vary over time. Over the next five years, our analysis indicates that earnings growth will contribute more than four percentage points of the 6.6% expected equity return. Dividends should account for more than two percentage points. As mentioned, the third driver, valuation changes, isn't expected to provide much contribution. As we see it, price/earnings ratios are a bit stretched for US stocks, both versus their own history and versus other regions today. So, there's not as much room today for US valuations to expand.

Even if valuations don't provide much of a return boost, we think rising profits will. As we've discussed in previous CMOs, US profit margins are already fairly high, and we think greater efficiency should keep them high and potentially rising.

Better Efficiency Supports High and Rising Incremental Margins





Historical analysis does not guarantee future results.
As of November 30, 2014
*1952 through 3Q:2014E. Trailing four-quarter data. Smoothed on a trailing three-month basis. Manufacturers include 173 companies with at least some manufacturing business.
†Excludes financials, energy and utilities. Base margins are one-year trailing operating earnings divided by revenues; incremental margins are year-on-year change in quarterly operating earnings divided by year-on-year change in quarterly revenues; 3Q:14E and 4Q:14E
Source: Empirical Research Partners, S&P, corporate reports and AB

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Where has this efficiency come from? As we show on the left, it has, and will, come from several sources. There will be continued benefits from globalization and outsourcing of some parts of the value added chain. We'd also include the further use of just-in-time production, which makes the production cycle more efficient. And reengineering of processes should wring more efficiency from them.

We think these trends will continue to provide incremental improvements to corporate margins. While overall margins are high, we'd note that there have been big gains in the manufacturing sector (the green line), which benefits most from the trends we just discussed. These gains have actually pulled up the overall net profit margin for equities. So, margins aren't quite as elevated across the rest of the market as they may seem from the overall number.

This makes the case for potential incremental margin increases. As we show on the right, base margins, the blue bars, have risen or remained relatively stable over the past four years or so, but we've seen pretty consistent and sizable gains in incremental margins (green bars) based on incremental top-line revenue growth quarter by quarter. In other words, once fixed costs are covered, each additional dollar of revenue actually adds to the overall margin—and therefore profitability.

Some investors are concerned that rising rates will hurt margins by increasing debt-servicing costs. However, businesses have already taken steps to head off this potential headwind.

Rising Interest Rates Are Unlikely to Hurt Profit Margins

Interest Expense Declined as Rates Fell
Interest Expense as Percent of Sales

Companies Extended Maturities to Lock in Low Rates
Long-Term Debt as Percent of Total Debt

Historical analysis does not guarantee future results.
Through December 31, 2014
Data is for US large-cap stocks, excluding financials
Source: S&P Compustat and AB

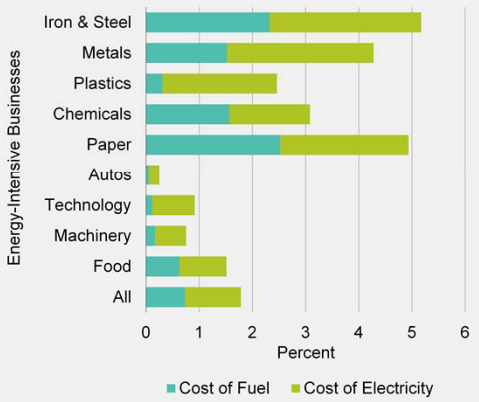
Corporations have taken advantage of the long-term decline in interest rates to address their interest expenses head on. Coming out of the last global financial crisis, firms began taking advantage of falling interest rates to strengthen their balance sheets and restructure debt. As a result, interest expenses on debt have fallen sharply as a percentage of sales.

We expect this benefit to continue. One of the biggest contributors has been the “terming out” of debt, which is illustrated on the right. Firms extended their debt into longer maturities to lock in lower interest rates on the amounts they owe. You can think if this long-term restructuring of debt expenses as a gift that should keep on giving in terms of supporting high profit margins, even in a rising rate environment.

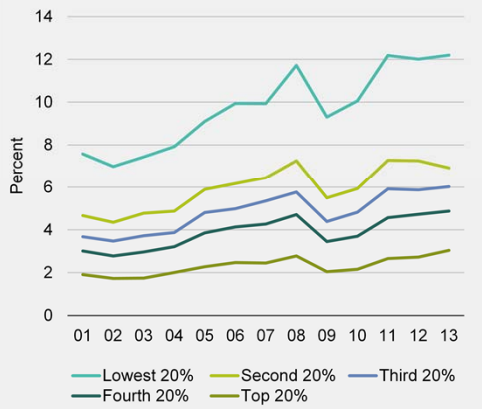
As we mentioned in the first section, another development that’s currently helping both corporate and household finances is the sharp decline in oil prices in 2014.

Falling Oil Prices a Boon for US Manufacturers and Consumers

Cheaper Oil Helps Energy-Hungry Industries…
Energy Costs of US Manufacturing Plants as Percent of Total Expenses*



…and Helps the US Low/Middle-Income Consumer Most
After-Tax Income Spent on Gasoline by Income Quintile†



Historical analysis does not guarantee future results.
Left display as of November 30, 2014; right display as of December 31, 2013
*2012 Annual Survey of Manufactures.
†Quintiles formed based on income before taxes, showing the percent of income after taxes spent on gasoline and motor oil.
Source: Empirical Research Partners, US Bureau of Labor Statistics and AB

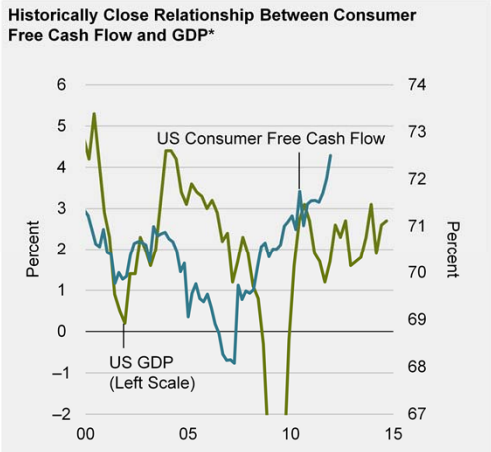
On the left, we show energy costs for US manufacturing plants in energy-intensive sectors. We've divided the bars into fuel expenses and electricity expenses. The green segment represents fuel costs. Some "energy-intensive" industries would see a bigger benefit from lower oil costs.

On the right, we indicate the potential consumer-sector impact of cheaper oil. Over the long term, all households have spent a growing percentage of their after-tax incomes on gasoline and motor oil, as prices have risen. Here, we've separated those cost percentages into quintiles based on pre-tax household income levels.

Lower-income households spend a bigger chunk of their income on these items, so if higher oil prices are considered as a "tax" on the ability to spend, it has a bigger impact on lower income consumers. But it certainly impacts all consumers. It stands to reason, then, that the reverse is true: falling oil prices mean energy subtracts less household income at all levels, and this translates into more overall spending potential for other items. We don't expect this windfall to last indefinitely, but it's likely to provide an important boost to consumers and businesses while it lasts.

So let's recap. We think margins can be sustained at high levels, and that the incremental earnings growth should support the equity market. Following from that, sales growth will be the key to driving earnings improvements moving forward.

Accelerating US Economic Growth Leads to Sales Growth



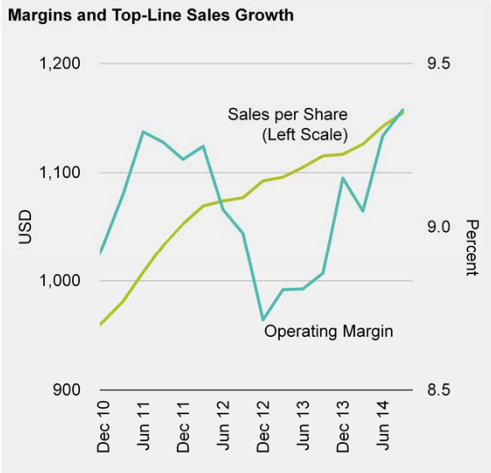
Past performance and current forecasts do not guarantee future results.
Through September 30, 2014
*Year-over-year GDP vs. consumer free cash flow advanced 12 months forward
†Consensus sales growth estimates. Forecast data is for 4Q:14 vs. 4Q:13 and for 4Q:15 vs. 4Q:14
Source: Bloomberg, Cornerstone Macro, FactSet, S&P and AB

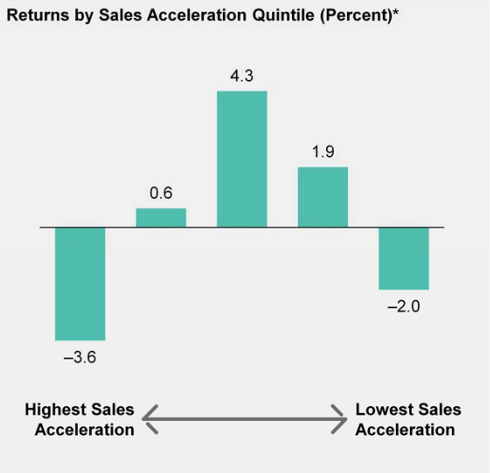
Contributing to that sales growth will be the consumer tailwind created by lower energy expenditures. This tailwind should drive stronger consumer spending, which further supports our call for accelerating US GDP. Historically, there's been a close relationship between consumer's free cash flow and GDP growth, which we show on the left hand display.

That GDP growth, particularly in a low-inflation environment, should benefit top-line sales growth for large-cap companies. Corporate revenue growth is heavily driven by GDP growth, so our constructive outlook for GDP—with real GDP growth on the order of 3% to 4%, combined with inflation expectations of about 2%, can lead to sales growth of 5% to 6%, which we show in the right. That's solid top-line growth for businesses, and should support further earnings growth.

Given the importance of sales growth to corporate profits, we favor high-conviction active equity strategies that focus on firms that can produce high-quality, sustainable—but not necessarily spectacular—growth.

High-Conviction Active Equity: Preference for Sustainable Growth





Historical analysis does not guarantee future results.
Left display through September 30, 2014; right display through November 30, 2014
*Returns for the largest 1,500 US stocks by market cap sorted into sales growth quintiles from January 1, 1969 to November 30, 2014
Source: CRSP, Empirical Research Partners, MSCI, S&P Dow Jones and AB

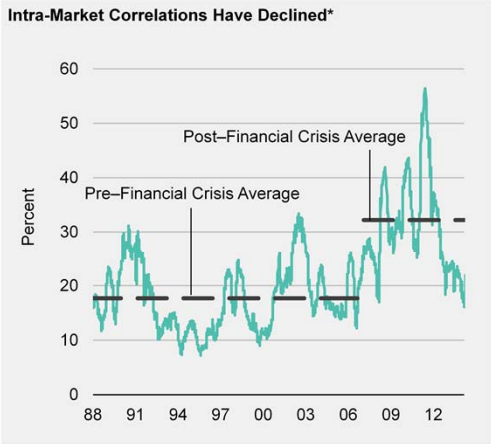
On the left, corporate margins, as we've mentioned, have been consistently high the last few years. As mentioned, we expect stable, but not substantially improved, margin expansion moving ahead. Instead, top-line sales, which continue to grow, should be mainly supportive of further earnings growth.

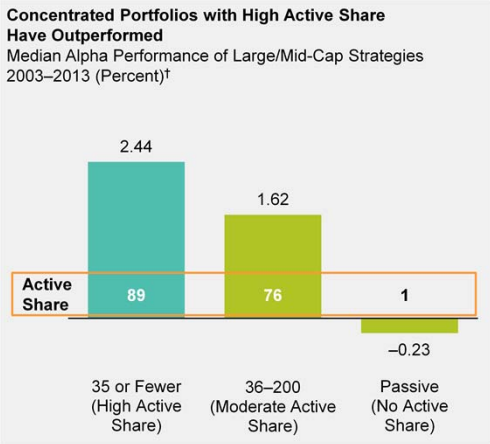
Here's something interesting about top-line growth. Historically, it hasn't been ultra-high top-line sales growth that has produced the most successful stocks—it's solid and consistent growth. We can see this in the right display, which shows the return attributable to sales acceleration dating back to pe-1970. Stocks with the highest sales acceleration have actually underperformed, as they typically disappoint investors' expectations.

Why? Very high sales-growth is usually not sustainable, and as these companies eventually begin to falter, their stocks are punished by the market. Similarly, investors also punish companies to the right, which post sales-growth acceleration that's too low. What actually outperforms over full cycles are the "Goldilocks" stocks in the middle of the chart—their sales growth may not be spectacular, but it's solid and tends to be more sustainable and consistent over time.

Once investors have identified good stocks, we think the current environment makes it preferable to concentrate portfolios on the best ideas

High-Conviction Active Equity: Preference for Concentrated Approaches





Historical analysis does not guarantee future results.
Left display through December 15, 2014; right display through December 31, 2013
*Daily average pairwise correlation of global stock returns based on the MSCI World Index
†Includes a universe of 1,253 large- and mid-capitalization US equity separate accounts with a minimum three-year track record and $100 million in strategy assets; 231 strategies have less than 35 stocks, 1,022 fall into the 36–200 bucket, and passive is represented by the top largest passive strategies (benched to the S&P 500). All data is shown gross of fees. Active share is a five-year average.
Source: Bloomberg, Lipper, Morningstar, MSCI, S&P Dow Jones and AB

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As you can see on the left, correlations among individual stock returns have fallen just about back down to their pre-financial crisis average.

Lower correlation means that individual stock returns aren't traveling in lockstep directionally as they were for much of the period after 2008, when macroeconomic issues drove stock returns to a greater degree. With correlations falling, and with divergence in earnings growth developing, individual company fundamentals are more likely to drive returns, rather than general market sentiment. This should provide active managers with the opportunity to find winners and avoid losers.

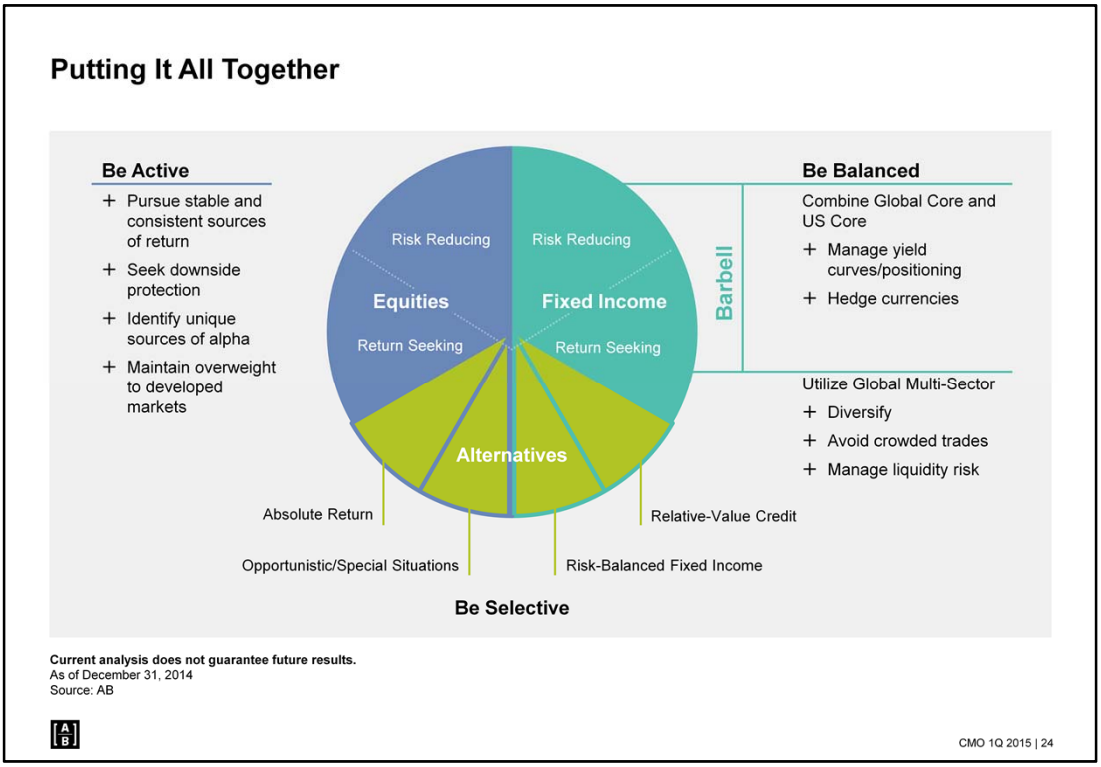
In the right display, we make a case for concentrated investing: in other words, focusing on the quality of stocks when building portfolios. By using research to focus on fewer but higher-quality stocks, we think concentrated investing has the potential to add substantial value through security selection—particularly in an environment where stock picking is rewarded.

To put numbers to this concept, we've segmented US equity managers relative returns based on the number of positions they hold. We'll call managers with 35 or fewer stocks "concentrated" active managers. These managers tend to have very high "active share." Active share gauges the level of active exposure for a manager by measuring the percentage of portfolio stock holdings that differ from those of the benchmark: the higher the active share, the more differentiated the manager relative to the benchmark.

Managers with 36 to 200 stocks can be referred to as "traditional" active managers. As a group, they have a fairly high active share, but it varies greatly within the category. Managers with more than 200 stocks are effectively "passive" investors with low active share.

Historically, concentrated managers have been very successful over investment cycles. The median concentrated manager has delivered 2.3% annualized excess returns over the last five years and 2.4% over the last 10 years. Traditional managers have also produced excess returns, though lower than those of concentrated managers (1.26% over five years and 1.62% over 10 years). Passive managers have posted slightly negative excess returns over both time periods. Sometimes, there's power in fewer stock holdings.

So, let's put it all together by looking at our perspective framed in the context of overall portfolio construction.



On the fixed income side, the buzzword is “be balanced.” We continue to suggest a balance between risk-reducing high-grade interest-rate risk and return-seeking credit-based risk. Both rates and credit should be global and multi sector. Within high-grade, the focus should be on which country yield curves and where on those curves to invest, but the currency exposure should be hedged to reduce volatility, which can be considerable—as seen in the divergent currency returns earlier. Within credit, our best idea remains diversification, including avoiding crowded trades such as bank loans and energy debt. And finally, it’s important to manage liquidity risk—the changing cost of security transactions across markets.

Within equities, the buzzword is “be active.” We expect reasonably solid market returns over the next couple years, but the real value is in the ability to differentiate between winners and losers in capital markets as divergences occur. For us, that means focusing on high-conviction, more-concentrated strategies. In addition, we’d suggest an overweight in risk-reducing equity strategies that may help in navigating potential volatility going forward.

This idea of downside protection is why we see value in including alternatives over the coming years. But we think the exposures should focus on two areas: beta management or downside protection, and alpha-driven absolute-return approaches that take advantage of divergences among securities and sectors. This could include long/short equity and credit strategies as well as special situations or opportunistic investments that take advantage of discrepancies in relative valuations and elevated liquidity premiums. And finally, in line with our fixed-income approach, an alternative strategy that is risk-balanced and doesn’t track a specific benchmark could be helpful.

Thank you. I’d be happy to take your questions now.

A Word About Risk

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Important Risk Information Related to Investing in Equity and Short Strategies

All investments involve risk. Equity securities may rise and decline in value due to both real and perceived market and economic factors as well as general industry conditions.

A short strategy may not always be able to close out a short position on favorable terms. Short sales involve the risk of loss by subsequently buying a security at a higher price than the price at which it sold the security short. The amount of such loss is theoretically unlimited (since it is limited only by the increase in value of the security sold short). In contrast, the risk of loss from a long position is limited to the investment in the long position, since its value cannot fall below zero. Short selling is a form of leverage. To mitigate leverage risk, a strategy will always hold liquid assets (including its long positions) at least equal to its short position exposure, marked to market daily.

Important Risk Information Related to Investing in Emerging Markets and Foreign Currencies

Investing in emerging-market debt poses risks, including those generally associated with fixed-income investments. Fixed-income securities may lose value due to market fluctuations or changes in interest rates. Longer-maturity bonds are more vulnerable to rising interest rates. A bond issuer's credit rating may be lowered due to deteriorating financial condition; this may result in losses and potentially default, or failure to meet payment obligations. The default probability is higher in bonds with lower, noninvestment-grade ratings (commonly known as "junk bonds").

There are other potential risks when investing in emerging-market debt. Non-US securities may be more volatile because of the associated political, regulatory, market and economic uncertainties; these risks can be magnified in emerging-market securities. Emerging-market bonds may also be exposed to fluctuating currency values. If a bond's currency weakens against the US dollar, this can negatively affect its value when translated back into US-dollar terms.

Bond Ratings Definition

A measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition, and not based on the financial condition of the fund itself. AAA is highest (best) and D is lowest (worst). Ratings are subject to change. Investment-grade securities are those rated BBB and above. If applicable, the Pre-Refunded category includes bonds which are secured by US government securities and therefore are deemed high-quality investment grade by the advisor.

[Read to audience]

Index Definitions

Following are definitions of the indices referred to in this presentation. It is important to recognize that all indices are unmanaged and do not reflect fees and expenses associated with the active management of a mutual fund portfolio. Investors cannot invest directly in an index, and its performance does not reflect the performance of any AB mutual fund.

Barclays EM USD Aggregate Index: A flagship hard-currency emerging-market-debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign and corporate EM issuers. The index is broad based in its coverage by sector and by country, and reflects the evolution of EM benchmarking from traditional sovereign bond indices to aggregate-style benchmarks that are more representative of the EM investment choice set.

Barclays Global Aggregate–Corporate Bond Index: Tracks the performance of investment-grade corporate bonds publicly issued in the global market found in the Global Aggregate. (Represents global corporate on slide 1.)

Barclays Global High Yield Index: Provides a broad-based measure of the global high-yield fixed-income markets. It represents the union of the US High Yield, Pan-European High Yield, US Emerging Markets High Yield, CMBS High Yield and Pan-European Emerging Markets High Yield indices. (Represents global high yield on slide 1.)

Barclays Global Treasury: Australia Bond Index: Includes fixed-rate, local-currency sovereign debt that makes up the Australian Treasury sector of the Global Aggregate Index.

Barclays Global Treasury Bond Index: Tracks fixed-rate, local-currency sovereign debt of investment-grade countries. The index represents the Treasury sector of the Global Aggregate Index and currently contains issues from 37 countries denominated in 23 currencies. The three major components of this index are the US Treasury Index, the Pan-European Treasury Index and the Asian-Pacific Treasury Index, in addition to Canadian, Chilean, Mexican and South African government bonds.

Barclays Global Treasury: Canada Bond Index: Includes fixed-rate, local-currency sovereign debt that makes up the Canadian Treasury sector of the Global Aggregate Index.

Barclays Global Treasury: Euro Bond Index: Includes fixed-rate, local-currency sovereign debt that makes up the Euro Area Treasury sector of the Global Aggregate Index. (Represents euro-area government bonds on slide 1.)

Barclays Global Treasury: Japan Bond Index: Includes fixed-rate, local-currency sovereign debt that makes up the Japanese Treasury sector of the Global Aggregate Index. (Represents Japan government bonds on slide 1.)

[Read to audience]

Index Definitions (continued)

Barclays Global Treasury: United Kingdom Bond Index: Includes fixed-rate, local-currency sovereign debt that makes up the UK Treasury sector of the Global Aggregate Index.

Barclays Investment Grade CMBS Index: Designed to mirror commercial mortgage-backed securities of investment-grade quality (Baa3/BBB-/BBB- or above) using Moody's, S&P and Fitch respectively, with maturity of at least one year.

Barclays Municipal Bond Index: A rules-based, market value–weighted index engineered for the long-term tax-exempt bond market. (Represents municipals on slide 1.)

Barclays US Aggregate Bond Index: A broad-based benchmark that measures the investment-grade, US dollar–denominated, fixed-rate taxable bond market, including US Treasuries, government-related and corporate securities, mortgage-backed securities (MBSs [agency fixed-rate and hybrid ARM passthroughs]), asset-backed securities (ABSs) and commercial mortgage-backed securities (CMBSs).

Barclays US Corporate Bond Index: A broad-based benchmark that measures the investment-grade, USD-denominated, fixed-rate, taxable corporate bond market. It includes USD-denominated securities publicly issued by US and non-US industrial, utility and financial issuers that meet specified maturity, liquidity and quality requirements.

Barclays US Corporate High-Yield 2% Issuer Capped Bond Index: A component of the US Corporate High-Yield Bond Index, which covers the universe of fixed-rate, noninvestment-grade corporate debt of issuers in developed-market countries. It is not market-capitalization weighted—each issuer is capped at 2% of the index.

Barclays US Corporate High Yield Index: Represents the corporate component of the Barclays US High Yield Index.

Barclays US Corporate Investment Grade Index: Represents the performance of US corporate bonds within the US investment-grade fixed-rate bond market.

Barclays US Treasury Inflation-Protected Securities (TIPS) Index: Consists of inflation-protected securities issued by the US Treasury. (Represents TIPS on slide 1.)

Barclays US Treasury Index: Includes fixed-rate, local-currency sovereign debt that makes up the US Treasury sector of the Global Aggregate Index. (Represents US government bonds on slide 1.)

Bloomberg Commodities Index: Consists of exchange-traded futures on 19 physical commodities that are weighted to account for economic significance and market liquidity. (Represents commodities on slide 1.)

[Read to audience]

Index Definitions (continued)

FTSE EPRA/NAREIT Global Real Estate Index: Designed to represent general trends in eligible real estate equities worldwide. (Represents global REITs on slide 1.)

MSCI EAFE Index: A free float–adjusted, market capitalization–weighted index designed to measure developed-market equity performance, excluding the US and Canada. It consists of 22 developed-market country indices. (Represents EAFE on slide 1.)

MSCI Emerging Markets Index: A free float–adjusted, market capitalization–weighted index designed to measure equity-market performance in the global emerging markets. It consists of 21 emerging-market country indices. (Represents Emerging Markets on slide 1.)

MSCI World Index: A market capitalization–weighted index that measures the performance of stock markets in 24 countries.

Russell 2000 Index: Measures the performance of the small-cap segment of the US equity universe. It is a subset of the Russell 3000 Index representing approximately 8% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. (Represents US small-cap on slide 1.)

S&P 500 Index: Includes a representative sample of 500 leading companies in leading industries of the US economy. (Represents US large-cap on slide 1.)

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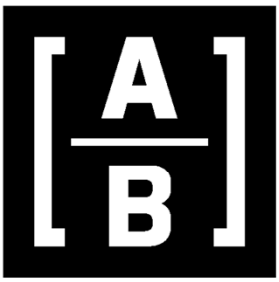

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