



SEEING THE FUTURE THROUGH EMERGING CONSUMERS' EYES

GROWTH INVESTING AT THE GRASSROOTS



IN THIS PAPER: Consumers in emerging markets represent one of the biggest investment opportunities in the world today. How can investors capture this opportunity most effectively?

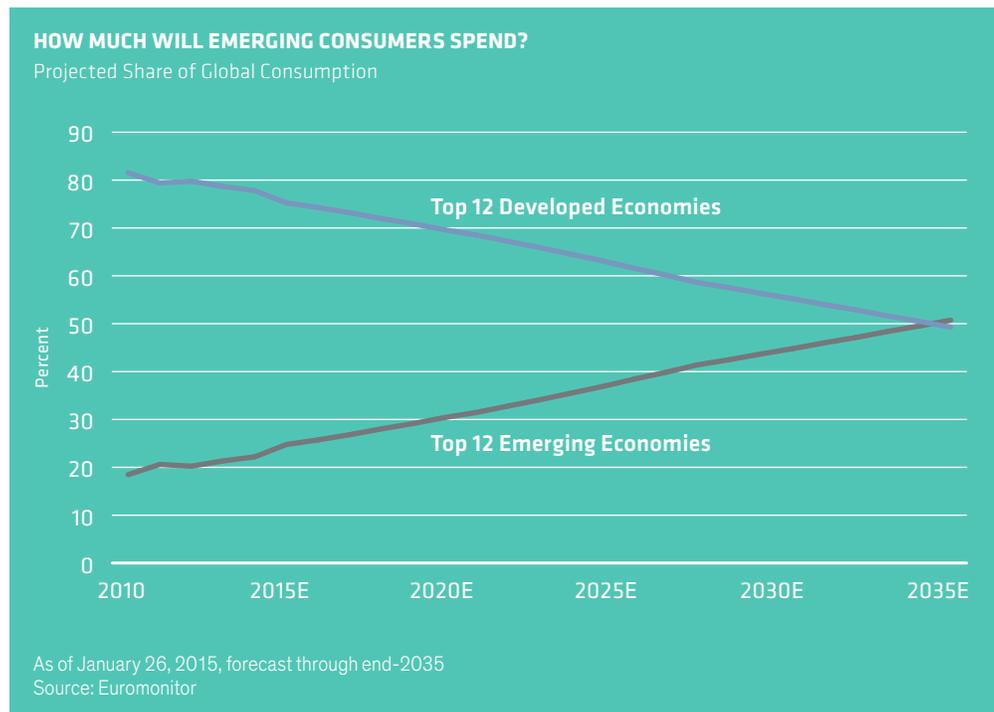
Traditional research is not the best way, in our view, because it focuses on companies that have succeeded in the past. We take a different approach which looks to the future by talking face-to-face with emerging-market consumers about their hopes, dreams and aspirations.

TO UNDERSTAND THE FUTURE, TALK TO IT

Several times a year we visit various emerging-market (EM) countries and, with the help of locally-based consumer research consultants and interpreters, talk face-to-face with consumers in their homes, to learn about their spending habits, life experiences, hopes, dreams and aspirations.

By doing this, we can identify spending patterns and growth trends before traditional investment researchers can and, indeed, before many companies do, too. We then conduct further research to identify the companies most likely to benefit from these trends.

In this way, we can invest in the success stories of tomorrow—the companies, whether listed in emerging or developed countries, that will be the most successful in serving the emerging-consumer market and in delivering competitive, sustainable risk-adjusted returns to their shareholders.



In a small village in India, a working mother wakes up at 4 a.m. to feed her family and says a refrigerator would change her life. Thousands of miles to the northeast in Inner Mongolia, a herdsman aspires to provide his children with an education. A continent away in Nigeria, a shopkeeper explains why her stall in a poor neighborhood of Lagos stocks premium brands.

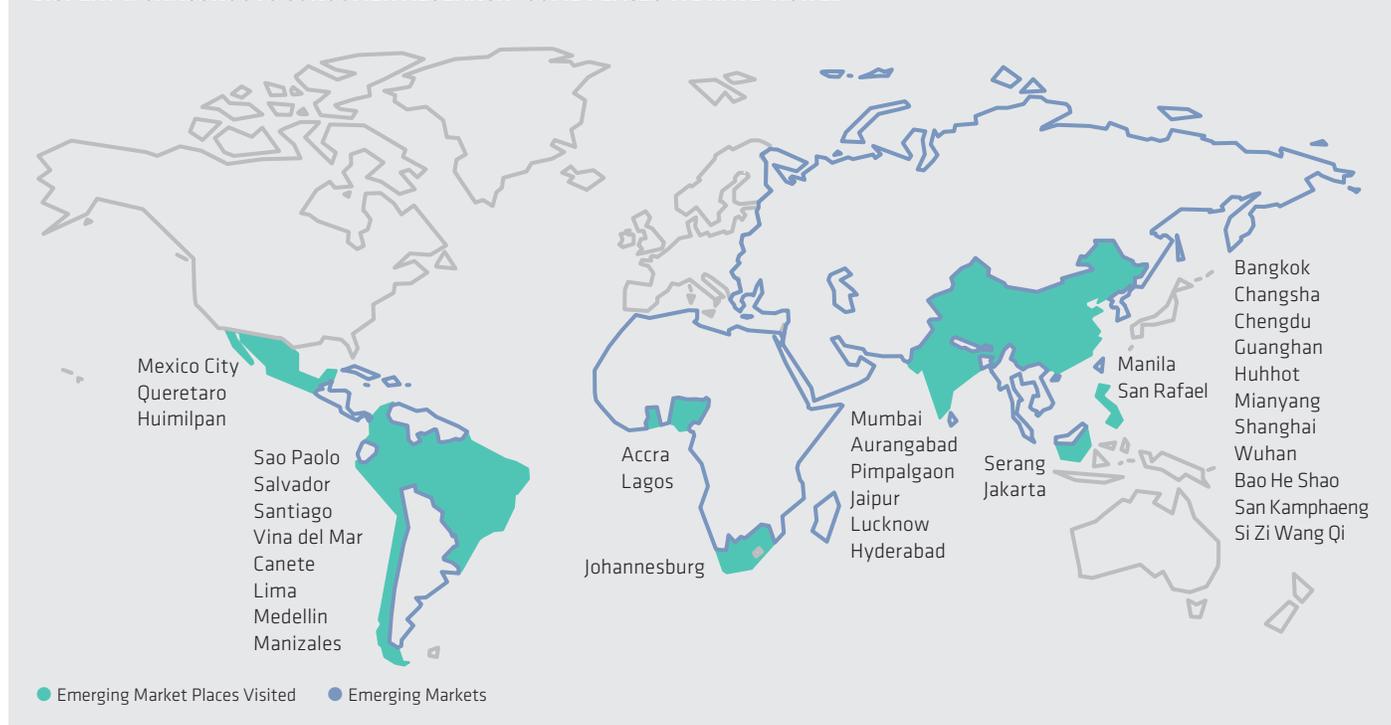
These disparate stories are tied together by a common theme: the consumer revolution in emerging markets. Around the world, emerging-market growth is transforming the lives of hundreds of millions of people and changing the way they spend their money. For investors, this represents a huge opportunity. But how can a portfolio capture the enormous growth potential represented in the stories of ordinary people in so many different countries and cultures?

To answer this question, we believe that real people in emerging markets must be put at the center of the investment research process. We call this grassroots research, and since 2011 it has

taken us to Nigeria, South Africa, Ghana, India, Indonesia, Thailand, the Philippines, Inner Mongolia in China and Brazil, Chile, Colombia and Peru (*Display 1*). During these field trips, we talked to people in their homes about their hopes, dreams and aspirations, in order to glean vital information about the trends that will redefine consumer markets. This paper presents some of our findings and explains how the grassroots approach complements traditional investment research methods to help illuminate diverse opportunities with powerful return potential.

Over the coming decade, trillions of dollars will be directed to new consumer spending in emerging markets (*See Gauging the Spending Trajectory, page 4*). But how can we figure out today where all this money will go and what companies will be the beneficiaries? Traditional investment research in consumer sectors often focuses on the biggest stocks in a benchmark and aims to predict short-term trends such as sales and earnings for the next few quarters. Consumer-oriented companies take a very different approach.

DISPLAY 1: GRASSROOTS CONSUMER RESEARCH—SOME PLACES WE HAVE VISITED



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There are many myths about the attitudes of emerging-market consumers

DISPLAY 2: MYTHS OF EMERGING CONSUMER INVESTMENT

- + EM exposure should be through EM listings
- + Consumers want cheap goods
- + Eating habits simply shift from carbohydrates to protein
- + Consumers in all fast-growing EMs are optimistic about their future
- + All multinational corporations can leverage brand strength into EM
- + The middle classes will experience the fastest rise in income
- + Leisure time is only for the emerging middle classes
- + Luxury goods consumption is just a China bubble
- + Baby formula is for the well-off

Source: AB

Global manufacturers of consumer brands engage with customers around the world in their homes and even look in their cupboards for strategic intelligence.

This is what our approach seeks to emulate. In our view, grassroots research is the key to anticipating trends in consumption habits and to discovering where companies are likely to go—even before they know themselves. It helps us think like consumers and the companies that market to them, while challenging assumptions and debunking myths that may lead investors astray.

DEBUNKING MYTHS

There are many common myths about the attitudes of emerging-market consumers and how they feed into market trends (*Display 2*). For example, it's often assumed that people in developing countries prefer local brands and cheaper goods. That's not what we heard from consumers and shopkeepers across the developing world.

QUALITY IS KING: FROM SOUTH AFRICA TO THAILAND

Just ask the South African women to whom we spoke in Soweto, Johannesburg. Every month, these unemployed women meet as participants in a stokvel, a local savings club that is very popular among poorer South Africans. In this particular group, the women contribute to a pool that is used to lend out to other people at a lower rate than loan sharks. Almost unanimously, they expressed an unequivocal preference for quality goods at a fair price.

Many stokvel members choose to buy affordable brand-name clothes from a second-hand market at 3 a.m., when containers are being unloaded, rather than cheaper clothes without a brand name. Every group member had at least two credit cards or store cards—despite having no formal bank savings. And unlike in developed countries, where consumers typically compare products within a preferred retail chain, these women described how they compare prices of everyday items—such as shampoo or toothpaste—across different retail stores in order to find affordable brand-name products. These demanding customers seek the best possible value within their means, and are prepared to pay for it. As one South African man told us: “I worked hard for this rand, so I'm not willing to risk it.”

Based on stories like these, we believe that a focus on the middle income groups in emerging markets may be misplaced. Our research suggests that consumer spending will increase at a much faster pace

for lower income groups. In rural India, engineers' salaries changed little between 2009 and 2014 while poor rural workers enjoyed income rises of 18% to 20% a year. And across emerging markets, income growth of lower income groups is expected to outpace middle income groups through 2030 (*Display 3*).

Shopkeepers confirm our observations. In Ikeja, a poor neighborhood on the outskirts of Lagos, Nigeria, Emsee's street stall is beating modern retailers. She undercuts supermarket prices on established brands by running tight margins at a high turnover. It is

an intense business, requiring her to be open from 6am to 10pm, seven days a week.

Similar evidence can be found in northern Thailand, where Nuttakarn has a stall in the village market of San Kamphaeng. Her shelves stock local brands such as Twin Lotus Herbal Toothpaste and Oishi Green Tea next to global brands like Colgate and Nescafé. These products are such an integral part of the local consumer's shopping basket that Nuttakarn isn't even aware that the brands are global.

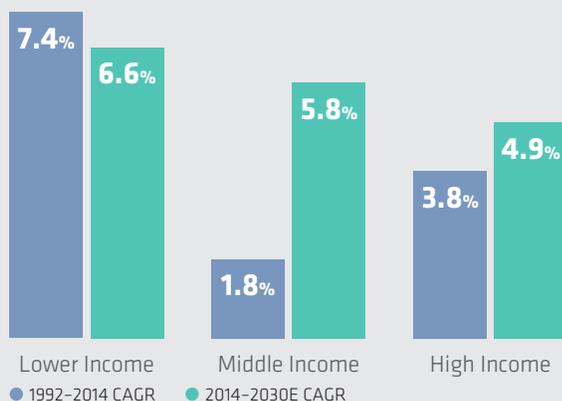
BRAND WARS: GLOBAL VS. LOCAL

What does this mean for investors? It means that in order to access the growth potential of consumer goods, investors must consider the dynamics of global and local brands. Often, local brands are gaining market share by attracting capital from overseas—and competing with multinationals. At the same time, global brands have been increasing market share by finding ways to get their products to poorer consumers who shop at traditional markets and stalls. So investing in companies listed in emerging markets isn't the only way to gain access to consumer growth. In some cases, investing in companies that manufacture and market global brands to sell in emerging markets can be an even more effective way to access the trend.

Yet not all multinational corporations can use their brand strength to penetrate emerging markets. Many of these markets are chaotic—they lack the developed world's physical, legal and institutional infrastructure. This supports a widely held belief that South Africa, which in some ways is more like a developed market, is a natural point of entry for doing business across the continent. In reality, companies that are good at managing chaos may have an edge—and these are often players from China, India, Indonesia and Korea, who are proving to be more successful at operating in other African countries where corruption is rife, bureaucracy is stifling and modern retail stores only account for a very small proportion of consumer sales.

DISPLAY 3: GROWTH FOR POORER GROUPS OUTPACES MIDDLE CLASS

Emerging Markets: Increase in Average Income by Income Group



As of June 30, 2014
 Based on data from 12 largest emerging markets: China, India, Indonesia, South Korea, Czech Republic, Hungary, Poland, Russia, Brazil, Chile, South Africa and Turkey
 Source: Euromonitor and AB

GAUGING THE SPENDING TRAJECTORY

Just how big is the emerging consumer opportunity? Boston Consulting Group believes China and India will consume US\$10 trillion by 2020; A.T. Kearney puts the figure at US\$15 trillion for all emerging-market consumers; McKinsey estimates it will be US\$30 trillion by 2025.

Drawing on OECD forecasts for consumption in the top 12 emerging-market economies, we expect growth rates of more than 8% a year to persist until at least 2035, when consumption will be US\$53 trillion, nearly five times current levels. Today the combined consumption of the top 12 developed markets and top 12 emerging markets is split 75:25 in favor of developed markets. We expect this to be 50:50 by 2035 (Display, inside front cover).

The scale of growth seems daunting—especially considering that it will unfold on three continents in dozens of countries. This is why it's especially important to adopt a research approach focused on identifying the underlying trends that will drive emerging-market growth from the ground up.

FUN TIMES: INVESTING IN LEISURE

Leisure spending is often misunderstood. Fast-food restaurants, Internet and cable TV are not just for the middle class. Take Tshilidzi, a 25-year-old freight forwarding contractor from Alexandra—one of the roughest townships in Johannesburg. Although he struggles to make ends meet each month, Tshilidzi spends 260 rand a month on pay television—and he wouldn't cut this cost under any circumstances. "I'd rather be hungry than bored," he says.

Downtime is also important to Abdu and Asnah, a low income couple from Jakarta, Indonesia. Abdu works as a service provider and Asnah is a housewife. Despite their low income, the couple have a television, a DVD player and a Chinese-made tablet, as well as a PlayStation 2 gaming console. And when they are in the mood for a fun day out with the kids, they head to Timezone, a popular game center at the local mall.

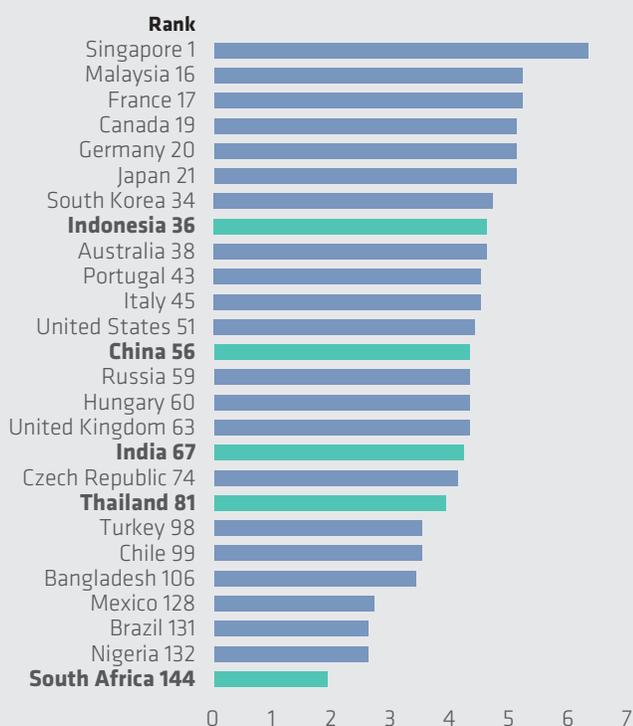
Fast food is becoming increasingly popular, too. In almost every country that we visited, people told us that fast-food restaurants—including global chains such as Pizza Hut and KFC—were the destination of choice for a family night out.

By speaking with consumers in different income groups, we discovered that television, leisure technology and fast food have become staples for poorer people in many countries. Similarly, grassroots research reveals that demand growth for baby formula should develop from lower income households, as more women across all income levels enter the workforce. And luxury goods consumption in emerging markets probably isn't a temporary bubble associated mainly with China, as commonly believed. In fact, we expect increasing wealth across emerging markets to spur more demand for luxury goods, which are an almost universal symbol of success.

Lifestyle preferences have global investment implications with local nuances. Naspers, a South-African media group, is poised to benefit from millions of people who want television as much as food. Yum! Brands, a US-based company that operates global fast-food chains, is well placed in key developing countries to benefit from increasing spending power. And a company like Starbucks should thrive in emerging markets, not only because more people can afford quality coffee; in India, a Starbucks coffee shop is perceived as a haven for quiet and personal space craved by people who generally live in crowded homes.

DISPLAY 4: EDUCATION IS THE BIGGEST RISK

Quality of Mathematics and Science Education*



As of December 31, 2014.

*Countries listed by rank, out of 144. Standard shown from 1—poor to 7—excellent

Source: "The Global Competitiveness Report 2014–2015," World Economic Forum.

CLARIFYING RISKS

As well as debunking myths, grassroots research can help to clarify risks. It is widely believed that the biggest risks to growth in emerging economies are corruption, war and undemocratic regimes. In fact, we believe that education is the biggest risk.

TALE OF A MONGOLIAN HERDSMAN

Education is high on the agenda of traditional herdsmen in Mongolia. Aituertai, a man in his thirties who has a flock of more than 800 sheep, has been temporarily relocated from his village of Si Zi Wang Qi to Baotou City under Chinese government policy to allow his land to lie fallow for five years. Government subsidies have increased his family's income—and dramatically changed his family's life.

From a rural existence without electricity, Aituertai's apartment now boasts a large-screen television, a PC, fridge and mobile phones. Yet he knows that the real promise for a better future is education. Aituertai's five-year-old son now goes to school in town to get a bilingual education—in Mongol and Mandarin—that will provide the tools for progress in China. Perhaps he stands a better chance than other rural herdsmen of empowering his son to succeed in the 21st century. For many of his peers, the cost of sending children to the city for a high school education, accompanied by a family member, is prohibitive.

EDUCATION AND THE MIDDLE INCOME TRAP

Families across the developing world value education. Collectively, their decisions—and the educational opportunities where they live—could influence the direction of entire economies. Several recent academic papers have argued that emerging consumers face a "middle income trap." The switch from a low-productivity sector like agriculture to a higher-productivity one like industry can trigger a one-off rise in GDP per capita, but it depends on the application of imported technologies in producing labor-intensive, low-cost products. We think education is the key to avoiding this trap.

The education risk varies significantly. Based on 144 countries surveyed for the quality of their mathematics and science education, India and China rank high while Thailand and Indonesia are lower and South Africa is at the bottom (*Display 4, prior page*). Each country faces unique challenges. In India, girls are only starting to receive equal opportunities in education; in South Africa, education is widely considered to be a free good. Our grassroots research has identified the particular educational challenges that every emerging market faces to help analyze the growth potential and investment opportunity.

Of course, there are many other threats to consumption growth. People in diverse countries expressed concerns about healthcare, the availability of finance for consumers and small businesses, security of food supplies and a need for reliable infrastructure (*Display 5*). All must be considered when weighing investments in a region, country, sector or company.

CASE STUDY: INDIA'S SWEET TOOTH EVOLUTION

Translating grassroots research into consumer-related investments with strong potential is a complex process. In this example, we demonstrate how a visit to Mumbai, India, helped identify investment opportunities in the food industry.

During our trip, we visited the home of Ranjana, the wife of a middle income jeweler, who was proud of her healthy diet. But, when we gave her US\$10 to spend in a convenience store, she bought a jar of instant coffee, some savory snacks and chocolate.

PREMIUMIZING CREATES NEW DEMAND

Later, after studying photos we had taken of the contents of her food cupboard, we saw that Ranjana did indeed cook healthy meals for her family. Yet the items she bought in the shop did not match those in her cupboard. We realized that when she spent our money she was “premiumizing”—or spending on goods that she would buy if she had more disposable income.

Using insight and data from similar encounters acquired during our field trips, we developed a picture of how premiumizing could spur demand for a range of food products and their ingredients—in this case, sugar-based snacks and desserts in India (*Display 6, next page*).

FROM ICE CREAM TO INVESTMENT

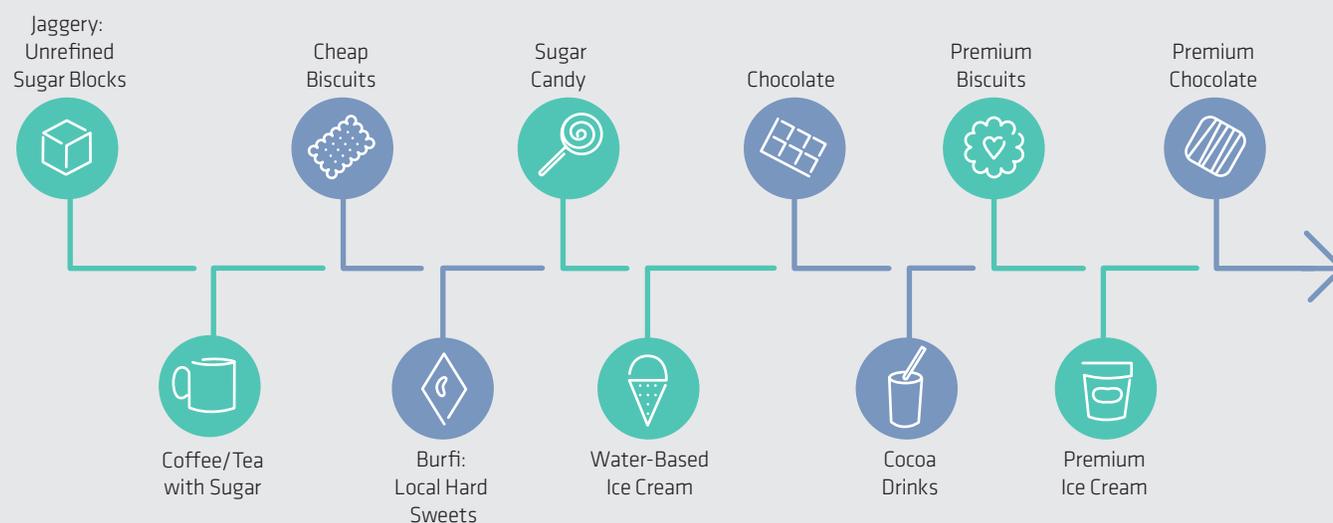
As the display shows, the product line begins with unrefined sugar and moves through sugar in tea as an energy boost to cheap biscuits, local sweets, cocoa drinks, and sugar candy. As refrigeration becomes available, the product line progresses through

DISPLAY 5: UNDERSTANDING THREATS TO CONSUMPTION GROWTH

Threat	Issue	Myth	Insight	Threat Level
Poor Education	Education is the path out of poverty	Education is highest priority for consumers	Regional variation of desire	High
Inadequate Healthcare	Life expectancy must go up	It's vital to invest in treating developed-market diseases (e.g., cancer)	Focus on rural obstetrics, childcare and trauma	Medium
Insufficient Finance	Consumers must borrow to finance consumption	Banks are the only source of finance	Self-help schemes allow consumers to help each other	Medium
Food Shortage	A modern lifestyle requires an intake of 2,000 calories per day	High calorie foods, e.g., protein, are resource-intensive. Farming methods cannot cope	Modern methods will be introduced	Low
Unreliable Infrastructure	Developed world took 250 years	Huge investment is required to “become developed”	Communication and technology can disrupt pace of development	Low

For illustrative purposes only
As of September 30, 2015
Source: AB

DISPLAY 6: EVOLUTION OF THE SWEET TOOTH IN INDIA



Source: Häagen-Dazs, Mondelez International and AB

ice cream, chocolate, premium biscuits, premium ice cream and premium chocolate.

By following this progression we can identify the potential risks and opportunities for companies operating in this market and which companies are likely to suffer or benefit. In our view, this is much more instructive than the traditional research approach of simply talking directly to companies. After all, a manufacturer of cheap biscuits currently enjoying strong growth is unlikely to share its concerns of a looming shift to more expensive products. Conversely, an ice-cream manufacturer isn't going to be keen to divulge the huge potential demand for its product given the value of such information to its competitors.

IT'S ALL ABOUT THE CONSUMER

The growth of consumption in emerging markets is an exciting investment opportunity. But the investors who should benefit from

it most will be those who grasp an important truth: consumers—not companies—will drive this growth.

We believe that it's time to cast aside conventional ideas about using country listings and market indices to access emerging consumer trends. Instead, think first and foremost about the aspirations of people in the developing world, because this is what will drive demand for products and services across emerging economies.

Grassroots research is the bridge from traditional investing methods to the engines of emerging consumer growth in the years to come. By trying to see the world from the perspective of emerging consumers, we can think like consumer companies and develop powerful investment ideas.

ESG CONSIDERATIONS ARE INTEGRAL TO OUR INVESTMENT PROCESS

Environment, Social and Governance (ESG) considerations and active ownership are a core part of our investment strategy: from identifying themes for alpha generation through grassroots research, followed by systematic inclusion of ESG factors in our risk assessment, and, finally, continuing engagement with the companies in which we invest.

ALPHA GENERATION

The questionnaires used in our grassroots research address social issues such as access to education, capital and healthcare, what drives empowerment for women, what are people at the bottom of the pyramid looking for and how do they live within their environment (*Display*). These ethnographic studies look at social, governance and environmental issues because for many rural communities these are key to their livelihoods. While ESG is an integral part of all of our investment themes, the following three themes have a particular ESG focus:

- + Bottom of the Pyramid: a theme on social inclusion
- + Changing Eating Habits: from environmental, health and social perspectives
- + Women's Empowerment: a theme on social inclusion

Rather than adopt a filtering system based on a third party vendor, or a simple set of criteria, we fully research the way that companies conduct their business. This is especially important in emerging markets where the regulatory frameworks are different from those of developed markets. Our work in Indonesia highlighted a strong desire among families for a good education. However, we found that corruption is endemic to the educational system. This made it

unsuitable as an investment case as we don't know when or if the government might intervene to curb corruption, and what effect this might have on individual companies.

RISK ASSESSMENT

When assessing stock-specific risk, we undertake a pre-mortem exercise in which our analysts assume that a company has failed and ask: what went wrong? Potential risks are classified into four categories: ESG, Financial, Operations and Strategic. Quantifiable ESG risks form part of a cost-of-equity calculation to compute risk-adjusted returns to assist portfolio construction. For example, the nature of the food production business means that many companies have a supply chain risk. We found one Colombian company that conducted internal audits of their supply chain. Although this lowered the company's risk score somewhat, we would prefer to see the company adopt an external audit practice. ESG risks are not always easy to quantify and when that is the case, a company will be deemed unsuitable for investment.

ENGAGED AND ACTIVE MANAGEMENT

Company engagement happens before a position is taken and on a continuing basis once a position is established. Initially, it is to understand the company and evaluate its management. We then use our position as long-term shareholders as an opportunity to drive positive change through effective engagement. In the case of the Colombian food producer, we met with management and explained the benefits of external supply chain audits and how they would reduce the cost of capital in our investment model. The board of the company accepted the feedback and resolved to hire an external audit firm. As part of our engagement programme we will monitor the adoption and effectiveness of this change.

ESG: A KEY DRIVER OF OUR INVESTMENT CHOICES

GRASSROOTS RESEARCH

IDENTIFIES AND ASSESSES ESG ISSUES

- + Education
- + Healthcare
- + Women's empowerment
- + Environment etc.



PRE-MORTEM RISK ASSESSMENT

SYSTEMATICALLY EVALUATES KEY RISKS

- + ESG
- + Financial
- + Operations
- + Strategic



CONTINUING COMPANY ENGAGEMENT

DRIVES POSITIVE CHANGE THROUGH ACTIVE OWNERSHIP

- + Boards and senior management
- + ESG and other governance issues

ALLIANCEBERNSTEIN L.P.

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

ALLIANCEBERNSTEIN LIMITED

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

ALLIANCEBERNSTEIN AUSTRALIA LIMITED

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

ALLIANCEBERNSTEIN CANADA, INC.

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

ALLIANCEBERNSTEIN JAPAN LTD.

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

ALLIANCEBERNSTEIN INVESTMENTS, INC. TOKYO BRANCH

Marunouchi Trust Tower Main 17F
1-8-3, Marunouchi, Chiyoda-ku
Tokyo 100-0005, Japan
+81 3 5962 9700

ALLIANCEBERNSTEIN HONG KONG LIMITED

聯博香港有限公司

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

ALLIANCEBERNSTEIN (SINGAPORE) LTD.

30 Cecil Street, #28-08, Prudential Tower
Singapore 049712
+65 6230 4600

SANFORD C. BERNSTEIN & CO., LLC

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

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