SWITCHING OFF THE EQUITIES AUTOPILOT

SELECTIVE STOCKPICKING FOR CHANGING TIMES

In recent years, investors have increasingly put their equity allocations on autopilot. Yet unlike commercial airliners, passive investment portfolios don't have a real pilot on hand to take the controls when turbulence strikes or to ensure a smooth takeoff and landing.

Most people aren't really ready to get onboard a fully automated plane. We're comfortable with computers managing much of our flight because we know that humans are in the cockpit, keeping watch over the complex systems and ready to instantly deploy their skills as conditions change. But when it comes to fast-moving markets, automated investment vehicles are widely accepted.

While exchange-traded funds (ETFs) are relatively cheap and simple, they aren't risk free. By providing blanket exposure to a market, passive portfolios don't even attempt to process the complex economic, corporate and market data that drive individual stock performance. In today's world of mounting political and economic uncertainty, we believe that active equity portfolios can help investors navigate dynamic market conditions for long-term success, just as long-haul pilots stay focused on delivering passengers safely to their destination—no matter how the weather may change along the way.

In this paper, we present five current insights on issues central to the active-passive debate:

+ Trump's agenda
+ Equity valuations
+ Passive distortions
+ Active advantages
+ Rising rates

Through these ideas, we aim to provide perspective on the importance of equities for investors today—and the pros and cons of passive portfolios. Of course, passive strategies have a role to play in investors' portfolios. At the same time, we believe that there are many important considerations about active management that often get overlooked and require closer attention.

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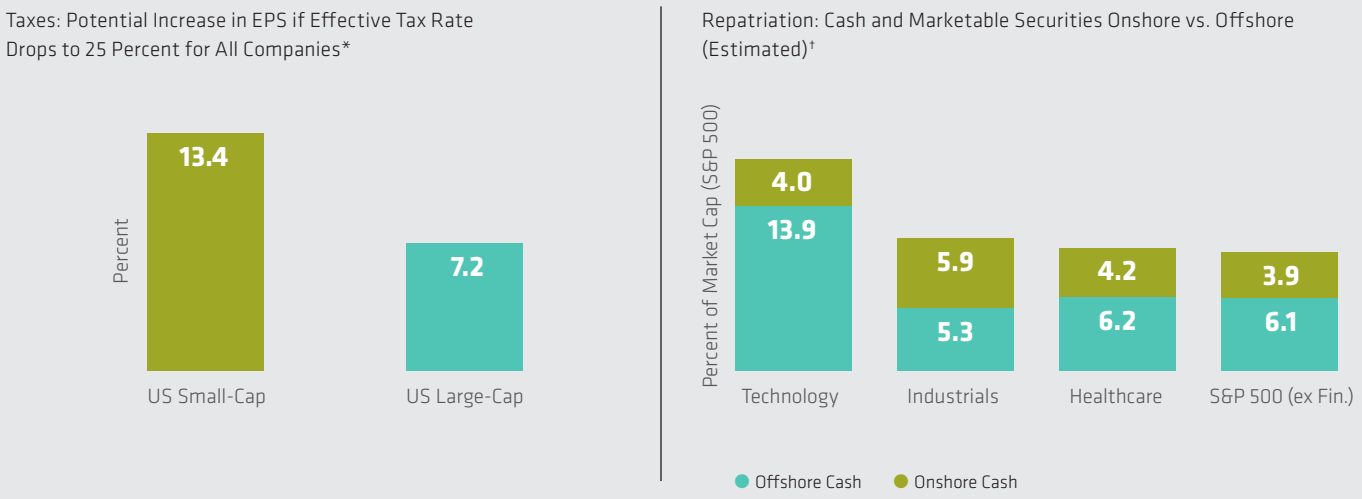
TRUMP'S AGENDA: AN EQUITIES ADVANTAGE

Donald Trump's election was a big surprise to markets, yet equity investors have been surprisingly sanguine. For several months after the election, US and global stocks rallied, driven by hopes that President Trump would push through an economic agenda that would inject fiscal stimulus into the economy, loosen regulation in several industries and fuel economic growth.

Still, it would be imprudent to assume that equity markets will rise uniformly during the Trump presidency, in our view. At the very least, Trump's unpredictable governing style is likely to prompt volatility. Indeed, in January, shares of some automakers and railway operators were hurt by Trump's tweets indicating that a border tax could be imposed on cars produced in Mexico for sale in the US. And in March, US stocks negatively reacted to the government's failure to repeal Obamacare. Over time, as Trump's policies are put into place, investors will need to focus on the following areas to identify potential winners and losers:

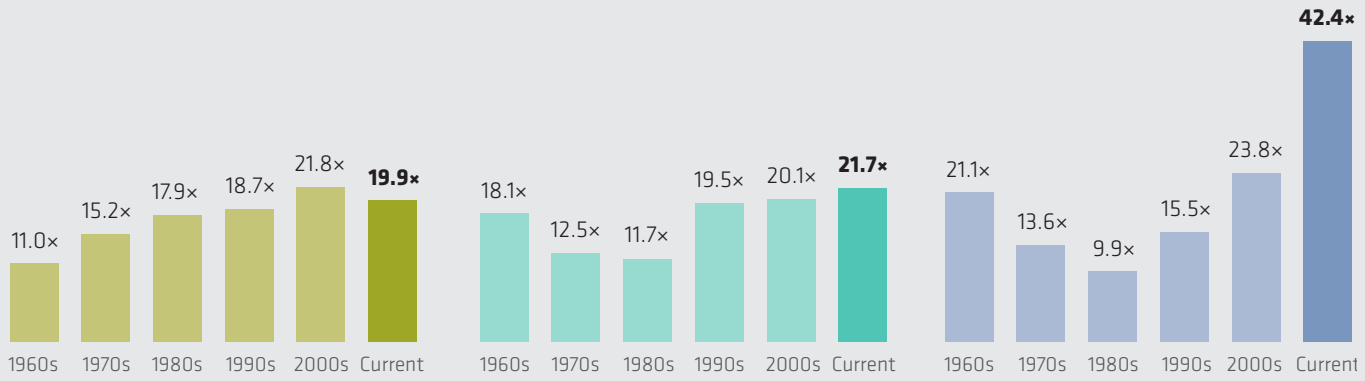
+ **Taxes**—The new administration has a stated goal of reducing corporate tax rates. But not all companies will benefit equally. Our research suggests that smaller-cap companies will benefit disproportionately. If the effective corporate tax rate drops to 25%, smaller companies should enjoy a 13.4% earnings boost, versus 7.2% for their large-cap peers (*Display 1, left*). However, Trump's difficulties with healthcare have exposed a rift within the Republican Party and raised doubts about his ability to push through tax cuts as promised.
+ **Repatriation**—US multinationals hold enormous amounts of cash abroad, which the Trump administration wants to bring back home. If new policies encourage a repatriation of cash from overseas, technology firms should do especially well (*Display 1, right*), as they hold much more cash overseas than companies in other industries. Extra cash in the US could be put to use for shareholders via buybacks, acquisitions or capital expenditures.

DISPLAY 1: WHO BENEFITS MOST FROM TRUMP'S CORNERSTONE AGENDAS?



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.
†As of October 10, 2016. Excludes financials
Source: Bloomberg, FactSet, Russell Investments, Standard & Poor's (S&P), UBS and AB

DISPLAY 2: HOUSING AND STOCKS STILL ATTRACTIVE RELATIVE TO BONDS



Past performance does not guarantee future results.
As of March 31, 2017
Indices are used for purposes of comparison only. An investor generally cannot invest in an index.
House P/E: National Association of Realtors Median Sales Price of Existing Single-Family Homes divided by median rent
Source: Strategas Research Partners and AB

+ **Deregulation**—Most likely, deregulation will focus on specific industries. In early 2017, shares of financial firms were the biggest beneficiaries of Trump's victory, as the industry was expected to be first in line to see the red tape loosened. Energy groups may also enjoy a boost as drilling rules are relaxed. Deregulation could deliver especially large benefits to smaller companies, because they spend a disproportionate amount of their fixed costs on compliance.
+ **Stimulus**—Plans to boost infrastructure spending could fuel growth for companies in various industries and support an increase in their stock prices.

EQUITY VALUATIONS

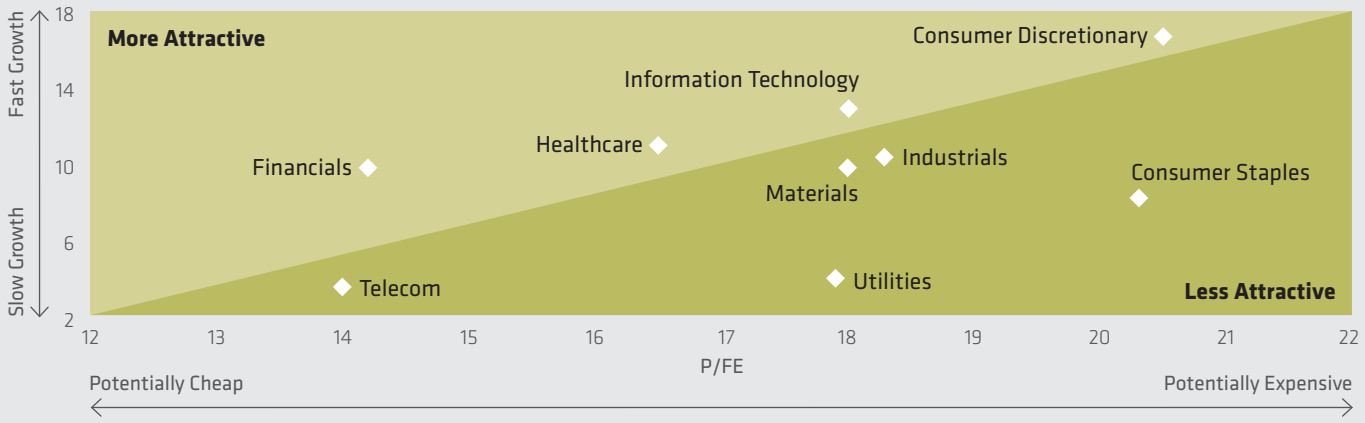
Equity markets have marched upward for the last eight years, since the trough in March 2009 during the global financial crisis. As a result, valuations have risen, particularly in the US, where some investors are concerned that stocks may be too expensive.

Yet we believe that market conditions today are markedly different from those in 2000 and 2007, just before equities tumbled into bear market territory. For example, in early 2017, there weren't really signs of panic buying or speculative excess, which fueled the technology and housing bubbles of the last decade. Inflows into equity funds have been relatively weak. And the pace of merger and acquisition activity and initial public offerings has been relatively moderate.

While US stock valuations are higher than their historical norms, we believe that equities are still attractive relative to Treasury bonds (*Display 2*). The S&P 500 Index trailing price/earnings (P/E) ratio was 21.7× at the end of March—slightly above the norm in recent decades. Yet US bond valuations look extremely inflated when compared with their historical norms, based on a measure in which we converted bond yields into a P/E-like metric, showing how much investors pay for the "earnings" on the US Treasury bond.

DISPLAY 3: US STOCKS—NOT EVERYTHING IS PRICED TO PERFECTION

Thomson Reuters I/B/E/S Five-Year Growth Forecast (%)



For illustrative purposes only. Historical and current analysis and forecasts do not guarantee future results.
As of March 31, 2017
Indices are used for comparison purposes only. An investor generally cannot invest in an index.
Excludes energy
Source: FactSet, MSCI, S&P Compustat, Thomson Reuters I/B/E/S, Worldscope and AB

There are many ways to assess stock valuations, and the picture can vary. The Shiller cyclically adjusted P/E ratio, which looks at stocks versus a 10-year moving average of earnings and adjusts for inflation, shows US stocks at 28.2 times earnings, slightly above their 25-year average of 26 times earnings. In the past, when stocks were at similar levels, annualized equity returns ranged from 5% to 10% over the following 10 years.

Most importantly, sector valuations are diverse. When we compare valuations of sectors against their five-year expected growth rates, the financials, healthcare and technology stocks look attractive (*Display 3*). In contrast, stocks in sectors such as telecom and utilities are growing at relatively slow rates, making their valuations less attractive.

Investors always need to be attuned to the valuations of assets. And in early 2017, US equities were not especially cheap in historical perspective or when compared with those in other developed stock markets, based on standard valuation metrics. That said, the sheer diversity of the US market offers active investors many different ways to capture attractively valued opportunities in sectors that are growing relatively fast and in individual stocks with stronger businesses and better fundamental characteristics than their peers.

PASSIVE DISTORTIONS

The passive investing boom has advanced at an explosive pace. The number of ETFs has risen from 629 in 2007 to 1,694 in 2016. Assets under management in these passive funds have grown fourfold, to $2.43 trillion, over the same period.

DISPLAY 4: PASSIVE (AND CLOSET INDEXING) CAN MASK HIDDEN RISKS
Navigating Risks Takes Active Skill
Percent

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 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

It's understandable why investors have been attracted to passive portfolios. They're simple, they're cheaper than active portfolios, and they offer investors new ways to access a wide variety of market, sector, style and factor opportunities. Yet we believe that these benefits may mask significant risks.

Risk 1: High margins and multiples. In the US, profit margins are very high and stock price multiples are slightly elevated relative to history. As a result, we don't expect an expansion of multiples to drive broad stock market gains in the future, and market returns may be muted. Active managers can identify individual stocks that have better growth prospects than the broad market.

Risk 2: Business disruption. In today's fast-moving business environment, disruptions are taking place at faster rates than ever. Digital advertising is transforming the media industry. Uber and electric vehicles are reshaping transportation. New markets are being created, often ones in which the "winner takes all." Passive portfolios cannot capture the big winners—or avoid the losers—from disruptive trends.

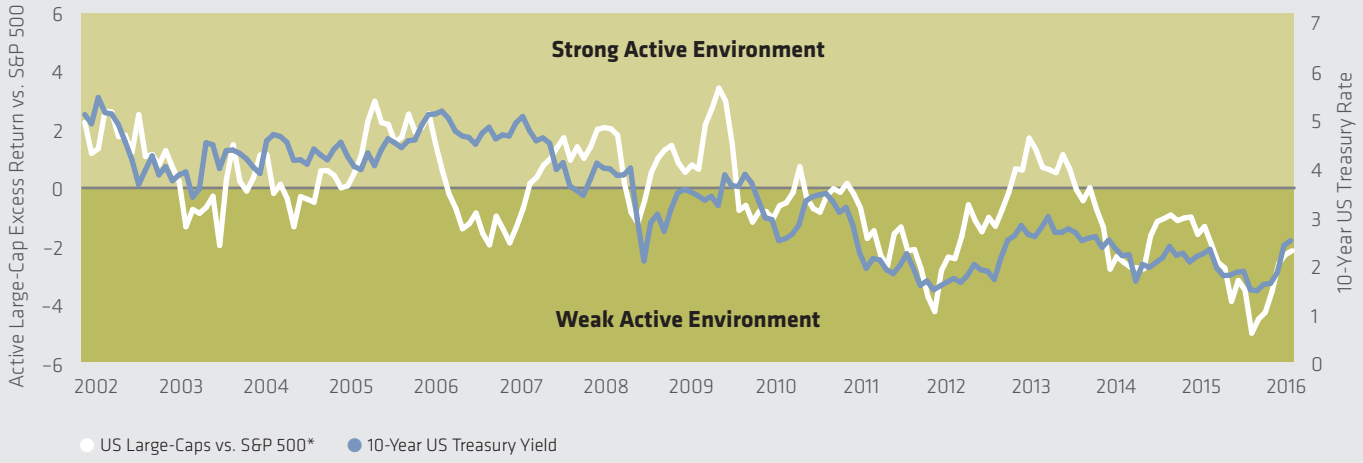
Risk 3: Backward-looking structure. For most passive funds, the market capitalization of stocks is the key factor in determining when a stock is added or removed. So a stock that has rallied and has an increased market cap will be given a greater weight in the portfolio. That means the portfolio is chasing yesterday's winners—instead of looking forward to tomorrow's success stories. For example, back in 2008, IBM was one of the 10 largest stocks in the S&P 500. After years of failing to maintain growth, it was ranked 31st in early 2017.

Since benchmarks are constructed by looking backward, concentration risks often develop (*Display 4*). During the dot-com boom in 2000, more than a third of the S&P 500 was concentrated in the technology sector, which tumbled by 38% in the next two years. Financials made up a fifth of the index in 2007, then dropped by 33% over the next two years. Today, high-dividend-yielding stocks make up 45% of the index, which we believe could leave a trail of collateral damage if the preference for these stocks unwinds quickly.

Risk 4: Index changes. Most equity indices are revised periodically as new entrants are added and others are removed based on the

DISPLAY 5: ACTIVE EQUITY PORTFOLIOS TEND TO DO WELL IN RISING-RATE ENVIRONMENTS

Median Active US Equity Fund Rolling 12-Month Relative Return vs. US 10-Year Interest Rates (%)



Past performance does not guarantee future results.

Through December 31, 2016

*Median excess returns of US large-cap value, blend and growth portfolios versus S&P 500. Oldest share class only. Excludes index funds

Source: FactSet, Morningstar, US Department of the Treasury and AB

changing market capitalization of companies. Upon announcement of a new entrant to an index, many investors rush to buy the stock, which artificially inflates its price before the portfolios actually buy it. Stocks that are to be dropped from an index similarly face tremendous selling pressure—pushing prices down ahead of the date that ETFs must remove the name.

Passive shareholders could find themselves on the losing side of both trends as index funds and ETFs adjust their constituents to match the benchmark changes.

Risk 5: Unintended exposures. Market distortions aren't purely a passive problem. They existed well before investors fell in love with ETFs. But the proliferation of passive investing could make the next market bubble even more painful for investors.

For example, stocks with the lowest volatility traded at a price/forward earnings ratio of 19.2× at the end of 2016—a 50% premium to their average over the last 38 years. Since the global financial crisis, investors have piled into portfolios offering these stocks as a haven of relative safety. Yet today, with more than $50 billion invested in low-volatility ETFs, we believe that a potential crisis of confidence in low-volatility stocks might leave many investors exposed to hidden risks.

ACTIVE ADVANTAGES

For many years, strong market returns—also known as beta—provided investors just riding the broad market trends with powerful gains. These days, the so-called beta trade has probably ended. That means market returns are expected to be lower and excess returns—or alpha—will matter much more for investor outcomes.

Since the global financial crisis, global and US equities have advanced at a rapid annual clip of 13.8% and 17.8%, respectively. Investors who followed a benchmark have enjoyed a free ride, fueled by extremely accommodative monetary policies that have allowed many companies, even those saddled by heavy debt, to prosper.

But our median forecasts suggest that global and US equities will probably advance by 6.3% and 5.6% a year, respectively, over the next five years. While much lower than in recent years, we think these returns are still attractive versus those of other asset classes. Because market returns are likely to be lower than in the past, adding even a modest excess return can make a big difference to investor outcomes. And since we expect margin and multiple expansion to be muted in the coming years, we believe that revenue growth will play a bigger role in driving equity returns. That means identifying stocks with above-average revenue growth will become more important for portfolio returns.

Market conditions might be setting the stage for active managers to display this advantage. Over the last five years, the monthly dispersion of stock returns was extremely low. In this environment, it's much harder for active managers to be rewarded for their differentiated insights. In fact, from October 2010 to February 2015, active portfolios didn't work well in any month recorded because dispersion was so low. And 2016 was the worst year on record for US large-cap growth managers: only 6% beat their benchmarks.

Things might be changing. Over the last five years, the average monthly stock market dispersion ranked in the 17th percentile of all months since 1980. Yet in the last three months of 2016, US stock market dispersion increased to the 39th percentile. A sustained increase in stock dispersion means that investors are discriminating more between the fundamental strengths and weaknesses of individual stocks. And it creates especially fertile ground for active managers to add value to equity portfolios.

RISING RATES

The recent increase in stock market dispersion is not taking place in a vacuum. Stock correlations have been coming down from elevated levels. There are growing signs of optimism in US consumer and business surveys. And short-term interest rates are widely expected to continue rising from historical lows that have been imposed by central banks as part of major stimulus programs.

The 10-year US Treasury yield climbed to 2.4% in March 2017, from a trough of 1.5% in mid-2016. Some of the new US administration's policies could add inflationary pressures to the economy, and interest rates could rise further.

Rising rates have been rewarding for active investing (*Display 5, page 6*). Our research found that equities often do well in rising-rate environments, with active portfolios in particular tending to benefit. That's because falling interest rates provide tangible benefits, such as lower borrowing costs, to a wide range of companies, and thereby support equity gains in general.

Yet when rates begin to rise, companies face new challenges. The rising cost of capital creates a new headwind for companies, which are forced to make tough decisions in order to continue to generate sustainable cash flows and earnings. In this type of environment, research becomes especially important for investors seeking to identify those companies that are making the right choices to support business success—and long-term returns.

Much will depend on what happens with inflation. If inflation rises too sharply, the broad benefits to stocks may be muted. Here, too, investors will need to be very selective in order to identify companies that can thrive through a period of reflation.

STEERING THROUGH CHANGING CONDITIONS

It's an exciting time for equity investors—but there's also a long list of uncertainties to reckon with. Equity market rallies have energized investors, while raising concerns about valuations. Political change has triggered hopes for fiscal stimulus in the US and beyond, yet sentiments currently sweeping the globe could prompt a backlash against globalization. Rising interest rates may improve the environment for stock pickers.

On balance, we believe that the time is right to invest in stocks. With the right approach, we think investors can find equity allocations to be especially rewarding—and essential components of a thoughtful, long-term investing program. Yet selectivity is paramount. With so many monumental changes shaping the economic, corporate and market environment, it's never been more important to have a captain at the helm of an equity portfolio to steer through quickly shifting market conditions.

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