2017

50 YEARS OF INVESTMENT MANAGEMENT & RESEARCH

# WHY ACTIVE EQUITIES NOW?

## FIVE THINGS TO CONSIDER…

# Five Reasons to Consider Active Equities Now

1. Trump's agenda is bullish for (most) equities
2. Equities are not as expensive as you think
3. Passive investing looking stretched
4. The Great Beta Trade is likely over
5. Confidence is up + dispersion is up + interest rates are rising = strong environment for active management

For illustrative purposes only. **Current analysis and expectations do not guarantee future results. There can be no assurance any investment objectives will be achieved.**

# REASON ONE

## TRUMP'S AGENDA IS BULLISH FOR (MOST) EQUITIES

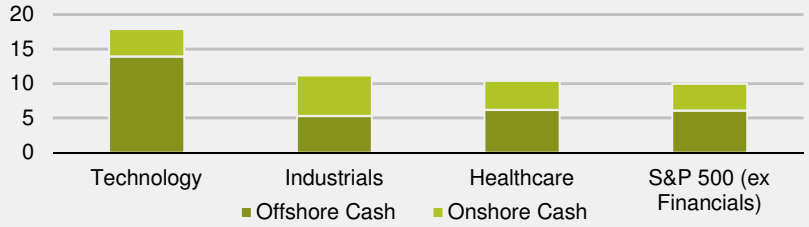
# Trump's Cornerstone Agendas Are Bullish for (Most) Equities

## 1 Taxes: Adds Directly to Bottom Line Earnings, Especially for Smaller Companies*

**Potential Increase in Earnings per Share if Effective Tax Rate Drops to 25 Percent for All Companies***

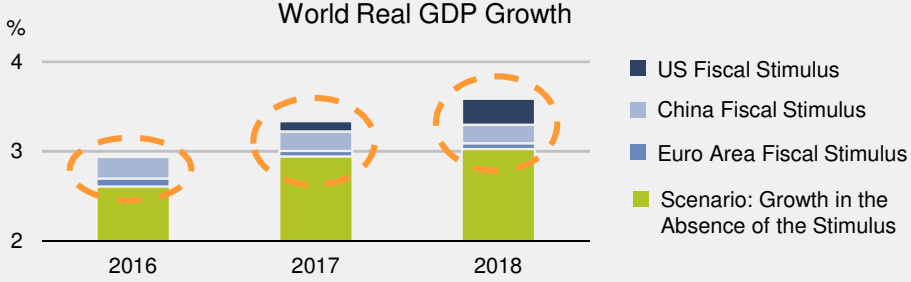

## 2 Repatriation: Bring Money Back to US for Buybacks, Acquisitions, etc.†

**Cash and Marketable Securities Onshore vs. Offshore**
Percent of Market Cap: S&P 500

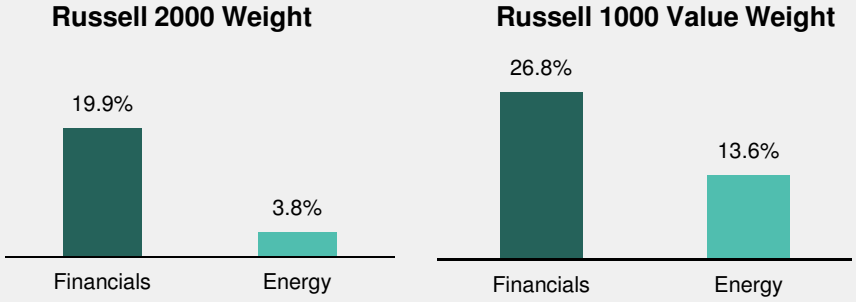



## 3 Stimulus: Adds Directly to Growth‡

**Positive Impact of Fiscal Stimulus on World GDP**
World Real GDP Growth




## 4 Deregulation: More Lenient Regulation Should Benefit Small/Value, Banks and Energy§



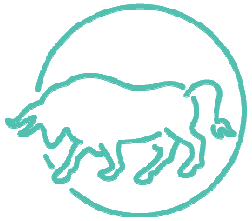

**Historical and current analyses and forecasts do not guarantee future results. There can be no assurance that any forecasts will materialize.**
*As of November 30, 2016. Based on median 2015 effective tax rate for S&P 500 and Russell 2000. Excludes real estate and negative pretax income companies. 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 the fees and expenses associated with the active management of a portfolio.
Source: FactSet, Russell Investments, S&P and AB
†As of October 10, 2016. Source: Bloomberg, FactSet and UBS
‡Source: OECD November 2016 Economic Outlook database, OECD calculations, Strategas and AB
§As of December 31, 2016. Source: Russell Investments and AB

# REASON TWO

## US EQUITIES AREN'T AS EXPENSIVE AS YOU THINK

# Is the Eight Year Bull Run Nearing an End?

## Bull Market Top Checklist



| | 2000 | 2007 | Current | Comments |
|---|---|---|---|---|
| **1. Blow-off top (rapid increase in prices/volume)** | ✓ | ✓ | × | No signs of panic buying or speculative excess in public equity markets |
| **2. Heavy inflows into equity market funds** | ✓ | ✓ | × | Inflows into equity funds compared to bond funds still remain below levels seen at prior peaks |
| **3. Big pick-up in M&A activity** | ✓ | ✓ | × | While M&A activity picked up meaningfully in 2015 and recently, both deal volume and deal value faded in 2016 |
| **4. IPO activity** | ✓ | ✓ | × | An already declining IPO market in 2015 has turned even worse in 2016. Activity has started to pick-up in recent weeks |
| **5. Rising real interest rates** | ✓ | ✓ | ✓ | Five year breakeven expectations have moved higher rather quickly, and potentially could be detrimental to multiples |
| **6. Weakening upward earnings revisions** | ✓ | ✓ | × | Upward earnings revisions are steady but are uninspiring |
| **7. Erosion in number of stocks reaching new highs** | ✓ | ✓ | × | The market's breadth is far healthier today than it was during the period of consolidation between 2014 and early 2016 |
| **8. Shift towards defensive leadership** | ✓ | ✓ | × | For the time being cyclicals and technology remain leaders |
| **9. Widening credit spreads** | ✓ | ✓ | × | With defaults rising, corporate credit spreads bear watching. At the moment however, credit spreads are behaving |

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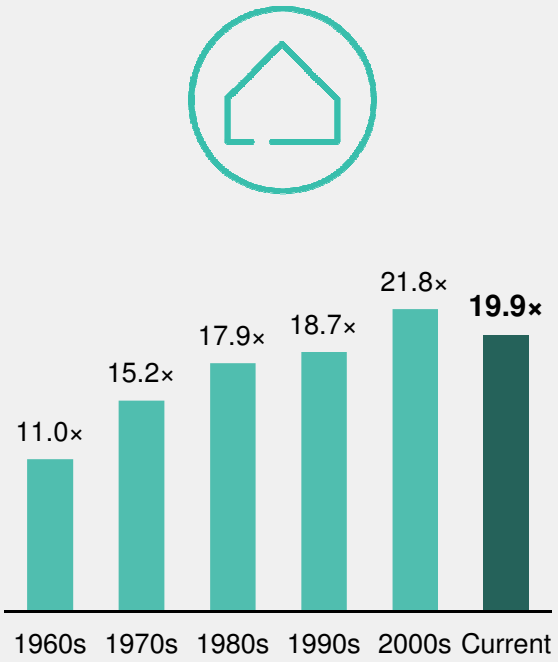
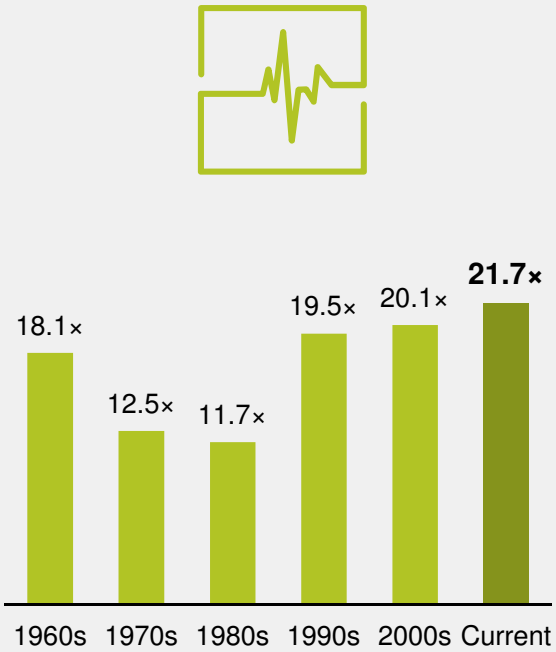
As of January 2017
Source: Strategas Research Partners and AB

# Housing and Stocks Still Attractive Relative to Bonds

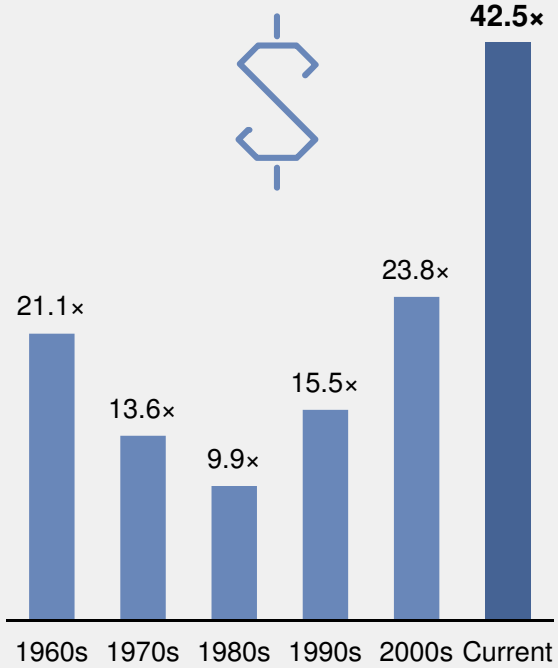
**Average House P/E by Decade**
US Median Home Price/Median Rent




**Average Equity P/E by Decade**
S&P 500 (trailing) EPS



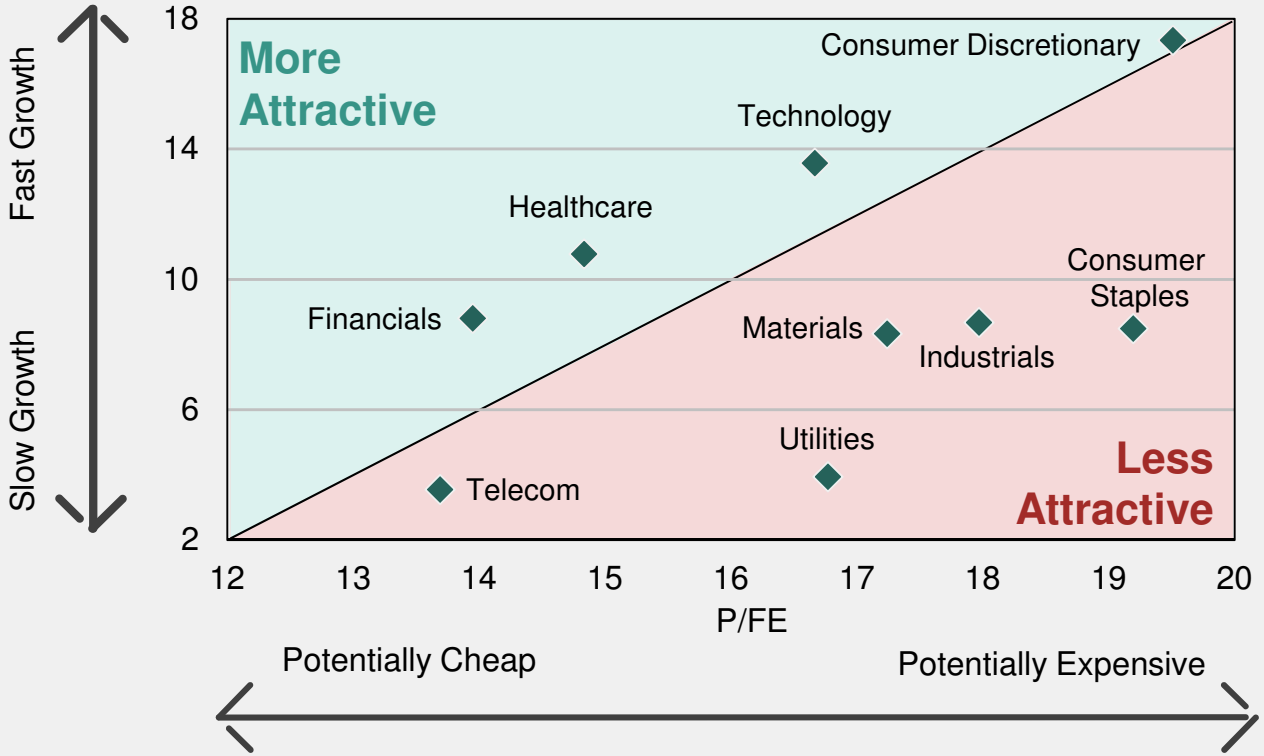

**Average Bond P/E by Decade**
100/10-Year Treasury Yield




**Past performance does not guarantee future results.**
Indices are used for purposes of comparison purposes only. An investor generally cannot invest in an index.
As of December 2016
Source: Strategas Research Partners and AB

# But Not Everything Is Priced to Perfection

**IBES Five-Year Growth Forecast (Percent)**




+ As massive flows have poured into “bond like” sectors, valuation distortions are being created

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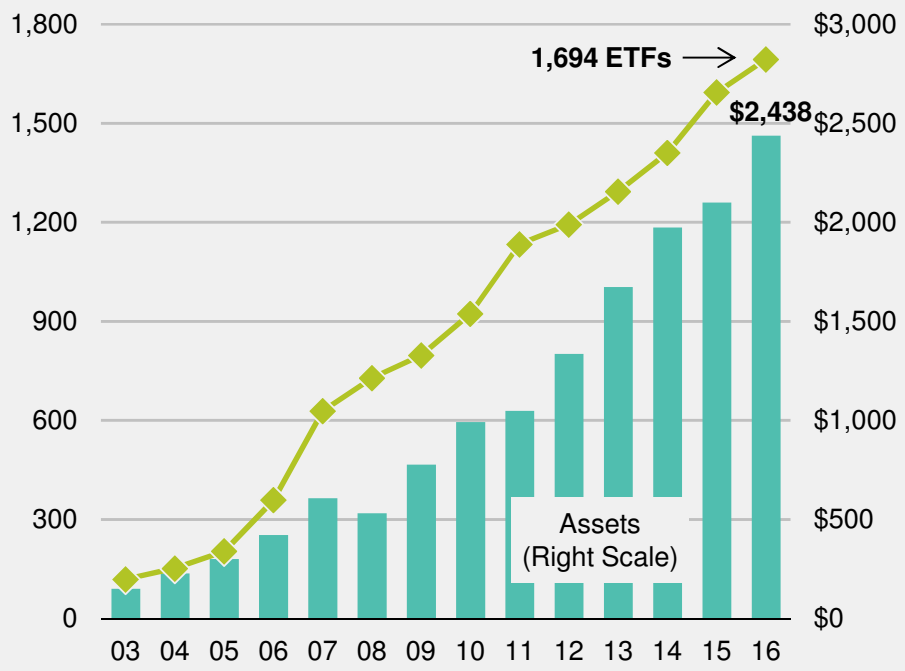
As of December 31, 2016
Excludes energy.
Source: FactSet, IBES, MSCI, S&P Compustat, Worldscope and AB

# REASON THREE
## PASSIVE INVESTING LOOKING STRETCHED

# Passive Investing Looking S T R E T C H E D…

## ETFs: Number and Total Assets (USD Billions)




## Challenges Include:

| | Likely Outcome | Favors Active Management |
|---|---|---|
| 1. Already high margins and multiples | Further multiple expansion not expected | ✓ |
| 2. Business model disruptions taking place at faster rates | "Winner take all" markets | ✓ |
| 3. Market reactions to stock changes in index | Larger distortions upon entering / leaving index | ✓ |
| 4. Majority of passive assets follow "market cap" based rules | Money continues chasing yesterday's winners | ✓ |
| 5. Potential slow down to passive net flows or outright redemptions | Something we have never seen… | ? |

**Historical and current analyses and expectations do not guarantee future results.**
There can be no assurance that any expectations will materialize.
As of December 31, 2016
Source: ICI and AB

# Passive (and Closet Indexing) Can Mask Hidden Risks

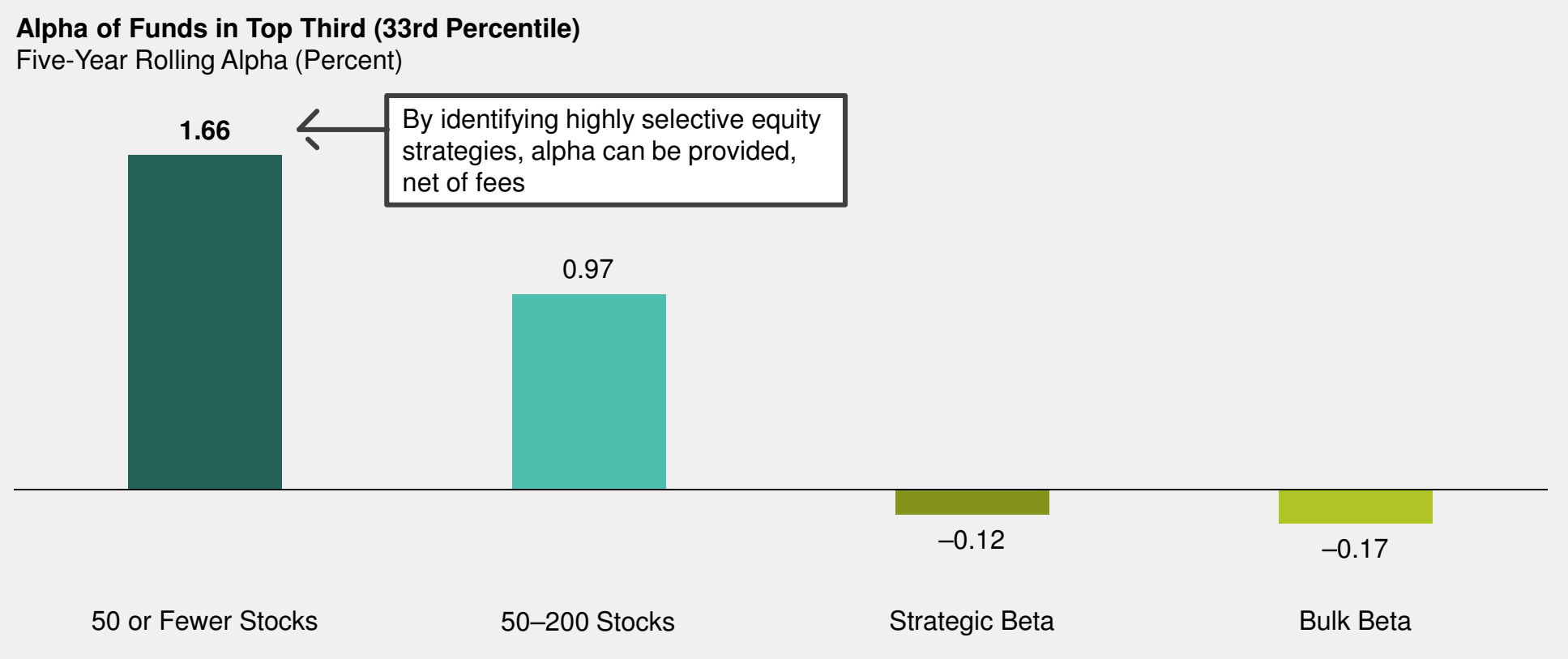
## Navigating Risks Takes “Active” Skill

| Component | Index Share at Peak | Subsequent Two-Year Relative Performance |
|---|---|---|
| 1980 Energy | 33% | –48% |
| 2000 Technology | 34 | –38 |
| 2007 Financials | 22 | –33 |
| 2016 High-Dividend-Yielding Stocks | 45 | ? |

**Past performance and historical analysis and expectations do not guarantee future results**.
As of December 31, 2016
Indices are used for purposes of comparison purposes only. An investor generally cannot invest in an index.
Long-term average shares of S&P 500 from 1965 through 2016
Source: FactSet, S&P and AB

# Highly Selective Approaches Have Worked over Time

## You Don't Need to Be Top Decile, but the More Selective, the More Alpha Potential



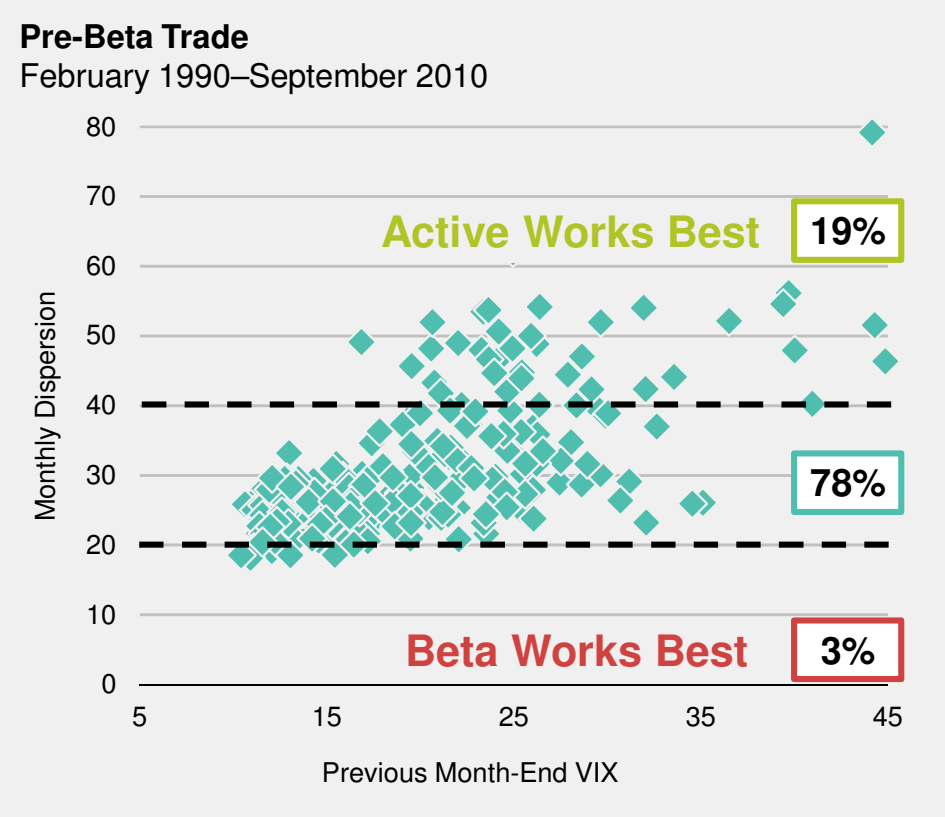

**Historical analysis does not guarantee future results.**
Analysis period from January 1, 2002 to December 31, 2016
All data is shown net of fees. Alpha is a five-year rolling monthly 33rd percentile and vs. primary prospectus benchmark.
Includes a universe of 879 large- and mid-capitalization US equity strategies; 286 strategies have less than 50 stocks, 593 fall into the 50–200 bucket. Strategic beta is represented by the 50 largest strategic beta ETFs; Bulk Beta represented by the 50 largest passively-managed funds benchmarked to S&P 500. Please refer to the Construction and Methodology in the Appendix for additional information on methodology.
Source: Morningstar and AB

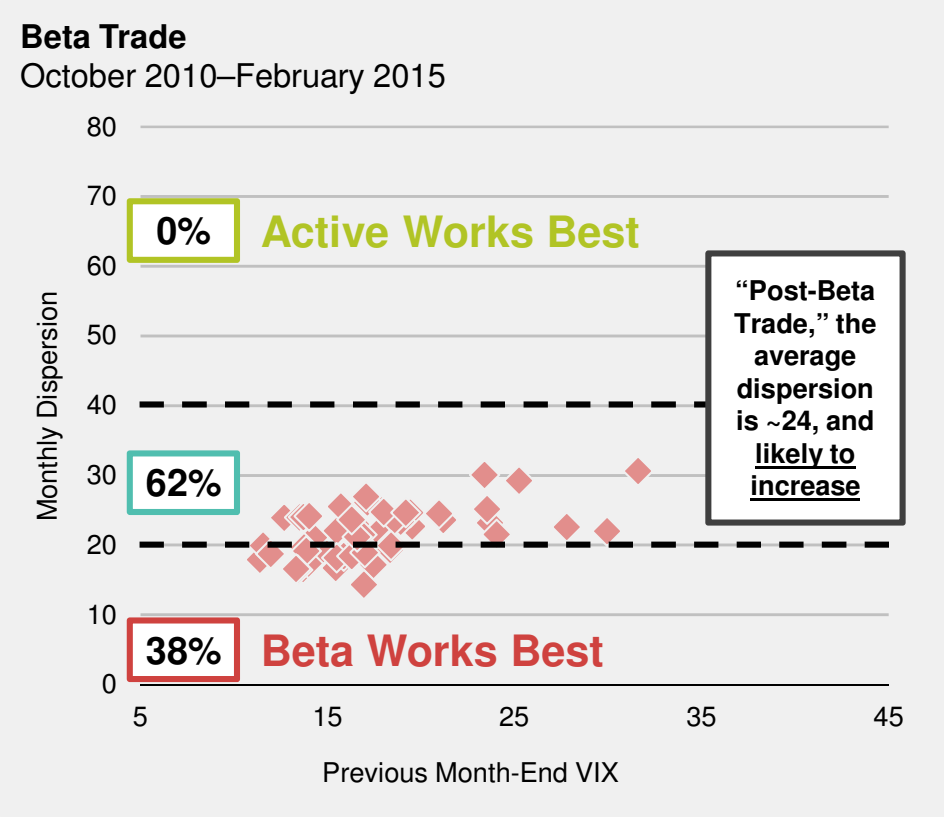
# REASON FOUR

## THE GREAT BETA TRADE IS LIKELY OVER

# While Recently Muted, Volatility and Dispersion Likely to Return

## Low Dispersion and Low Volatility Environment: Dark Ages for Active Management



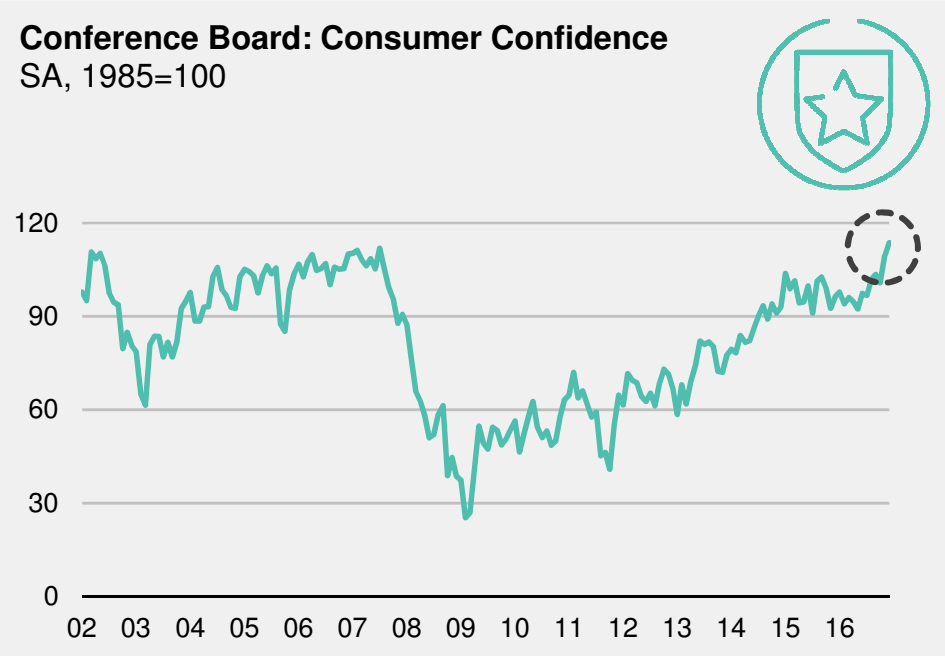



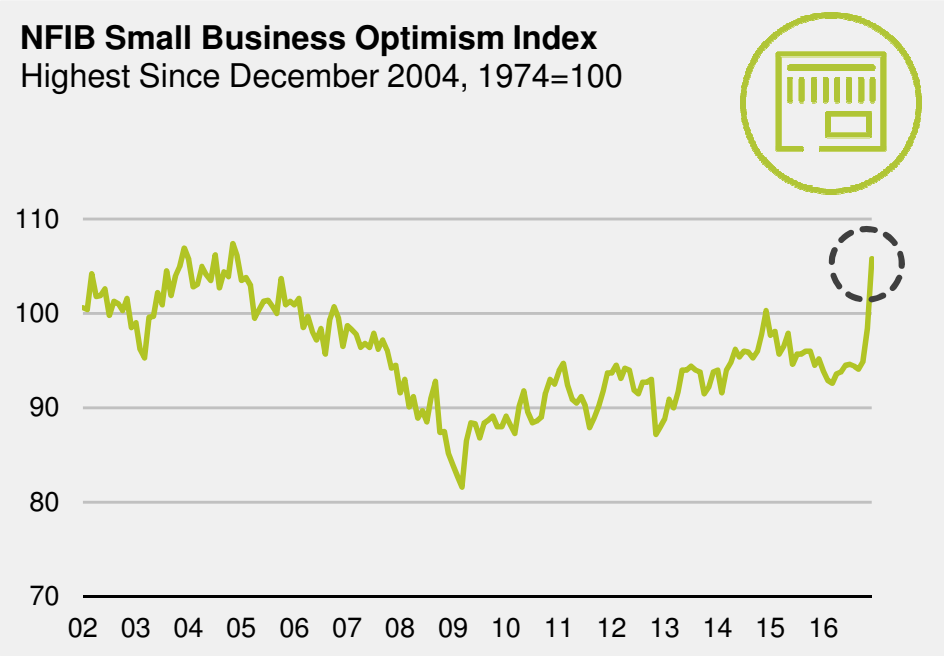

**Past performance, historical and current analyses and expectations do not guarantee future results.**
Indices are used for purposes of comparison purposes only. An investor generally cannot invest in an index.
As of December 31, 2016
Dispersion is cross-sectional standard deviation of monthly returns.
Source: Bloomberg Barclays, Chicago Board Options Exchange, MSCI, S&P and AB

# REASON FIVE

CONFIDENCE IS UP + DISPERSION IS UP + INTEREST RATES RISING = STRONG ENVIRONMENT FOR ACTIVE MANAGEMENT

# Sentiment: Confidence Is Back!



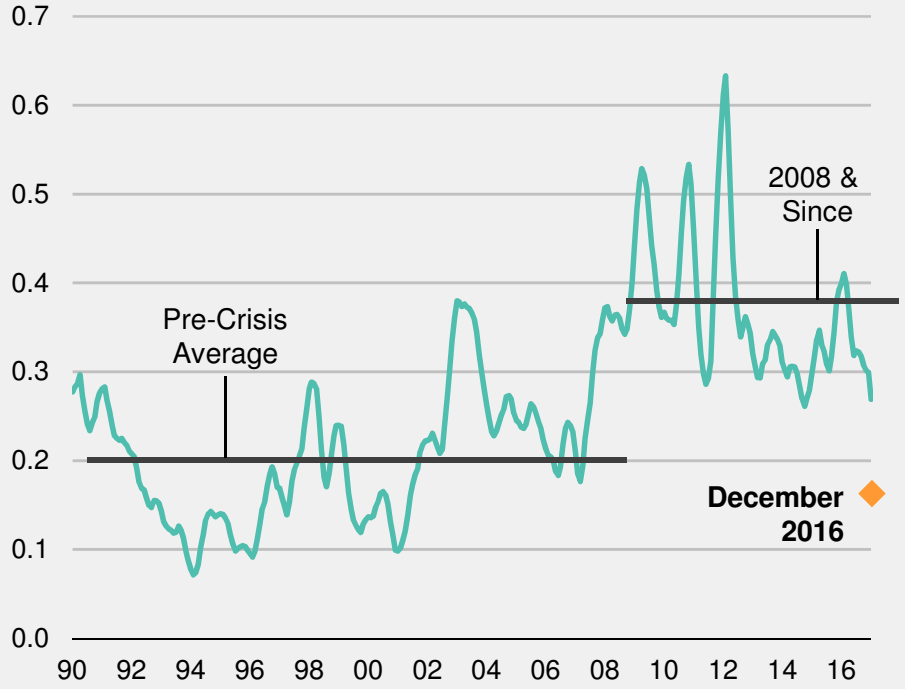




- With the passing of the US election, consumer sentiment measures popped recently—and so did expectations
- 68% of GDP is consumer-based, so this is a positive signal for continued consumption
- US small business confidence, a leading indicator, also rose to a 12-year high following the US election
- There historically has been a strong correlation between small business confidence and small cap equity performance

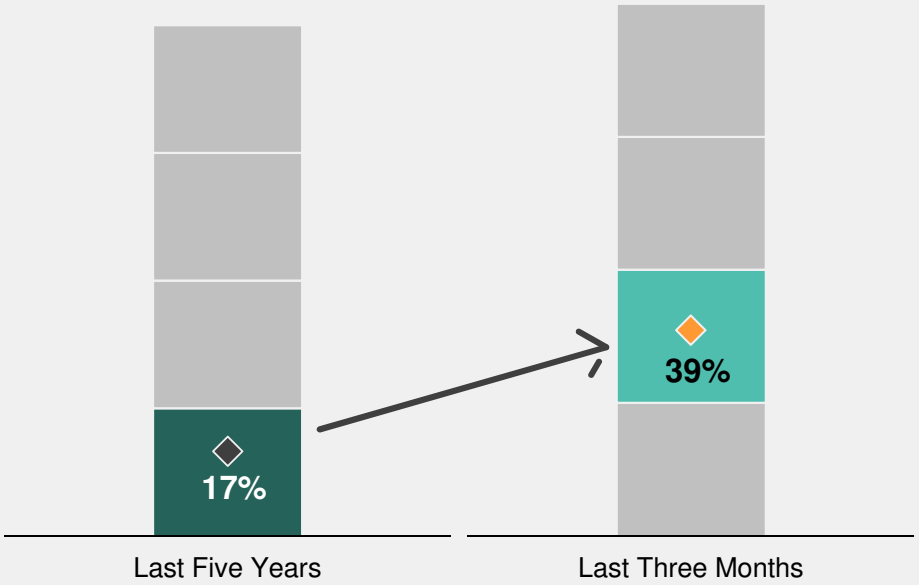
**Historical and current analyses and expectations do not guarantee future results.**
As of December 31, 2016
Source: The Confidence Board/Analytics, FactSet, National Federation of Independent Business (NFIB), Strategas and AB

# The Recent Backdrop Has Been Materially Better for Active

**Intra-Stock Market Correlations***
Approaching Pre-Crisis Levels

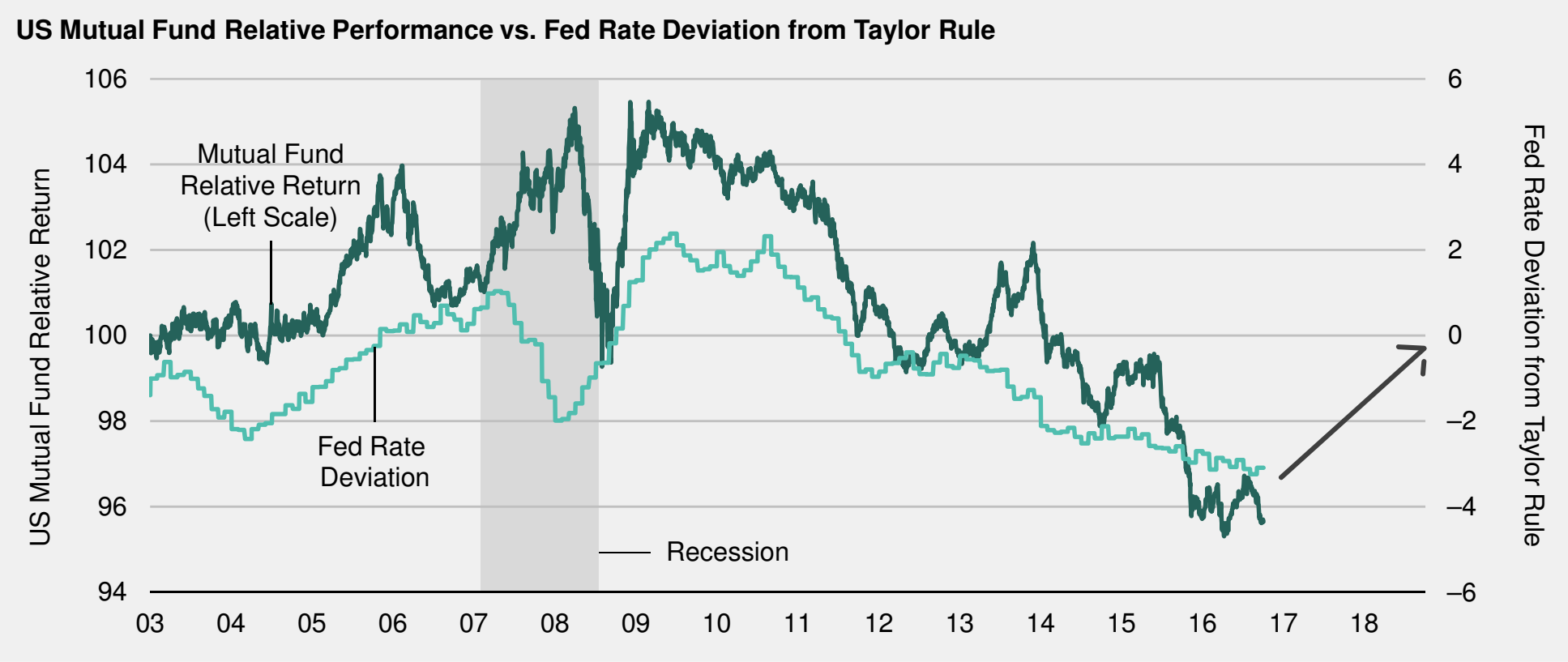



**Stock Market Dispersion† Has Gone from One of the Narrowest on Record to Near Normal**




**Past performance is not necessarily indicative of future results.**
As of December 31, 2016
Indices are used for purposes of comparison purposes only. An investor generally cannot invest in an index.
Both correlation and dispersion are on the S&P 500 universe.
*Correlation uses a six-month moving average. Latest figure is December, 2016. Precrisis average is from 1990–2007.
†Dispersion corresponds to the cross-sectional standard deviation of monthly returns and captures the magnitude of return differential among stocks in the universe. Percentile rank is since 1980. Last five years reflects the monthly average of the 2012–2016 period, ranked.
Source: S&P and AB

# As Rates Have Normalized, Active Managers' Performance Has Historically Improved




**For illustrative purposes only. Past performance , historical analysis and expectations are not necessarily indicative of future results.**
Through December 31, 2016
Taylor Rule is a formulaic recommendation for Fed interest rate changes, based on targeted vs. actual inflation levels and potential output vs. actual output.
Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Congressional Budget Office, Deutsche Bank, FactSet, Federal Reserve Bank, Haver, S&P and AB

# Thank You for Listening to the Five Reasons to Consider Active Equities Now

1. Trump's agenda is bullish for (most) equities
2. Equities are not as expensive as you think
3. Passive investing looking stretched
4. The Great Beta Trade is likely over
5. Confidence is up + dispersion is up + interest rates are rising = strong environment for active management

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# APPENDIX

# Construction Methodology

- **Concentrated (50 or fewer):** Using Morningstar, we began with the active US Equity universe and excluded Small & SMID universes and those that are sector-based. We used the oldest share class fund with five to 50 stock holdings. We eliminated all strategies that did not have a three-year track record and with less than $100 million in assets as of December 31, 2016. We ended with a final sample of 286 strategies

- **Traditional (50–200):** Using Morningstar, we began with the active US Equity universe and excluded Small & SMID universes and those that are sector-based. We used the oldest share class fund with 50 to 200 stock holdings. We eliminated all strategies that did not have a three-year track record and with less than $100 million in assets as of December 31, 2016. We ended with a final sample of 593 strategies

- **Strategic Beta:** Using Morningstar, we began with the US equity ETFs that were characterized as “strategic beta” funds. We took the top 50 largest funds by assets as of December 31, 2016. We ended with a final sample of 50 strategic beta funds

- **Bulk Beta:** Using Morningstar, we began with the index funds that were benchmarked to the S&P 500 and used the oldest share class fund. We took the top 50 largest funds by assets as of December 31, 2016. We ended with a final sample of 50 passive strategies

As of December 31, 2016
Source: AB

# 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.

# 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.

- **MSCI World Index:** A market capitalization–weighted index that measures the performance of stock markets in 24 countries.
- **Russell 1000 Index**: A stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, representing about 90% of the total market capitalization of that index.
- **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.
- **S&P 500 Index:** Includes a representative sample of 500 leading companies in leading industries of the US economy.
- **The CBOE Volatility Index® (VIX®)** is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.
- **S&P/Case-Shiller Home Price Indices** measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan region across the United States. In addition, the S&P/Case-Shiller® U.S. National Home Price Index is a broader composite of single-family home price indices for the nine U.S. Census divisions and is calculated quarterly.

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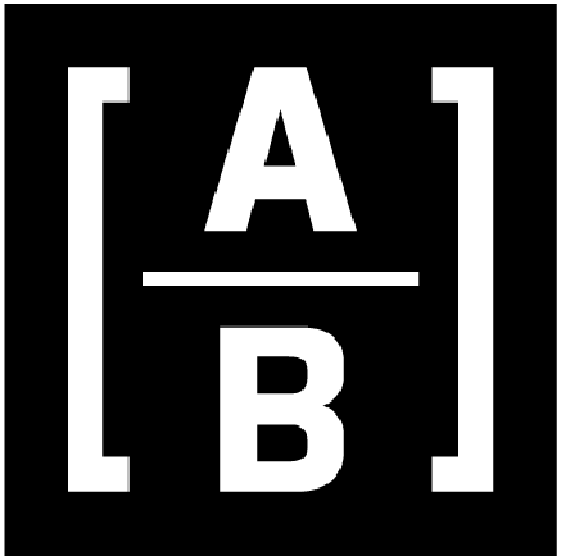
# Definitions of Terms

- **Alpha** is the risk-adjusted measurement of "excess return" over a benchmark. A positive alpha of 1.0 means the portfolio has outperformed its benchmark index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%.
- **Beta** is a measure of an investment's volatility in comparison to the market as a whole. A beta below 1 indicates less volatility than the market; a higher beta indicates more volatility.
- **Correlation** is a statistical measure of how two securities move in relation to each other.
- **Standard deviation** is a measure of volatility, indicating the percentage by which an investment's performance has varied from its average; the higher the standard deviation, the greater the range of performance, indicating greater volatility.
- **Basis Point (b.p.)** - 1 b.p. is equal to 1/100 of 1% (0.01%)
- **Dispersion** is a statistical term describing the size of the range of values expected for a particular variable. Dispersion is used in studying the effects of investor and analyst beliefs on securities trading, and in the study of the variability of returns from a particular trading strategy or investment portfolio. It is often interpreted as a measure of the degree of uncertainty, and thus risk, associated with a particular security or investment portfolio.
- **Price-to-earnings ratio** (P/E Ratio) is the ratio for valuing a company that measures its current share price relative to its per-share earnings.
- **Cyclically Adjusted Price-to-Earnings (CAPE) Ratio:** Also known as the P/E 10 ratio, is a valuation measure, generally applied to broad equity indices, that uses real per-share earnings over a 10-year period. The P/E 10 ratio uses smoothed real earnings to eliminate the fluctuations in net income caused by variations in profit margins over a typical business cycle.



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