Strategic Value*

KEY INVESTMENT THEMES

- Despite a fourth-quarter rally, the bear market continued in 2002—and broadened. Every major equity index and sector was down.

- Our portfolios outperformed the S&P 500 in the fourth quarter and the year.[1] We also outperformed Russell 1000 Value in the last quarter but underperformed for the year due to our holding in WorldCom. Over the entire bear market, we have outperformed both indexes by substantial margins.

- Equities appear very attractive to us versus fixed income. On their own, they appear fairly valued relatively to history. Our research suggests that the US equity market should provide annualized returns of 9.0% to 9.5% going forward.

- We see ample opportunity to achieve our performance premium over the market's returns. The opportunities we see are in stocks spread over a wide array of industries. We believe that our deep research resources position us to capitalize on the potential we have identified.

*This is one of a group of portfolios managed by Alliance Capital Management L.P. through its value-investing unit, Bernstein Investment Research and Management ("Bernstein").

[1]This reflects the performance of the majority of accounts. Individual account performance may differ from the typical results owing to a variety of factors, including choice of benchmark or timing of account opening or cash flows.

STRATEGIC OVERVIEW

Despite a fourth-quarter rebound, the S&P 500 ended the year down 22.1%, dragged down by concerns about the economy, the continuation of the tech stock collapse, corporate malfeasance and the threat of war. The market thus posted its third consecutive annual loss for the first time since 1939–1941. This bear market has not only been among the most severe since World War II; it has been the longest.

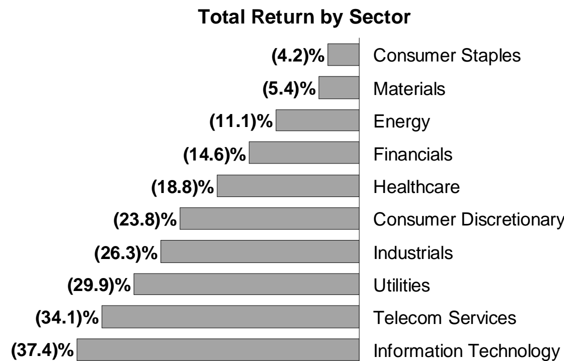
In some ways, the third year of this bear market was the most painful. In the first two years, value investors like ourselves were able to avoid declines in absolute returns by avoiding the casualties of the bubble: tech, telecom and merchant-energy firms. In 2002, however, there was nowhere to hide. Every sector was down (**Display 1**), and equity indexes fell sharply for large- *and* small-cap, growth *and* value, developed international and emerging-markets, and US equities (**Display 2**). Only high-quality fixed-income securities posted positive returns. The market's pervasive gloom is manifested in an extreme risk aversion that has led to extraordinarily low yields on T-bills and Treasury bonds—and a very high equity risk premium (**Display 3**).

In this environment, our deep-value portfolios outperformed the S&P 500 for the year as a whole, thanks to our choice of financial-services stocks, underweight of technology and emphasis on industrial resources. It is hard to take comfort, however, in positive relative performance when absolute performance is so far in the red. Moreover, we underperformed the Russell 1000 Value Index for the year, due primarily to our unsuccessful investment in WorldCom.

In the fourth quarter, however, the market reversed sharply: The S&P 500 gained 8.4%, powered by technology and telecom, which soared 34%. The Value Index did slightly better than the broad market, and our deep-value portfolios outperformed both, mostly due to strong stock selection.

Display 1

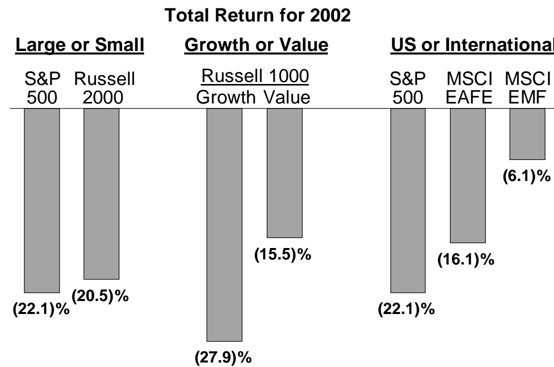
Every Sector Fell in 2002



Source: Standard & Poor's

Display 2

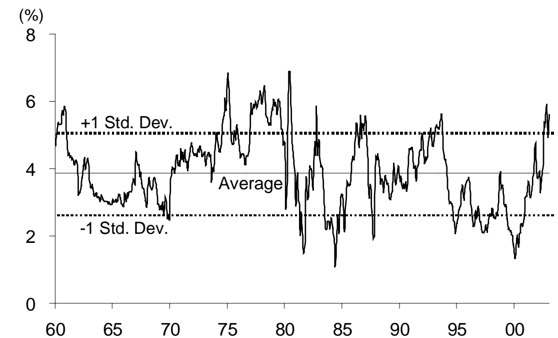
There Was Nowhere to Hide in Equities



Source: Frank Russell Company, MSCI and Standard & Poor's

Display 3

The Equity Risk Premium Is High



Through December 31, 2002; equity risk premium is the difference between the expected return on equities and the 10-Year US Treasury yield.
Source: Federal Reserve Board and Bernstein

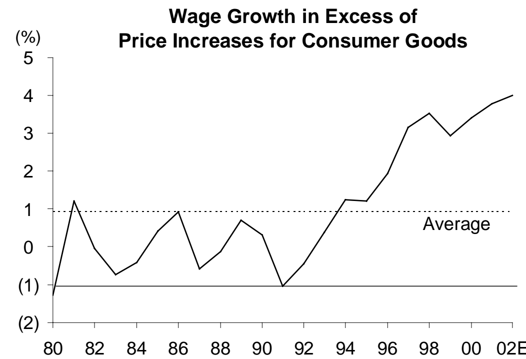
Is an end in sight?

It is too soon to tell whether the fourth-quarter rally represents a real turning point or is merely a temporary blip. While the economy is expanding, short-term indicators continue to be mixed; the potential impact of war remains uncertain, and concerns about corporate malfeasance may not fade quickly.

Our investment process, of course, is not based on short-term economic forecasts, yet it is worth noting that there are signs that the economy is on a path of sustainable growth. Declining unit costs have increased the affordability of many products, from electronic equipment to automobiles. Since wages have continued to rise while the price of goods has fallen, consumers have significantly greater buying power **(Display 4)**. Aggressive monetary policy that has made it possible for consumers to refinance their mortgages and obtain consumer credit at lower rates has also increased the likelihood of continued strong consumer spending.

Display 4

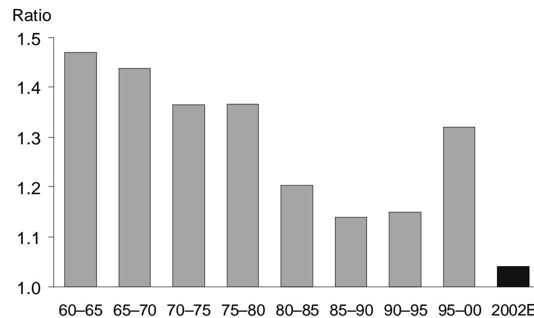
Consumer Spending Should Remain Strong



Through November 30, 2002
Source: Bureau of Economic Analysis

Display 5

Business Capital Spending Should Rise



**For equipment and software*
Source: Department of Commerce, Haver Analytics and Alliance Capital

The persistent problem is the extremely low rate of corporate capital spending. Since its cyclical peak in the third quarter of 2000, non-residential capital spending, which includes spending on structures, equipment and software, has declined by $170 billion, or 15%—by far the biggest and longest correction in business spending in the post-war period. The ratio of capital spending to depreciation is just about 1, the lowest level for any year since 1950 **(Display 5)**.

The drop in capital spending reflects the working off of the excessive investments made during the bubble years, the unavailability of capital, the weak economy, and a risk aversion in executive suites akin to that which afflicts financial investors. In our view, companies will have to increase spending—and in aggregate, they have the cash flow to do so. When it comes, this turnaround should spur the economy overall and be particularly beneficial to the hard-hit tech sector.

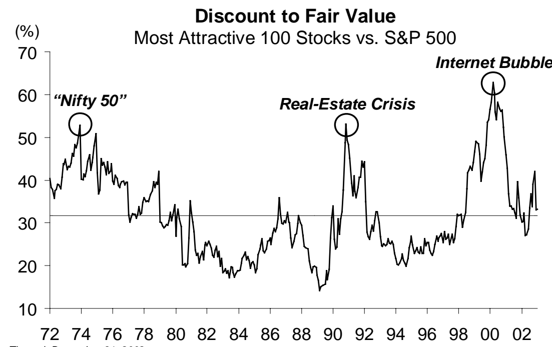
Stock selection: more important than ever

The value opportunity, as we measure it, is back to average after a brief spike in early fall **(Display 6)**, and its composition has once again shifted. The fourth-quarter rally in tech and telecom reduced those groups' share of our top quintile of value to about 34% from 45% in September. Technology, financials, consumer cyclicals and utilities are now the biggest components of a top quintile of value that is unusually diverse. Thus, while our portfolio retains a pro-cyclical tilt, because market anxieties are greatest about stocks that are sensitive to a decline in the economy, our portfolios are more diversified by sector than usual.

Short-term disappointments in corporate earnings announcements or industry data continue to have devastating effects on the absolute and relative returns of individual securities, and may continue to do so in the near future. In many instances, however, this extreme sensitivity to disappointment is likely to be misplaced, increasing the opportunity to add value through research. As in past periods when there was no major theme in undervalued or overvalued sectors, research-based stock selection is now critical to generating a premium.

Display 6

Value Opportunity Suggests Normal Premiums



Through December 31, 2002
A capitalization-weighted average of the most attractive (cheapest) 100 stocks vs. the S&P 500 according to Bernstein's valuation model. The proportion of Bernstein investments in stocks from this group will vary over time but will typically be high. Bernstein estimates of the fair value of these stocks may not be realized for a variety of reasons.
Source: Bernstein estimates

Display 7

We See Great Opportunity in Diverse Stocks

		Price/Earnings	
	Sector	2003E	Normalized
Nortel Networks	Tech	n/a	5.0×
Hewlett-Packard	Tech	14.6×	8.3
Chubb	Finance	10.0	7.9
ConocoPhillips	Energy	11.3	9.6
AEP	Utilities	9.6	7.8
S&P 500		15.9×	12.5×

As of December 31, 2002
Source: Company reports and Bernstein estimates

With that in mind, we are taking a somewhat different approach than usual to the Portfolio Themes section of this Investment Strategy Report. Rather than discussing two or three broad themes and our holdings within them, we are focusing on five companies that we find particularly attractive right now: Nortel Networks and Hewlett-Packard in technology, Chubb in financial services, ConocoPhillips in energy and AEP in utilities. Some of these companies have done relatively well in the last year; some have done poorly. But they are all *very* attractively valued **(Display 7)**.

PORTFOLIO THEMES

Nortel: Downsized for unsustainably low demand

Few industries have taken a harder hit in the last three years than telecom-equipment manufacturing. With telecom capital spending in North America down 50% from its peak of $110 billion in 2000 to an estimated $55 billion in 2002, equipment providers have posted massive losses, as much of the capacity they built in the boom years lies idle. Nortel, for example, saw its revenues fall from $28 billion in 2000 to an estimated $8 billion in 2002; the drop, coupled with related asset writedowns and restructuring charges, led to its posting total losses of more than $30 billion since the beginning of 2001.

In our view, however, the worst is behind the industry—and Nortel. In the third quarter of 2002, capital spending for traditional local and long-distance fixed-line carriers in North American was about 30% below depreciation. This situation—of capital spending rates below depreciation—is unprecedented and unlikely to persist: As current infrastructure ages, replacement spending will rise. Moreover, we see two trends on the horizon that should boost demand for telecom equipment: rising demand for voice and data services, and the availability of cost-cutting technology, such as next-generation cellular transmission equipment and convergence of voice and data networks.

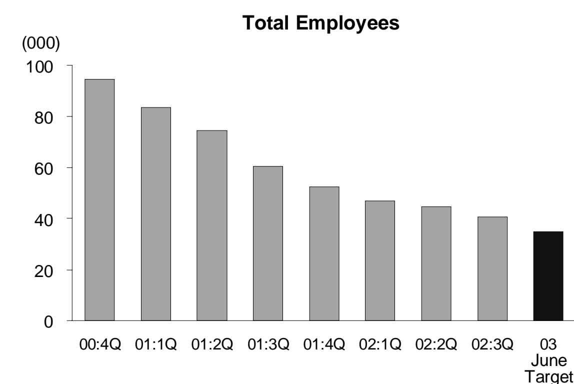
We expect demand for local and long-distance fixed-line equipment, which fell from $90 billion in 2000 to $35 billion in 2002, to rise to $60 billion by 2006. When it does, Nortel should enjoy a robust revenue and earnings recovery. Its longer-term earnings prospects should also be enhanced by industry consolidation: The sharp industry downturn of the last three years drove many current and would-be competitors out of the market.

Perhaps most important, Nortel has made great strides in improving its income and balance sheet. On the operating side, Nortel has slashed its headcount from 95,000 to about 40,000 over the past three years (**Display 8**); the company expects to reach its target of 35,000 employees in the first half of 2003. The layoffs, and related cost savings, should bring Nortel's costs in line with reduced demand and contribute to positive pro-forma earnings in the second quarter of 2003.

Furthermore, Nortel has taken various steps to strengthen its balance sheet and ensure its liquidity so that it can get through the downturn. After raising equity and selling assets, Nortel had more cash than debt on its balance sheet at the end of the third quarter of 2002 (**Display 9**). Even when we assume a longer period to breakeven, restructuring charges, operating losses and capex would leave approximately $1 billion in cash after meeting debt retirements in 2003 and 2004. Nortel has no other significant debt maturities until 2006. By that time, industry spending should be stronger and Nortel should be well into its operational recovery.

Display 8

Nortel Has Downsized Dramatically



Source: Company reports

Display 9

Nortel Built Liquidity to Survive the Downturn

Cash at End of 2002:3Q	**$4,590 Mil.***
Uses of Cash through 2004	
Restructuring	(1,575)
Operating Losses and Capex	(1,200)
Debt Maturities	(800)
Cash at End of 2004	**$1,015 Mil.**

**Includes $420 million in restricted cash*
Source: Company reports and Bernstein estimates

Another source of strength is Nortel's diversified product set and customer base, which includes wireless, long-distance and metro wireline, as well as enterprise customers. For most of the last two years, the continued strength in sales of wireless infrastructure equipment helped Nortel survive the sharp drop in spending by wireline carriers (especially long-distance carriers) and the smaller drop in equipment spending by enterprise customers. A likely rebound in demand for wireline equipment and for enterprise systems, in turn, is likely to cushion the drop in wireless revenues that began in late 2002, but should correct in 2004.

In the fourth quarter, Nortel's stock rallied dramatically from its extraordinarily low level but remains inexpensive versus the stock market overall, selling at five times our estimate of normalized earnings.

Hewlett-Packard: A secular and cyclical growth story

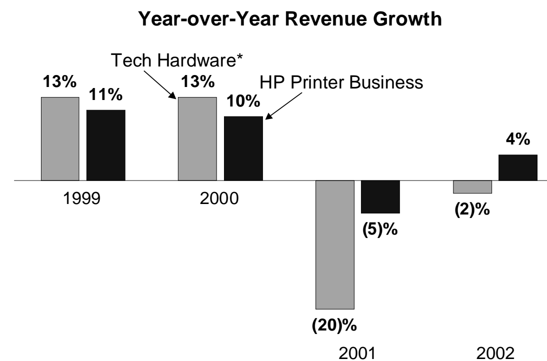
We originally purchased Hewlett-Packard primarily for its dominant position in traditional computer printers and printer cartridges: It has a 60% market share for laser printers and 40% share for inkjet printers. This is a stable business with strong recurring revenues from the replacement of ink cartridges, even when new equipment sales fell (**Display 10**). Printing also offers strong growth prospects in digital photography, a rapidly growing market that is even more profitable because photographic images use up to 10 times as much ink per page as type.

While we continue to see large upside in printing and imaging, the merger of Hewlett-Packard and Compaq earlier this year has added a turnaround dimension to this investment. Both companies had been posting losses in PCs for several years due to a downturn in industry demand and intense pricing pressure; in recent years, only Dell has been able to earn consistent profits from PCs. The Hewlett-Packard/Compaq combination, however, fundamentally improves the cost position of the merged entity: The company plans to cut headcount by about 15% and use its increased leverage over vendors and distributors. Our research indicates that operating margins in personal computing should swing from a 2.3% loss in 2002 to a 4% profit in 2006 (**Display 11**). That is still less than Dell's margin but would provide a good return on investment due to fast inventory turns in the PC business.

In enterprise computing, meanwhile, the merger creates an entity with strong products across all segments. At the fast-growing low end of the server and storage market, the merged operations have cost and technology advantages relative to Dell, its main competitor. In middle-range servers, it has scale economies relative to IBM. At the high end of the market, it is cutting infrastructure costs, combining complementary product lines and moving to employ Intel's Itanium chip, rather than continuing to design its own, which should also give it a cost advantage versus Sun Microsystems, in our view. When corporate capital spending picks up, HP should also benefit from its dominance in industry-standard, Linux and NT servers, which are gaining share as customers seek to cut costs.

Display 10

HP Printers: Stable Sales in Industry Crunch



*Total US spending on information technology hardware
Source: Bureau of Economic Analysis and company reports

Display 11

Merger Should Boost PC Margins Dramatically

HP's PC Business	2002	2006E
Unit Sales	20 Mil.	24.5 Mil.
Revenue	$22 Bil.	$22 Bil.
Operating Income	$(0.5) Bil.	$0.9 Bil.
Operating Margin	**(2.3)%**	**4.0%**

Source: Company reports and Bernstein estimates

In sum, we estimate that improvements in HP's cost position and product line-up, combined with a cyclical recovery in demand, should allow the PC and enterprise computing businesses to go from *taking* 35 cents from earnings per share in 2002 to *contributing* 50 cents in 2005. Since we also expect EPS from printers to rise from 80 cents to $1.00, and EPS from services to rise from 35 to 50 cents, we expect total EPS to more than double from 80 cents in 2002 to $2.10 in 2006. Thus, we find the stock very attractively valued at its current low price.

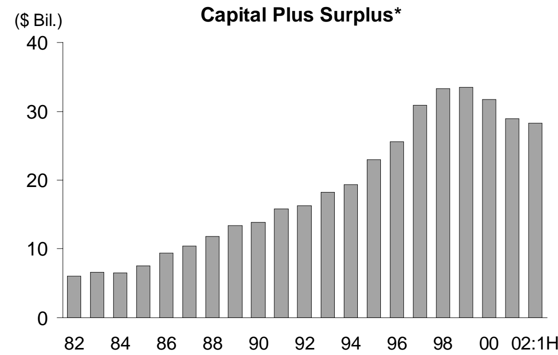
Chubb: Positioned to capture industry growth

Property & casualty insurance today offers faster medium-term growth prospects than any other major industry: Total premiums for the industry were up 13.6% in the first nine months of 2002. We expect this growth to continue for several years, due to the recent sharp contraction in industry capacity and an upswing in demand.

Huge September 11 payouts were just the most dramatic and concentrated drain on industry capital, and thus capacity. The prolonged downturn in the capital markets has also been a drain: European insurers, some of which are important competitors in the US market, have suffered sharp losses on their equity portfolios; US insurers, meanwhile, have registered smaller, but still significant, losses on corporate bonds. Even after new equity issuance, total capital in the US industry is down by about 16% (**Display 12**).

Display 12

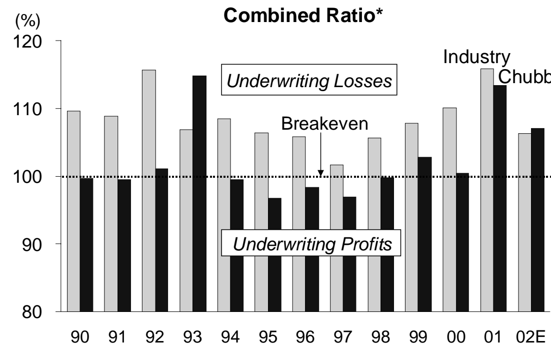
Capacity Has Fallen Sharply for P&C Industry



*US property & casualty insurance industry
Source: A.M. Best

Display 13

Chubb: Consistently Profitable Underwriting



*Combined ratio is claims plus expenses as a percentage of premiums.
Source: A.M. Best and company reports

On the other hand, demand has risen sharply, due to fear of terrorist attacks, and, in the US, rising property values, extension of asbestos liability to peripheral defendants and increased focus on corporate malfeasance. The jump in demand, just when capacity is off sharply, is pushing up premiums. As such, the outlook for underwriting profits has dramatically improved.

No company in the industry is better positioned to capture this growth opportunity than Chubb, because none other has both the capital needed to expand right now and Chubb's strength in underwriting. Chubb's roughly $8.8 billion of capital (including debt) supports roughly $9 billion of premiums; that nearly 1:1 ratio is much stronger than the 1:1.4 industry average. Chubb also has enough reserves to fund asbestos and environmental claims at historical averages for the next 12 years, nearly double the industry average. A.M. Best gives Chubb its highest rating, A++. Chubb's strong capital and reserves give it far greater capacity than most competitors to write a greater volume of new business at today's higher pricing.

Second, Chubb has demonstrated skill in underwriting profitable business. Unlike most of the industry, which has relied on ample investment returns to subsidize money-losing underwriting for most of the last 10 to 12 years, Chubb has made money on underwriting in most years (**Display 13**). Even in its seemingly risky guarantees of credit derivatives, Chubb limits its exposure to the AAA or super AAA layers. It also invests conservatively—mostly in municipal bonds—which has helped recently, when corporate bond losses have hit other insurers much harder.

Chubb has succeeded in underwriting by avoiding competitively priced business such as low-end auto and homeowner insurance. About 36% of Chubb's premiums comes from high-margin specialty business insurance, such as directors & officers and errors & omissions insurance. Another 36% comes from commercial insurance, and the rest comes from personal insurance for the wealthy, a high-margin business because these clients tend to focus on quality service, not price.

Nonetheless, Chubb has become particularly cheap, mostly due to a jump in underwriting losses in 2002 from a variety of sources. It has some asbestos exposure. It is a leader in corporate directors & officers and errors & omissions insurance. And in homeowners insurance, where mold damage has recently emerged as an issue in Texas, Chubb has larger-than-average claims than its competitors because of its focus on high-end clients whose more expensive homes suffered more damage.

Our research shows that all of these short-term problems are less serious than they appear, and that investor overreaction to them has made Chubb cheap, just when its growth and earnings prospects are greatest.

ConocoPhillips: Leveraged to refining

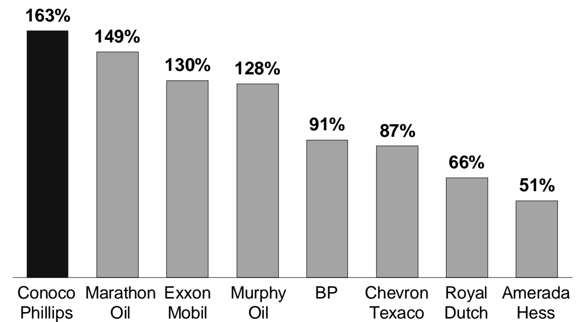
In a period when most energy stocks are not particularly cheap, ConocoPhillips stands out from the pack. Largely due to its above-average exposure to the recently depressed refining and marketing business in North America (**Display 14**), ConocoPhillips is trading at a sharp discount to its peers.

We think the market has overreacted to a cyclical downturn that will not last. Refining margins have been very volatile in North America—bad in 1999, very good in late 2000 and the first half of 2001 and bad again in 2002. Recent margin pressures reflect the sharp drop in jet fuel consumption after the 9/11 terrorist attacks; the decline in industrial consumption since the economy has slowed and the drop in heating fuel due to warm weather last winter. (Only gasoline consumption has remained strong.)

The pressure on refining margins also reflects OPEC's recent cuts in production, particularly of heavy crude oil, which reduced the discount of low-quality to high-quality crude. For complex refiners like ConocoPhillips, which refine low-quality crude, the smaller discount on low-quality crude reduces upgrading margins (**Display 15**).

Display 14

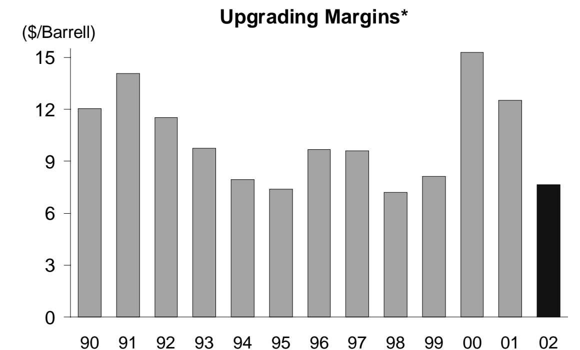
ConocoPhillips: More Exposure to Refining



Source: Company reports and Bernstein estimates

Display 15

Refining Margins Are Depressed



**A measure of the profit from upgrading a unit of low-value crude products, such as residual fuel oil, into higher-value products such as gasoline*
Source: Bloomberg L.P.

Yet this cyclical downturn, like others before it, will not persist. Stronger economic growth and normal winters, when they come, will boost demand and improve refining margins. While one can never predict the timing of an upturn, such downturns have always proved to be a value opportunity.

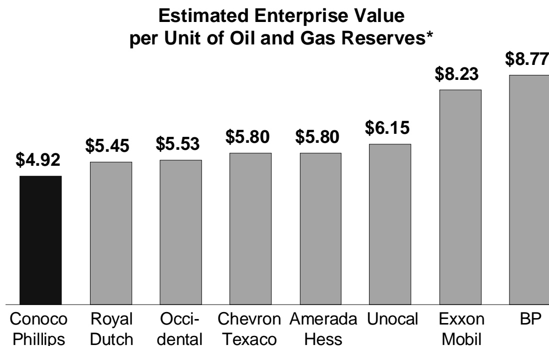
In addition, another longer-term shift is also positive for refining margins, and thus for Conoco Phillips. The US regulatory requirement that energy companies begin to reduce the sulfur content of gasoline in 2004 and of diesel fuel in 2006 will reduce the yield of gasoline and diesel fuel per barrel of crude oil, thus improving the long-term supply and demand picture.

When the cycle does turn for refining margins, ConocoPhillips' earnings power in refining should offset the likely drop in oil prices from their current high levels. Today, the firm has more than $5 per share in earnings. Our research shows that cyclical and regulatory shifts could add about $1.40 to earnings per share by 2006. We see another 50 cents in EPS coming from cost savings related to Phillips' acquisition of Conoco, which was completed in August 2002. In all, that represents about a 45% improvement in just three years. That makes ConocoPhillips very attractive at its current low price.

The firm is also very attractively valued versus its peers, the major integrated oil companies, when priced off the value of its proven reserves **(Display 16)**.

Display 16

ConocoPhillips: Cheap on Proven Reserves



As of December 31, 2002

**Market value of equity plus book value of net debt per barrel of oil equivalent*

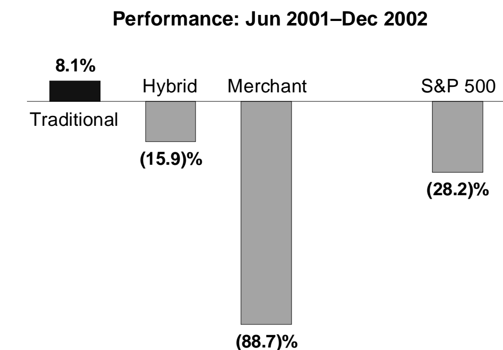
Source: Company reports and Bernstein estimates

AEP: Unfairly tarred by industry scandals

In most bear markets, utilities outperform. But for the last 18 months, many utilities have underperformed dramatically in the wake of Enron's collapse, controversy over electricity-market manipulation in California and the submitting of false market data to publications, and excess generating capacity built in the bubble years. Since their peak in mid-2001, the deregulated merchant-power producers have fallen furthest, but many hybrid utilities with some exposure to merchant power have also plunged **(Display 17)**.

Display 17

Nontraditional Utilities Have Plunged



Source: FactSet, Standard & Poor's and Bernstein

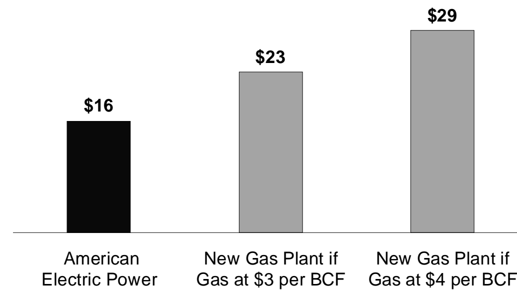
AEP is in the second group. The bulk of its business is, and has always been, traditional generation, transmission and distribution of electricity: It is the largest US power producer. It also has a solid balance sheet, a competitive advantage in its low-cost coal-burning plants **(Display 18)** and quite dependable earnings. While some electric-power producers are suffering from a drop in wholesale prices for contracts governing peak hours or weekday hours, AEP sells most of its electricity to its retail clients at steady prices. Its smaller volume of wholesale business, which is focused on constant delivery contracts, also enjoys stable pricing (**Display 19**). We expect continued slow growth in capacity utilization, cost control and retail revenues to boost earnings from about $2.85 per share in 2002 (excluding trading profits) to $3.50 in 2006.

While most of AEP's business is in these traditional businesses, AEP has also been an important player in the merchant-power business, particularly trading electricity, gas and coal. Even now, AEP has $11 billion in trading assets on its balance sheet. This business, however, is far less risky than it might appear because AEP manages its trading book conservatively, keeping its long and short positions closely matched and short-dated. And while some of its traders were among those that submitted false data to publications, they have been dismissed and no charges against the company or the traders have been filed in the months since.

Display 18

AEP Is a Low-Cost Producer

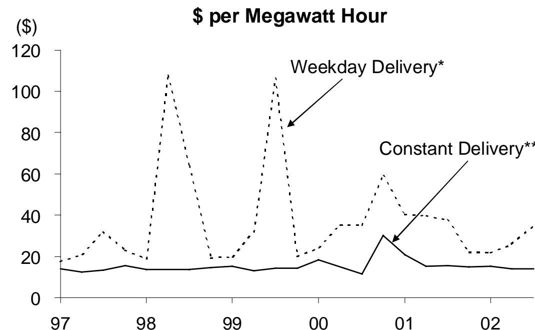
Cash Cost of Producing One Megawatt Hour



Data for AEP reflects costs in their core Midwestern operations. Data for new gas plants assume a state-of-the-art combined cycle natural gas plant.
Source: Company reports and Bernstein

Display 19

AEP's Wholesale Contracts Have Steady Pricing



**5 day/week, 16 hour/day contracts*
***7 day/week, 24 hour/day contracts*
Through third-quarter 2002
Source: Bloomberg L.P.

In any case, the market's overreaction to the perceived risk of merchant power has put such strong pressure on AEP's stock price and credit spreads that the company is unwinding its trading book. What was a small part of AEP's total business mix will be virtually gone in just a few months.

Yet AEP is trading at just $27, about nine times current earnings, or half the market multiple. Its dividend yield of 8.8% is *five times* the market yield. While management may opt to trim its dividend to pay down debt, the market is likely to reward that action. One way or another, we expect to see the stock recover to levels appropriate to its new, more traditional business mix. ♦

The specific securities identified and described above do not represent all of the securities purchased, sold or recommended for the portfolio, and it should not be assumed that investments in the securities identified were or will be profitable. We would be happy, upon request, to furnish a listing of all investments made during the prior one-year period.