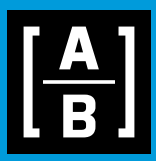
APRIL 2016



SILVER LININGS EQUITY PLAYBOOK

INVESTING IN A CLOUDY US MARKET

Frank Caruso
Chief Investment Officer, US Growth Equities

Kurt Feuerman
Chief Investment Officer, Select US Equities

Daniel Roarty
Chief Investment Officer, Global Growth and Thematic

James T. Tierney
Chief Investment Officer, Concentrated US Growth

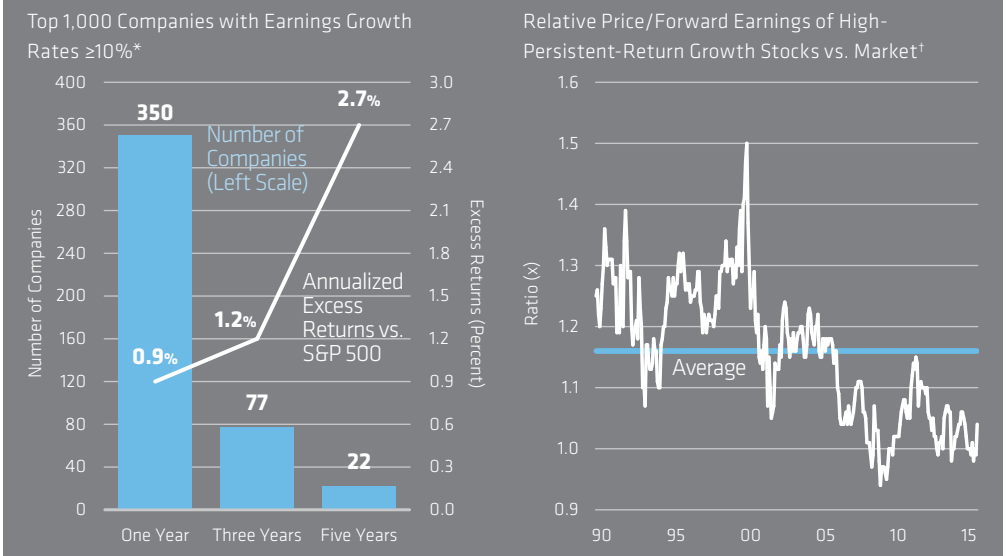
IN THIS PAPER: Investors in US equities are facing tricky market conditions. Valuations are above the long-term average for many stocks, the economic recovery is tepid, and companies are struggling to increase earnings. In this environment, we believe that identifying companies that can deliver sustainable earnings growth without depending on a strong cyclical economic recovery is the key to investing success. This paper surveys the prospects for US equity returns and presents a playbook for finding the silver linings in a cloudy market.

CONVICTION IN SUSTAINABLE GROWTH

The sharp market correction in early 2016 has rattled investors in US equities. Concerns about earnings growth, valuations and an anemic economic recovery have increased uncertainty and eroded confidence in stock returns. But in a world of lower expected returns across asset classes, we believe that equities still offer the best potential for long-term investors. And with a broader view of market trends, we believe investors can gain comfort in equity strategies that can help them meet their investing goals over time.

Our playbook for US equities focuses on finding companies with sustainable growth prospects in a volatile, low-growth world. While relatively few companies fit this profile, investors who find them can enjoy outsize returns (*Display 1*). To do so, we've outlined five "plays," or investing principles, for identifying the long-term drivers of a company's business, which should foster sustainable growth, in our view. By developing conviction in companies like these, we believe equity portfolios can be created to withstand short-term economic and market pressures and deliver superior long-term returns.

DISPLAY 1: FIRMS THAT CAN GROW ARE POISED TO LEAD—AND THEY'RE CHEAP



Historical analysis does not guarantee future results.
As of December 31, 2015
* Universe consists of the top 1,000 companies by market cap each year from 1979 to 2015, with annual rebalancing.
† Price to forward earnings of highest quintile of persistent profitability stocks relative to the Russell 1000 Index
Source: Center for Research in Security Prices, FactSet, Russell Investments, S&P Compustat, S&P Dow Jones and AB

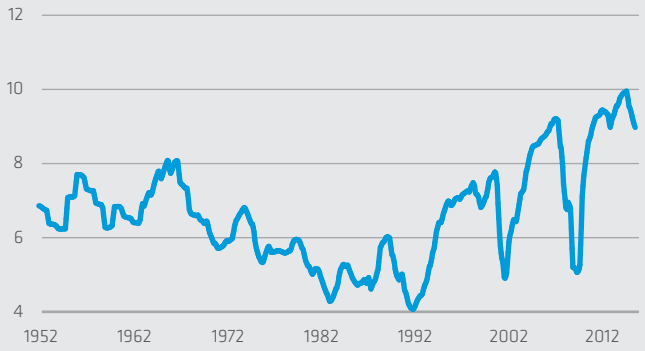
When Hillary Clinton announced her intention to impose controls on prescription drugs with a tweet last September, investors in pharmaceutical companies reacted instantly. It didn't matter that she had not even been nominated as a candidate for the presidency or that the political hurdles to her proposals would be formidable. That day, shares of drugmakers in the US and Europe fell sharply.

Among those companies was Zoetis, which tumbled by 11% over the following week—more than the broader US pharmaceutical sector. But investors had missed something. Zoetis manufactures animal health products, so it probably wouldn't be a target for pricing controls on medicines for people.

The Zoetis story sheds light on the US equity market today. Valuations are above average for many stocks. Earnings growth is hard to find. And concerns about the economy and political risk have mounted. In this environment, markets often react violently, with little regard for the fundamentals or long-term growth prospects of an individual company like Zoetis.

For many companies, the growth environment is challenging. After several years of profit gains, US companies are having a much harder time delivering earnings growth. Corporate operating margins today are about 1% higher than they were during the prior cycle peak, and 3% above their average since the early 1950s (*Display 2*). These profitability levels are very high, even when taking into account that the mix of US economic activity has shifted toward more capital-light business models (e.g., services and technology), which inherently generate higher margins.

DISPLAY 2: MARGINS ARE UNLIKELY TO RISE FURTHER
S&P 500 Net Profit Margins (%)



Through December 31, 2015
Based on trailing four-quarter data. Smoothed on a trailing three-month basis.
Source: Empirical Research Partners and corporate reports

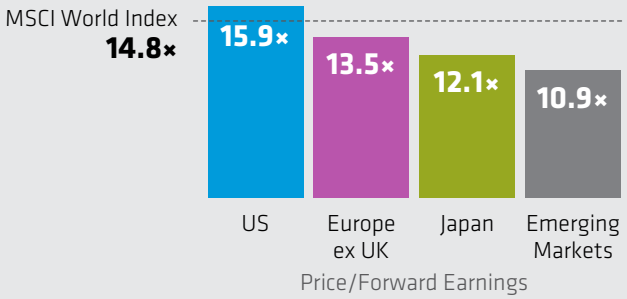
Lower earnings growth has prompted closer scrutiny of equity valuations. By the end of February 2016, the price/forward earnings

ratio of US stocks was 15.9—higher than 55% of all months since 1996 (*Display 3*). US stocks were also trading at high valuations relative to other regions.

Investors have legitimate concerns about the outlook for US equities. Confidence has been further battered by the sharp declines in early 2016. Yet although market conditions are complex and rife with uncertainty, we believe that active investors can still find big opportunities in US equity markets. In this paper, we take a close look at US equity return prospects and show how selective, high-conviction approaches can help investors develop a playbook to find the silver linings in a cloudy US market.

DISPLAY 3: EQUITY VALUATIONS IN PERSPECTIVE

Equity Market Valuations



Percentile Rank vs. History	**55**	**42**	**7**	**48**

Historical analysis does not guarantee future results.
As of February 29, 2016
Based on MSCI USA, MSCI Europe ex UK, MSCI Japan and MSCI Emerging Markets. Price/forward earnings ratios are based on earnings estimates for the next 12 months. Percentile rank based on monthly valuations from March 1996 through February 2016.
Source: FactSet, MSCI and AB

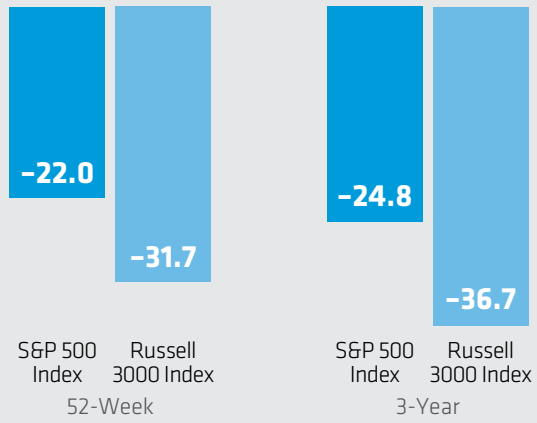
WRITING A PLAYBOOK

After the sell-off in early 2016, equity investors were licking their wounds. Yet at the same time, valuations had become more attractive. By the end of January, S&P 500 stocks were trading at an average of 22% lower than their 52-week highs and 25% below their three-year highs (*Display 4*). Small- and mid-cap stocks were hit even harder.

The recent stock market correction has been severe and widespread. Yet it also underpins a compelling opportunity, in our view. Since the correction, equity managers have been able to access stocks of stronger companies at attractive valuations to better position a portfolio for a long-term recovery. By using research to focus on the long-term drivers of a company's business—and with a disciplined approach to portfolio construction—we believe that investors can steer through the volatile markets ahead by sticking to a playbook of clear investing principles.

DISPLAY 4: MARKET CORRECTION OPENS OPPORTUNITIES

Percent Decline from Peak Levels



Past performance does not guarantee future results.
As of January 31, 2016
Source: Russell Investments, S&P and AB

THE EQUITY INVESTING PLAYBOOK[1]

Play 1: Be on the Right Side of Change
Play 2: Look for Sources of Secular Growth
Play 3: Find Businesses That Control Their Destinies
Play 4: Don't Confuse Price Momentum with Business Momentum
Play 5: The Best Defense Is a Solid Offense

PLAY 1: BE ON THE RIGHT SIDE OF CHANGE

Not every company or industry is facing the same squeeze on earnings growth. As the narrow performance of last year's market showed, investors have been willing to reward companies that have promising earnings growth potential. In particular, changes triggered by technology, regulation or structural shifts in specific markets are excellent sources of growth potential—even in an earnings-constrained world.

Technological change isn't only about the Internet or social networks. Consider the retail sector, where new technology and information systems allow companies to take advantage of the massive amounts of available data on customer behavior. Companies that recognize this potential and invest accordingly are using these tools to deepen their relationships with customers—and are capable of doing better than their rivals who haven't.

Manufacturing is another case in point. Innovation in manufacturing increases the flexibility that companies have in managing their businesses, providing a powerful way to boost profitability (*see "Building Better Models"*).

BUILDING BETTER MODELS
FRANK CARUSO

Equity markets are increasingly being driven by narrow and short-term thinking. It's not just the economic headlines or the latest report of Middle East mayhem that is driving volatility. The analyst forecasts that move stocks are often built on standard models that are too short-term focused and that don't capture unconventional catalysts of long-term growth.

The earnings expectations based on these models have become a focal point for investors. In recent years, optimistic beginning-of-the-year earnings estimates have been taken down regularly as the year has unfolded and reality has set in. No wonder so many companies regularly beat expectations.

We think that playing the earnings surprises game is the wrong way to invest. Instead, look closely at a company's fundamentals and try to understand what will really drive its business. In other words, you need to incorporate financially grounded ideas into your earnings models that others do not.

For example, when we researched Nike in 2015, we discovered innovations that looked likely to significantly improve the company's earnings growth potential. Nike may be adding sophisticated chips to some of its sneakers; this will allow it to deepen its relationship with customers by offering personalized deals that bypass retail outlets, bringing more profit to the shoemaker. It's also using a new automated manufacturing technology called Flyknit that lets customers customize their orders with minimal labor, allowing Nike to shift its production closer to consumers—in the US and around the world—and save costs on shipping, duties and tariffs. Our research suggests that innovations like these are transforming Nike's business model and could potentially trigger a leap in its profitability.

Why the gap between our view and the street's? Because most analysts aren't evaluating how new technologies and processes will filter down to the bottom line over several years—the potential payoff is a couple of years beyond their horizon. In a short-term world, building thoughtful, independent models like these can make the difference in choosing stocks that stand out from the crowd.

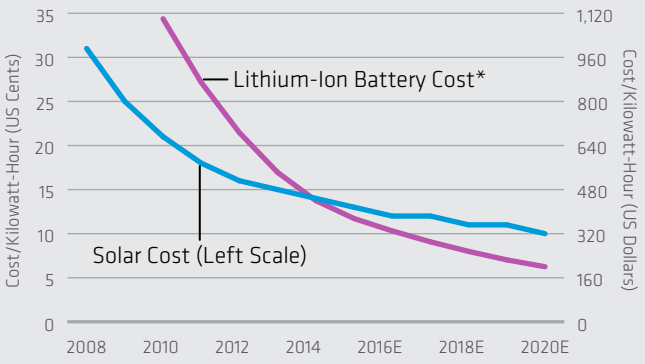
1 Source: AB

Change is often driven by broad themes that transcend traditional industry and sectors (*see "Embracing the Trends of Tomorrow"*). For example, increasing environmental awareness is spurring global efforts to address challenges that include carbon emissions, clean water, food availability and sanitation. Policy support and technological progress are making the shift to decarbonized energy inevitable, in our view. And the costs of renewable energy such as solar or lithium-ion batteries for electric cars are falling dramatically (*Display 5*). We believe that many investors have underestimated the disruptive potential of exponential cost improvements to drive faster and broader adoption.

These changes are opening up big investing opportunities. Over the next 15 years, we estimate that US$4 trillion will be invested in new solar and wind capacity. Industries like these are highly fragmented, and offer strong growth opportunities for winners. But identifying investment targets requires a substantial research effort to understand the technological and business dynamics of many of the public companies operating in nascent industries. Companies that are on the right side of changes like these should be well positioned to grow their earnings, even when broader business conditions are stagnant.

DISPLAY 5: RENEWABLE ENERGY COSTS ARE FALLING DRAMATICALLY

Renewable Energy Costs



Historical analysis does not guarantee future results.
Solar data as of June 30, 2015; battery data as of August 31, 2015
* Represents cost for an individual battery cell
Source: Bank of America Merrill Lynch, Bloomberg, Tesla Motors, UBS, Umicore, US Department of Energy and AB

EMBRACING THE TRENDS OF TOMORROW
DANIEL ROARTY

In a world of scarce earnings growth, investors need to expand their horizons to find sources of solid equity returns. Focusing on the key mega trends that will unfold in the coming decades can help identify stocks with outperformance potential and long-term resilience to short-tempered markets.

Demographics and the advent of intelligent machines are two areas of profound change that affect each other. As the global population ages, more doctors will be needed. At the same time, many daily tasks associated with caring for patients can be automated, freeing up doctors to spend more face time with patients. Looking up medical information and reviewing charts are simple mechanical tasks that are ripe for automation. And using miniature sensors to continuously monitor the human body will transform healthcare.

Water scarcity is a global challenge that is fostering change. In its 2015 Global Risks report, the World Economic Forum said water crises are a bigger risk to the world than fiscal crises, interstate conflicts and even weapons of mass destruction. Worldwide, 750 million people currently lack access to clean drinking water, and 2.4 billion have no access to proper sanitation facilities, resulting in an estimated 3.5 million deaths each year.

It's getting worse as the global population grows and the climate warms. Global water demand is projected to outstrip sustainable water supplies by 40% in the next 15 years, with half the world's population living under conditions of severe water stress by 2030. Solving the crisis will require significant investment in water treatment, management and infrastructure for many years to come.

Mega trends like these are powerful forces reshaping society and redirecting capital flows. We expect these forces to persist regardless of the pace of economic growth or the level of interest rates. For investors to benefit, an unconventional research effort is required that spans sectors and regions, and incorporates science, social and environmental issues. This framework can help investors gauge the implications of disruptive forces and discover the companies that stand to benefit, that have undervalued growth potential and distinct competitive advantages. When the framework is applied with a disciplined investment approach—and unconstrained by a benchmark—we believe a portfolio can be created that captures premium earnings growth, provides effective diversification and helps mitigate damage during episodic market downturns.

> Identify growth trends that aren't held hostage to a country's economic fortunes.

PLAY 2: LOOK FOR SOURCES OF SECULAR GROWTH

When the market is fixated on short-term macroeconomic trends, investors should think differently. Look for companies and industries that benefit from distinctive long-term growth trends, that aren't held hostage to a country's macroeconomic fortunes.

For example, the healthcare sector is generally a good source of independent growth. People suffering from an illness don't stop buying medications in an economic downturn. The aging US population is increasing the demand for drugs. And the Affordable Care Act has triggered a seismic shift in patient numbers and spending patterns that isn't going to be dented by the direction or magnitude of economic growth.

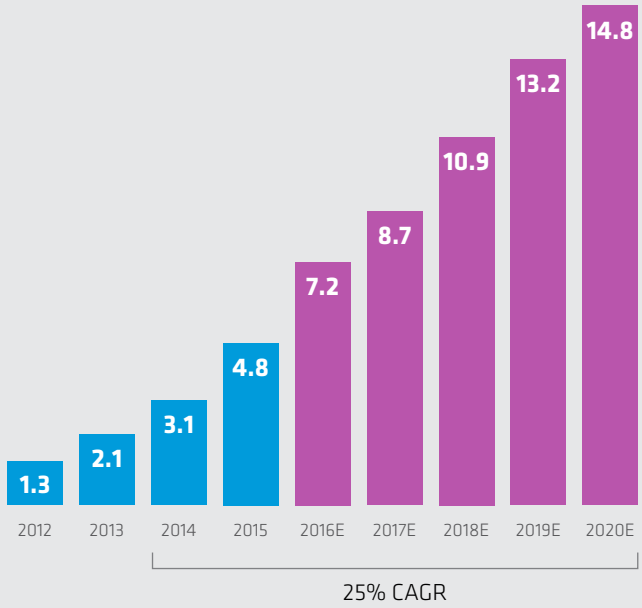
Financial firms are often seen as vulnerable to economic momentum. Yet within the sector, credit card companies are benefiting from a long-term shift from cash and checks to electronic forms of payment. As a result, underlying transactions for some companies have been growing at around 10% for some time—approximately two to three times faster than underlying consumer spending. In an economic slowdown, that growth might slip a bit, but it should still be robust compared to other companies, because the payment-shift trend is continuing.

Big Data is another source of secular growth. The amount of data in the world is growing exponentially, thanks to social media, Netflix, YouTube and the Internet of Things. All of that information must be stored, transported, analyzed and protected, which creates tremendous growth opportunities that are likely to persist through changing economic conditions.

In the auto industry, demand is steadily rising for cutting-edge safety systems. Revenue from advanced driver-assistance systems is poised for rapid growth (*Display 6*), as the installed base is projected to increase from 3% of vehicles today to 30% in 2020, fueled by consumer preferences, regulatory changes and insurance incentives. Growth in the auto industry tends to be cyclical, as sales rise and fall with the ebb and flow of the economy. However, as these systems become standard features on more new car models, we expect their growth to increase at a much steadier pace.

DISPLAY 6: DEMAND FOR VEHICLE SAFETY SYSTEMS SHOULD CONTINUE TO RISE

Advanced Driver-Assistance Systems Revenue (USD Billions)



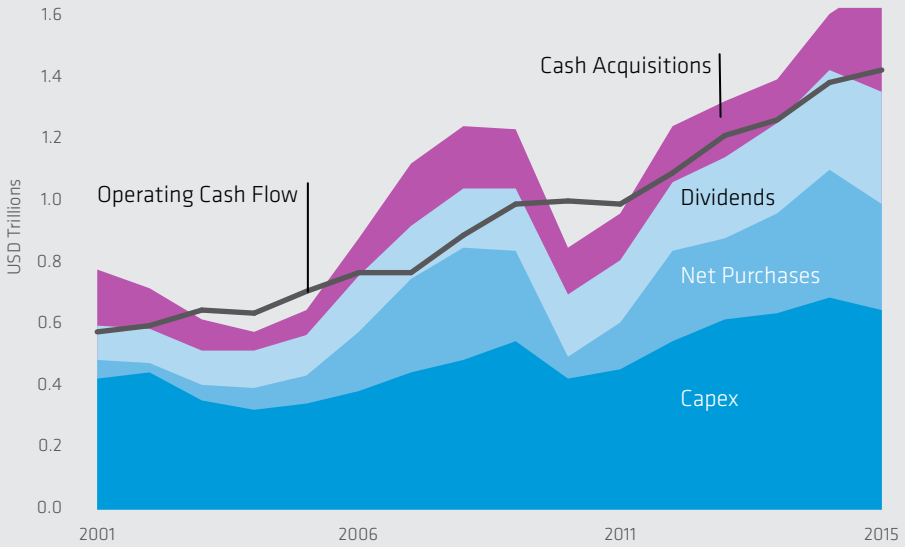
Historical analysis and current estimates do not guarantee future results.
As of March 6, 2016
Source: Barclays and company reports

In contrast, earnings in the retail and manufacturing sectors are more directly tied to GDP growth and interest-rate trends than earnings in other sectors. And of course, most energy companies are vulnerable to downturns, especially when an oil-price slump is at the heart of the problem. That doesn't mean you should avoid all cyclical companies. But attractive equity opportunities in sectors like these should be approached with caution, given the uncertainty surrounding economic growth prospects.

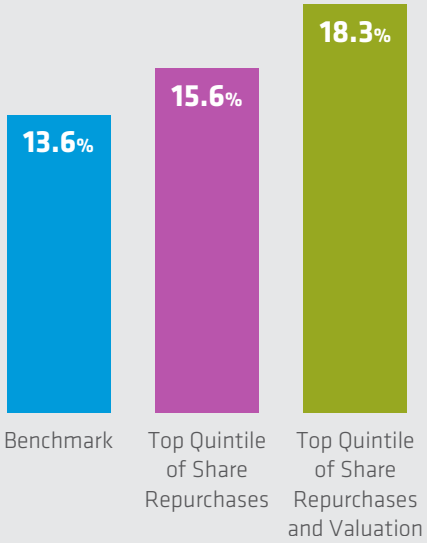
> Balance-sheet health is a great indicator of resilience.

DISPLAY 7: HIGH FREE CASH FLOW GIVES FIRMS MORE OPTIONS TO GENERATE RETURNS

S&P 500 ex Financials: Use of Available Cash



Average Annual Return (1986–2015)*



Historical analysis and past performance do not guarantee future results.
Through December 31, 2015
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.
* Equally weighted average of annual forward-year returns of S&P 500 top quintiles by factor (1986–2015). Quintiles formed once a year, at the start of each year. Benchmark represented by equal-weighted S&P 500 ex financials. Top quintile of valuation defined as cheapest companies based on price/free cash flow.
Source: Center for Research in Security Prices, Compustat, S&P and AB

PLAY 3: FIND BUSINESSES THAT CONTROL THEIR DESTINIES

In a volatile world, it often feels as though companies are subject to forces beyond their control. However, not all companies are created equal in this regard. Some exercise a much greater degree of control over their fate by virtue of having fundamentally sounder businesses based on stronger people, better products, superior operating execution and more responsible financial behavior.

Balance-sheet health—and low profit volatility—is a great indicator of resilience. Investors should always scrutinize a company's balance sheet, but in times of stress, this is even more important. Companies with less debt to service will pay less of a penalty in their financing costs when interest rates rise. Low debt ratios are also good indicators of a company's flexibility to execute its strategy without relying on banks or credit markets. And businesses that can generate the cash they need to fund and invest in their operations are less beholden to the demands of externally sourced capital, and less vulnerable to a potential tightening of credit markets.

Solid balance sheets and sustainable sources of growth are a winning combination. Companies with both are much better equipped to reward shareholders by increasing their dividends or buying back shares—even in tough market conditions. Companies in the top quintile of share repurchases—especially those with attractive valuations—have outperformed the market historically (*Display 7*).

Pricing power is another indicator of a company's ability to deliver sustainable growth. With China and emerging markets slowing down, and with anemic recoveries from the US to Europe, it's difficult to find sources of new demand. And with inflation stuck at very low

levels, it's not easy for companies to raise prices. So companies that demonstrate pricing power in their industries are better positioned to improve their earnings than their competitors that lack it.

We think there are three keys to pricing power: innovation, competition, and cost and inflation dynamics. Innovative products and services are capable of commanding higher prices even in a tough economy and amid low inflation. For example, Apple commands premium prices for its smartphones because of their innovative features and an ecosystem that allows all the company's devices to work together seamlessly. Highly competitive industries make it much more difficult for companies to raise prices. And in a low-inflation world, cost dynamics are crucial. For example, a company like Ecolab makes chemicals for cleaning that are derived from oil-based products. With oil prices at extreme lows, Ecolab's input prices have dropped dramatically, and the company also saves fuel costs on its fleet of service vehicles. So even without raising prices, profitability can increase.

PLAY 4: DON'T CONFUSE PRICE MOMENTUM WITH BUSINESS MOMENTUM

When a stock price tumbles, investors often think that something is really wrong with the company. But that can be a mistaken assumption. Share price momentum isn't necessarily an indicator of business momentum. Sometimes a stock is falling simply because investors are taking profits after its outperformance, or because a portfolio is changing its risk profile in a volatile market. There are countless reasons why share prices fall.

Last year's narrow market is a case in point. Investors might assume that the underperformance of a large swath of the US stock market means that most companies are in bad shape. But there is another plausible interpretation. It could also mean that there are a lot of buying opportunities in undervalued companies that have much better businesses than widely believed.

When the healthcare sector tanked last year on Hillary Clinton's remarks about drug-pricing controls, nothing changed in the business prospects of many pharmaceutical groups. The downward stock price momentum was fueled by speculation about a potential shake-up of industry dynamics, without any real consideration of individual company positions, cash flows or earnings power.

Similarly, not every stock that rallies sharply has a healthy underlying business. Instead of blindly following the crowd into every stock that surges, it's important to scrutinize the fundamental business prospects of each one in order to ensure that its long-term earnings path is sustainable. By being attuned to surges of upward momentum, portfolio managers can also make tactical trims to positions in richly valued holdings, raising cash temporarily in order to redeploy into attractive stocks when the prices correct.

PLAY 5: THE BEST DEFENSE IS A SOLID OFFENSE

Volatility often compels investors to search for pockets of safety in the markets. But some sectors, such as utilities or real estate, have become such popular refuges from volatility that their valuations have risen to elevated levels. Stocks in these sectors often behave like bonds, so if interest rates rise, their prices can be expected to fall.

It's also worth preparing for the possibility that economies or markets will beat expectations. For example, although low oil prices have triggered heightened anxiety about economic growth, there could be positive effects as well. If US consumers decide to spend more as they benefit from declining energy bills and gas prices, retail sales may beat expectations. So even when positioning for a deteriorating environment, we believe a portfolio should hold some positions in high-quality, cash-generative companies that could do well if consumer spending exceeds expectations.

Good defenses for difficult markets can be built by following a disciplined strategy for the long term (*see "Differentiating Downturns"*). And popular safe havens aren't always as secure as they might seem. Hiding out in the same places as everyone else may provide an illusion of security that won't necessarily be safe when markets shift from risk-off to risk-on mode. Instead, be creative when searching for stocks that are capable of withstanding volatility. By following clear guiding principles, investors can find companies that have both solid long-term prospects and the ability to hold up well during a downturn.

DIFFERENTIATING DOWNTURNS
KURT FEUERMAN

Nobody has a crystal ball to predict the future direction of the US economy. But even if it heads into a slump, not all companies and industries will be affected equally—and there are different drivers of every downturn.

Back in 2000, the recession was caused by the bursting of the Internet bubble. Capital investment in technology tumbled. Yet over the next five years, homebuilding was the best sector in the stock markets.

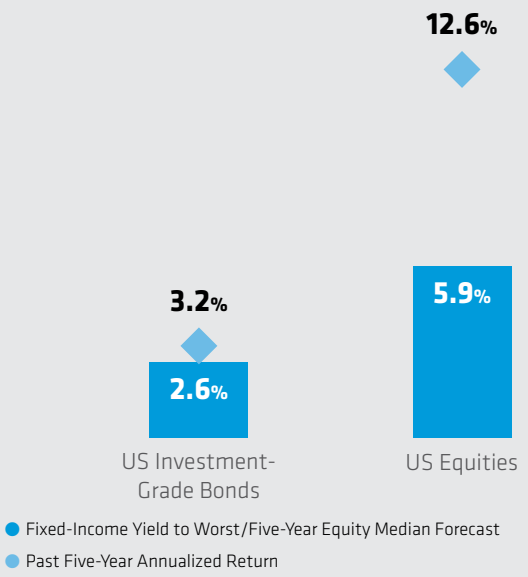
Today, challenges to the US economy are emanating from the oil-price slump and slow global growth. These are far removed from the US household, which is benefiting from low energy prices and continuing to spend. Similarly, American banks aren't directly affected by these issues. By some metrics, the US banking system is stronger than it's been in decades. The equity-to-asset ratio is 9.4%, its highest level in over two decades. Credit losses are extremely low—a dramatic turnaround from the mountain of bad debt that caused the 2007 financial crisis.

Still, investors shouldn't be complacent. Mounting challenges to the US economy in 2015 and early 2016 have increased the odds of a recession, in our view. However, we believe that there's also a good chance the US will dodge a recession and experience a growth scare or slowdown instead. Several positive forces continue to support the economy, including consumers' record household free cash flow and wealth, as well as a healthy banking system.

So what should investors do? Balance portfolio exposures. We believe a barbell approach can be effective in this environment. Create a portfolio that balances exposure to high-quality, less cyclical stocks with exposure to some cyclical stocks that have solid fundamentals. For investors seeking a more defensive solution, a portfolio that actively allocates to long holdings, short holdings and cash can help to manage their market exposure. These types of constructions can provide solid defenses for a deteriorating economy while also providing upside potential if a worst-case scenario is avoided and the economic recovery persists—or accelerates.

> Don't let short-term volatility influence a long-term investment plan.

DISPLAY 8: ADJUSTING RETURN EXPECTATIONS
Historical and Forecast Returns



Neither past nor forecast performance is a guarantee of future results. Annualized returns and current yields as of December 31, 2015. Median forecast based on proprietary AB forecasts as of December 31, 2015. Current yield represented by yield to worst. Annualized returns in US dollars. US investment-grade bonds represented by Barclays US Aggregate Index. US equities represented by S&P 500 Index. 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: Barclays, FactSet, S&P and AB

WHY STICK WITH EQUITIES?

Our playbook can help investors cope with a variety of investing challenges and stick with equities through changing market conditions. It's important not to succumb to short-term volatility when developing a long-term investment plan.

There are good reasons to maintain a strategic allocation to equities, in our view. In a world of lower expected returns across all asset classes, we believe that equities still offer the highest return potential. Investments in stocks offer investors a route to participate in economic growth, to potentially increase their wealth and to maintain spending power over a long time horizon. With a sober perspective on equity return potential and a broader view of market trends, investors can find ways to gain comfort in equity strategies by following a few simple steps.

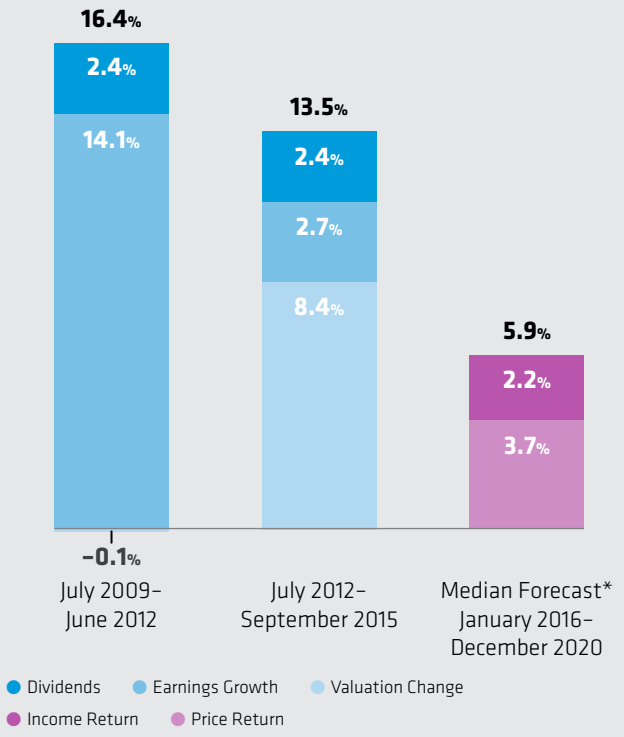
The first step is to adjust expectations. Since the global financial crisis, equity investors have become accustomed to unusually strong annualized returns, with the S&P 500 advancing by 12.6% from 2011 through 2015, driven by a recovery from a crash of historic proportions. We don't expect returns of this magnitude to continue in the coming years.

At the same time, fixed-income returns are also likely to remain low. Our Capital Markets Engine, which projects 10,000 possible outcomes based on a variety of market conditions, expects the S&P 500 to return an annualized 5.9% over the next five years (*Display 8*). That's much lower than the past few years, yet still significantly higher than our return projections from investment-grade fixed-income securities. This outlook highlights why we think maintaining an allocation to equities is essential for many investors to meet their long-term goals.

The second step is to understand the composition of equity returns. In the first few years of the recovery, US equity returns were driven primarily by earnings growth, as companies cut costs dramatically in response to the recession and increased their operating margins. From 2012 to 2014, equity returns were fueled mostly by rising price/earnings valuations (*Display 9*). We estimate that the lion's share of

DISPLAY 9: EQUITY RETURNS ARE DRIVEN BY DIFFERENT FACTORS OVER TIME

S&P 500 Returns: Attribution by Source



Past performance and current forecasts do not guarantee future results.
Latest available return attribution data as of September 30, 2015.
* Five-year annualized expected return for US equities uses proprietary AB forecasts as of December 31, 2015. Display reflects composition of expected US equity returns.
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. Numbers may not sum due to rounding.
Source: Compustat, FactSet, S&P Dow Jones and AB

REVENUE IS KING

JAMES T. TIERNEY

With US profit margins peaking and valuations looking frothy, a different approach is needed to make money in US equities. Instead of focusing on margins and P/E multiples, look for companies that can deliver sustained revenue growth.

In 2008–2009, operating margins for the S&P 500 fell to a low of 4.5%. Today, margins have rebounded to about 10%, according to S&P. But profitability gains have mostly come from cost-cutting rather than revenue growth. Positive economic forces can help drive revenues. For example, low unemployment, accelerating wage increases and low fuel prices should augment US consumer purchasing power. And consumer spending accounts for about 70% of US GDP. Car sales are already booming, and over time, we believe consumer purchases should extend to lower-ticket items, propelling a broader cross section of the economy.

Currency and energy trends should also help support growth. Although a strong US dollar eroded revenues in 2015, at current currency rates, its impact in 2016 will be much lower than it was in 2015. Likewise, stable energy prices will remove the significant revenue headwinds seen in 2015 in the energy sector.

These two factors should push revenues back into positive growth territory, from their decline in 2015. And we believe revenue growth will distinguish the winners from the losers.

Revenue trends are diverse. While aggregate revenues slipped in the third quarter, 16% of S&P 500 companies reporting increased their revenues by more than 10% in the fourth quarter of 2015, compared with the same period in 2014, and 31% of them boosted revenues by up to 10%. However, 53% saw their revenues fall.

Investing in US equities is never easy. Today, with low expected returns across various asset classes, we think that choosing the right manager is likely to be increasingly important. One way to gain conviction is to focus on managers that take a highly selective approach to finding companies that can increase revenues in a challenging market to deliver solid long-term investment returns.

> A challenging market environment may be good for active managers.

investor returns over the past six years has come from corporate profit margins and P/E expansion.

The third step is to recognize that future stock returns are likely to be different from those of the recent past. Over the next decade, our forecasts indicate that earnings and dividend growth are likely to drive equity gains, while multiple expansion will probably be modest. Indeed, with profitability touching historical highs, US corporate margins could face a range of downward pressures, including wage inflation, a rebound in commodity prices, and higher interest rates. And as rates rise, the dollar is likely to strengthen, which could compress the dollar value of revenues that American companies generate in other currencies from international markets (*see "Revenue Is King," page 10*).

But there are some silver linings in the market. Recently, dividends have continued to grow faster than earnings. According to Fundstrat Global Advisors, S&P 500 dividends per share rose by 13% in 2014, compared with earnings-per-share growth of 9%. In 2015, EPS growth was negative (or flat, excluding energy), but dividends per share grew by about 12%.

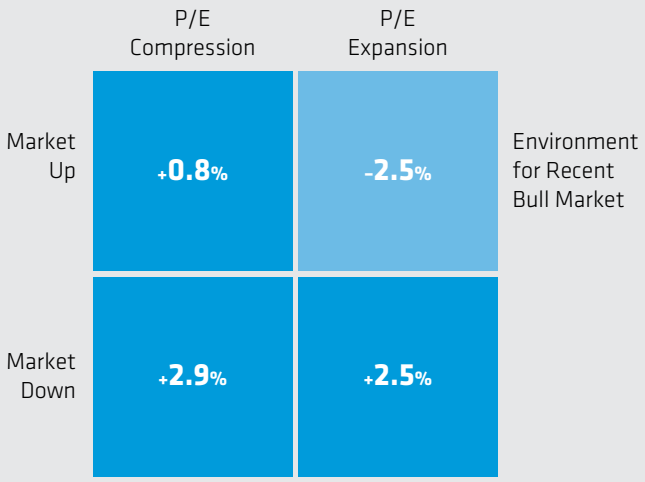
We think dividend growth could continue to be robust, as many companies have large cash reserves and little appetite for large capital expenditures in a moderate-growth world economy.

Finally, the challenging market environment may actually be good for active managers. Our research suggests that active managers add more value when P/E multiple growth is constrained. Looking at the past 20 years, when multiples were rising across the board—as they did in the US bull market of recent years—US active managers underperformed the S&P 500 by 2.5% a year, net of fees (*Display 10*). Yet when multiples were compressed—in both up and down markets—active managers outperformed.

By delivering excess returns of 2.9% in down markets with compressed P/E multiples, we believe active managers can help investors gain the confidence to stick with equities during downturns,

DISPLAY 10: ACTIVE MANAGEMENT LIKELY POISED TO OUTPERFORM

Relative Return*



Past performance and current forecasts do not guarantee future results.

As of December 31, 2015

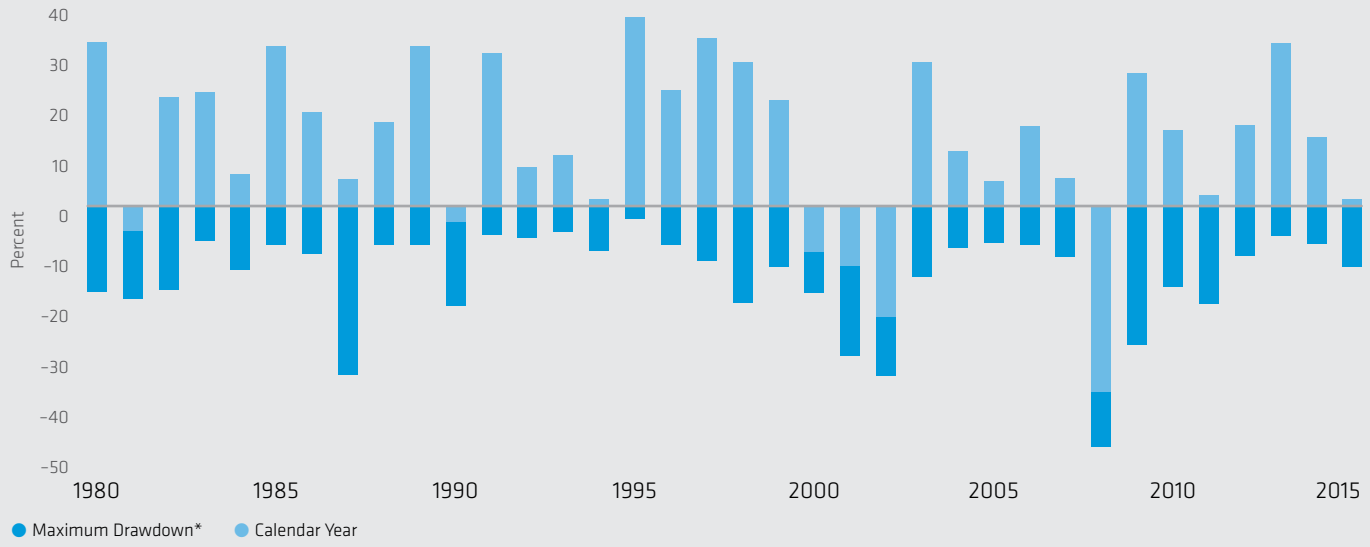
* Represents relative performance of Morningstar US Open-End Large-Cap managers vs. S&P 500 starting January 1, 1995, when the one-year (YoY) change in P/E was positive or negative when the market return was positive or negative over that same one-year period.

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. Numbers may not sum due to rounding.

Source: Morningstar, S&P Dow Jones and AB

DISPLAY 11: EQUITIES HAVE GAINED IN 30 OF 36 YEARS DESPITE SIGNIFICANT DOWNTURNS

S&P 500 Index Calendar-Year Returns and Market Corrections (1980–2015)



Historical analysis and current forecasts do not guarantee future results.
As of December 31, 2015
***** Maximum drawdown refers to the largest market drops from peak to trough during the year.
Source: Bloomberg, J.P. Morgan, S&P Dow Jones and AB

in order to benefit from being in the market on the way up. And despite significant drawdowns over time, US equities have advanced in 30 out of the past 36 years (*Display 11*). For investors who need to access equity returns over time, staying in the market is crucial, because it's almost impossible to time inflection points.

FOLLOWING THE PLAYBOOK FOR INVESTING SUCCESS

When volatility strikes, it's hard to stick to an investing playbook. Just as a football team that's losing an important game might abandon a plan and improvise in the hope of staging a recovery, investors under duress can be tempted to shift a portfolio or allocation in response to market surprises, while losing sight of their strategic goals.

It usually doesn't work. Staying disciplined in the face of adversity is more likely to yield better results, in our view.

Of course, there are many different ways to implement our investing plays in the US stock market. A growth-centric manager can use them to find high-return, cash-generative businesses with clear paths to implement its strategy through changing conditions. An unconstrained manager can use them to create a portfolio of companies that balances high-quality and cyclical holdings. The playbook can also be used to create a concentrated equity portfolio consisting of a very small group of stocks with unique, differentiated business advantages. And for a thematic approach, a portfolio manager can apply these ideas to navigate disruptive trends that are creating big opportunities in new markets. By applying these concepts with differentiated research, high conviction and disciplined investment processes, we believe investors can find the right approach to capture excess US equity returns over long time horizons, no matter how unruly markets are.

NEW YORK
1345 Avenue of the Americas
New York, NY 10105
(212) 969 1000

LONDON
50 Berkeley Street, London W1J 8HA
United Kingdom
+44 20 7470 0100

SYDNEY
Level 32, Aurora Place, 88 Phillip Street
Sydney NSW 2000, Australia
+61 2 9255 1299

TORONTO
Brookfield Place, 161 Bay Street, 27th Floor
Toronto, Ontario M5J 2S1
(416) 572 2534

TOKYO
Marunouchi Trust Tower Main 17F
1-8-3, Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9000

HONG KONG
Suite 3401, 34/F
One International Finance Centre
1 Harbour View Street, Central, Hong Kong
+852 2918 7888

SINGAPORE
One Raffles Quay
#27-11 South Tower
Singapore 048583
+65 6230 4600

INDEX DEFINITIONS:

Barclays US Aggregate Index represents the performance of securities within the US investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, asset-backed securities, and commercial mortgage-backed securities. **MSCI World Index** (and corresponding country-specific indices) represents the equity market performance of developed markets. **MSCI Emerging Markets Index** is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consisted of 21 emerging-market country indices. **Morningstar Open-End US Large Cap Managers** reflect large-blend, large-value and large-growth portfolios that invest primarily in big US companies. **Russell 1000 Index** represents the performance of 1000 large-cap companies within the US. **Russell 3000 Index** represents the performance of the largest 3000 US companies as a representation of the broad market. **S&P 500 Index** includes 500 US stocks and is a common representation of the performance of the overall US stock market. Net returns include the reinvestment of dividends after deduction of non-US withholding tax.

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