AllianceBernstein

Going the Distance

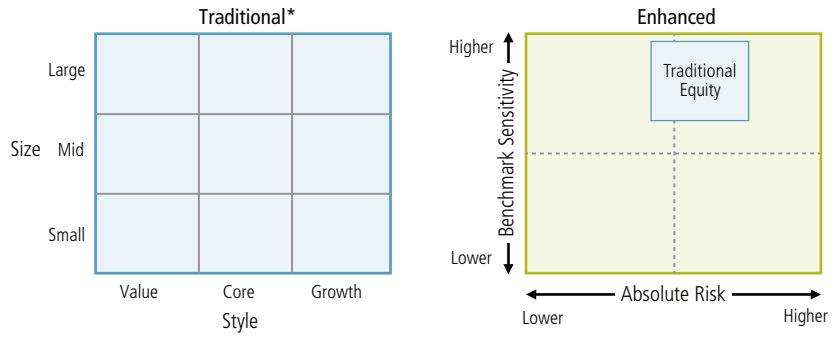
Long-Equity Strategies in Short-Tempered Markets

Equity investing is facing a crisis of confidence. Years of high volatility and disappointing returns, as well as the failure of conventional diversification, have challenged the tenets of traditional long-only equity investing that had prevailed through bull and bear markets for decades. Changing client needs add to the conundrum.

Institutional investors are grappling with pension fund deficits and new regulation that forces them to fund liabilities more often, making volatility more punishing. Individual investors are living longer than ever; they need strong equity returns, but in the aftermath of the global financial crisis, the fear of stocks is pervasive. After all, how can anyone rely on equities to meet future targets when extreme market turmoil can destroy years of careful planning in a heartbeat?

In our view, this question warrants a new way of thinking about equities (*Display*). The traditional framework of investing by style and market capitalization is evolving toward an enhanced paradigm in which benchmark sensitivity and appetites for absolute risk will determine equity strategies. Seen through this prism, we believe that there are more ways than ever to deliver long-term returns while managing short-term volatility in portfolios and allocations of portfolios.

Evolving Framework for Equity Investing



**Morningstar Style Box™*
Source: Morningstar and AllianceBernstein

IN THIS PAPER

Asset managers and individual investors are grappling with a crisis of confidence in stocks after several years of acute volatility. In this paper, we demonstrate how there are more ways than ever to tap equity markets while managing volatility to suit diverse investor needs by using a combination of traditional style strategies and approaches offering greater stability.

Sharon E. Fay, CFA
Head of Equities and CIO—Global Value

Kent Hargis
Portfolio Manager—Low Volatility Equities and Director of Quantitative Research—Equities

Christopher W. Marx
Senior Portfolio Manager—Equities

(continued) Despite recent challenges, it's important to remember why equities should still play an integral role in long-term investment programs. Equities represent a claim on company cash flows and offer investors an opportunity to access global economic growth. Volatile markets have lured investors away from equities toward safer assets like bonds, leaving stocks at attractive valuations. For many investors, we believe that the risk of avoiding equities today may be greater than the risk of investing in them. We will explore the case for equities in greater detail in a forthcoming research paper.

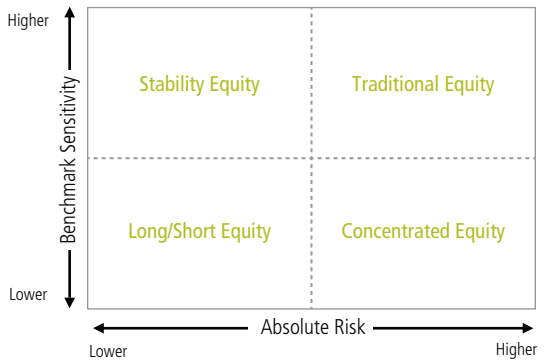
In this paper, we will demonstrate our evolving analysis of the interaction of equity risk and return drivers in portfolios and collections of portfolios. Armed with this insight, we believe that investors should be able to overcome their fear of stocks and assemble the best combination of equity strategies to meet their changing needs.

Completing the Picture

By taking a closer look at what investing strategies worked during the market meltdown, we have developed a greater appreciation for the intricate fabric that defines the risk/return profile of different types of stocks. For example, the performance of certain types of stocks can vary over different time periods and in different market environments. Their interaction with one another is complex. And risk management is no longer just a defensive tool—effective risk budgeting can be used to generate better returns.

Display 1

Enhanced Framework for Equity Investing



Source: AllianceBernstein

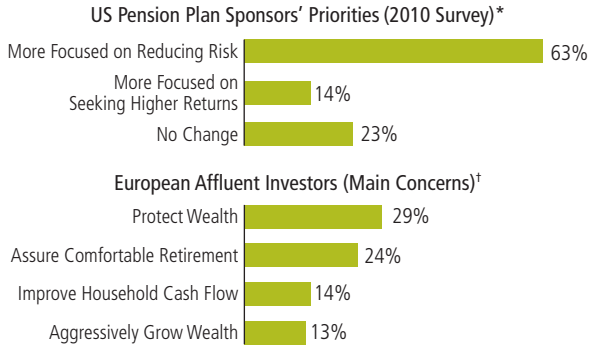
In our enhanced framework for equities (*Display 1*), traditional style strategies offer the prospect of higher long-term returns, though the level of absolute risk is high and performance is closely tied to the benchmark. Moving to the upper-left-hand quadrant, strategies that provide more stability can help manage absolute risk. They offer equity-like returns and alpha[1] that is less correlated with traditional strategies.

Some investors may prefer to mitigate absolute risk by deviating more sharply from benchmarks. Higher benchmark sensitivity means that most of the return comes from market movements. In contrast, long/short strategies—in the lower left quadrant of our framework—are less benchmark-sensitive, so most of the return comes from stock selection. Long/short equities are also less correlated with traditional equities. Similarly, concentrated equities (which we don't cover in this paper) are less driven by benchmark movements, though their focus on a small number of stocks or a single industry may add to the risks.

We believe that this framework reflects a more complete picture of equity strategies across a two-dimensional spectrum that can be aligned with investor needs. It can help investors dramatically broaden exposure to a combination of stocks tailored for different risk appetites and goals, to navigate changing market conditions more effectively than before.

Display 2

Investors Are Focused on Reducing Risk



*Towers Watson survey *(2010) of corporate, state and local government pension plans*
† The Cerulli Edge Europe Edition survey *(2011). Average of results from France, Germany, Italy, the UK and Spain. Affluent investors are defined as individuals holding more than €175,000 of investable assets.*
Source: The Cerulli Edge—Europe Edition *1Q 2012, TowersWatson.com and The Vanguard Group*

Crisis of Confidence

It's hardly surprising that equity investors feel anxious about the future. Although equity returns are rarely smooth, nobody was prepared for the upheavals in global stock markets when the US subprime mortgage market began to unravel in 2007. The experience of recent years has humbled the asset-management industry and paralyzed investors. Many are afraid of investing in equities for three main reasons:

1. Volatility—it feels like markets are out of control
2. Visibility—it's difficult to see through current uncertainty and to trust earnings forecasts
3. Catastrophic events—the collapse of Lehman Brothers and the euro-area crisis have made people afraid of the next potential market meltdown

These fears have been magnified by the failure of diversification. Before 2008, investors made sure they had exposure across regions, investing styles and market capitalizations, to protect their portfolios from pockets of weakness. None of this helped when equity markets collapsed in unison.

New Approaches for Volatile Markets

The crisis has shaken the foundation upon which traditional equity investing was based in two important ways. First, investors now realize they must complement their allocations to traditional style equities, such as value and growth, with other equity strategies that will hold up better during volatile periods. Second, investors crave new approaches that are capable of mitigating downside risk (*Display 2*) even in the most ruthless market conditions.

What Works in Tough Markets?

During the market crisis of 2008–2011, traditional equity style strategies such as value and growth faced extremely harsh conditions and failed to deliver (see "Value and Growth: Reaffirming the Roots of Traditional Style," *page* 5). But perhaps there is something that did work. Our research shows that there was indeed a way to diminish the impact of market turmoil on a portfolio. Portfolios that had at least one of the following characteristics performed relatively well:

- Fundamental stability—consistent cash flows and lower earnings volatility
- Price stability—stocks with less volatile prices
- Market stability—less exposure to directional equity-market moves (long/short portfolios with betas of less than 1)[2]

Rethinking Risk in a Volatile World

Key measures that are commonly used to assess risk in equity portfolios may be assuming different roles as investors reexamine how they think about equities.

In a world where benchmarks were the predominant way to tap equity markets, investors tended to focus more closely on information ratio when scrutinizing a manager's performance. However, the vulnerabilities of benchmarks have been exposed, and we believe that closer attention will be paid to Sharpe ratios as investors seek to ensure that they can achieve solid long-term absolute returns while dampening volatility.

- **Information ratio (IR)** is the relative return of a portfolio to a benchmark divided by its deviation from the benchmark. But it doesn't tell you anything about absolute returns. So in a bear market, a manager with a high IR may outperform the benchmark modestly while absolute returns fall sharply.
- **Sharpe ratio** compares absolute returns with absolute risk. Like the IR, it is a good indicator of an active manager's ability to deliver returns with less volatility. But this ratio focuses on absolute returns, with a higher value indicating that a manager is able to deliver better returns with lower volatility—regardless of the movement of the benchmark. ■

[1] *Alpha is the risk-adjusted excess return delivered by a portfolio over a benchmark.*
[2] *Beta measures the degree to which a security or a portfolio responds to market swings. A portfolio with a beta of 1 will move with the market. A portfolio with a beta of less than 1 will be less volatile than the market. When beta is greater than 1, the portfolio or security will be more volatile than the market.*

Stability Equity: Resilient Stocks in Rough Markets

By choosing stocks with fundamental or price stability, an investor could temper portfolio volatility in turbulent markets (*Display 3*). Such stocks did well because fearful investors preferred the security of dividends and stable prices in tough times. And these investments play out over a much shorter time horizon than those in traditional styles like value and growth.

Tapping into stocks with stability characteristics is a conceptual shift in investing. For decades, equity investors focused primarily on exploiting market anomalies to generate returns, while managing risk as a secondary goal. Today, many investors are more focused than ever on risk management when assembling their equity strategies (*Display 4*).

Long/Short: Letting Go of the Benchmark

In many cases, mitigating risk would require moving away from a tight adherence to benchmarks in portfolio construction. One way to do this is to use a long/short portfolio, which takes long positions in stocks that are expected to increase in value while shorting those that are expected to decline. Such portfolios tend to have greater market stability and can combat the shortcomings of benchmarks.

This is another important conceptual shift in equity investing. For many years, when the climate of equity markets was relatively benign, investors had faith in the long-term appreciation potential of equities. That's why they overwhelmingly used benchmarks as the anchor for equity strategies, and why judging performance relative to a benchmark became an industry standard. However, when markets collapsed, there was little consolation in finding that an active manager beat its benchmark by a few percentage points yet still delivered steep losses.

Benchmarking also created incentives for active managers to stay close to an index—even when this entailed great risks. For example, during the technology bubble, high-priced Internet stocks became a disproportionate part of equity benchmarks, and many active managers were compelled to load up their portfolios with them in order to lower relative risk. Of course, when the technology bubble burst, they found that holding so many inflated technology stocks actually *increased* portfolio risk.

As a result of these types of experiences, which were repeated in the recent financial crisis, many investors are reevaluating the way they assess performance. What's more, disappointing capital-market returns are putting pressure on sponsors of pension plans to shore up their shortfalls. And volatility is inflicting higher costs because accounting rules often force pension sponsors to fund liability deficits more quickly.

Because of these pressures, we believe that we're in the early stages of a shift in the way investors think about risk and return. Instead of focusing solely on risk-adjusted relative returns, as measured by information ratios, we think investors will increasingly rely on the Sharpe ratio to gauge risk-adjusted absolute performance (see "Rethinking Risk in a Volatile World," previous page).

Display 3

The Evolution of Equity Investing

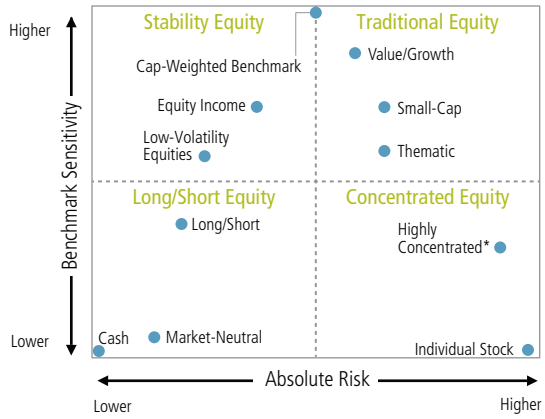
When Do Different Equity Strategies Work Best?

	Volatility	
	Decreasing/Stable	Increasing
Value	✓	✗
Growth	✓	✗
Stability	✗	✓
Long/Short	✗	✓

Source: AllianceBernstein

Display 4

Enhanced Framework for Equity Investing



**An example would be a 20-stock portfolio or a sector-specific portfolio.*
Source: AllianceBernstein

Value and Growth: Reaffirming the Roots of Traditional Style

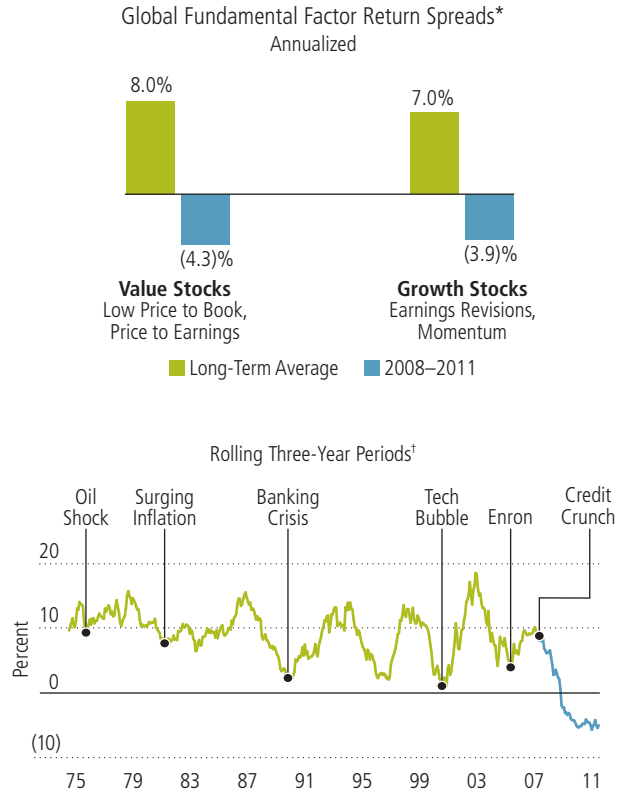
Investing in value stocks, growth stocks or a combination of both offered compelling benefits for years (*top display*). Since 1973, the cheapest quintile of global value stocks outperformed the most expensive stocks by 8% a year. Growth stocks also regularly beat their lower-growth peers. Good years for value were often weaker for growth—and vice versa—so investors could diversify by holding a bit of both.

While the ride wasn't always smooth, a combination of the most attractive value and growth stocks regularly beat the least attractive stocks from 1973 to 2007, often by a significant margin. So why did growth and value stocks collapse together since 2008 (*bottom display*)?

In our view, unprecedented market conditions and a hostile economic environment undermined traditional diversification. Style investing worked because markets ultimately rewarded undervalued stocks with strong cash flows or profitability, or high and underappreciated growth potential. But since 2008, markets have been dominated by macroeconomic fears. Investors have assigned value only to what companies offered in the short term. They lost faith in long-term fundamentals such as valuation, growth prospects and earnings power. Stocks have been highly correlated, meaning they generally traded in the same direction, with little regard to their underlying strengths and weaknesses. In this environment, many managers paid a high price for sticking with disciplined style investing, as value and growth equities generally posted disappointing performance.

Yet we still have conviction in these strategies, because they are rooted in human behavior. Value opportunities are created because investors' loss aversion causes them to shun stocks facing stress. Mounting pressure on margins and stock prices encourages management teams to take steps to improve profitability. As profits recover, stock prices often follow suit. Growth works because investors tend to anchor views in the present, overlooking the potential of sustained future success. Winning growth stocks consistently beat investor expectations. In both strategies, it can take several years for investment theses to play out. In recent years, when investors' time horizons were extremely short, these types of strategies have struggled. But when markets once again begin to reward the long-term cash flow and earnings potential of companies, we're confident that traditional style strategies will deliver, because the basic behavioral inclinations behind them haven't changed. ■

Growth and Value Stocks Collapsed Simultaneously



As of December 31, 2011

**Long-term average from 1973 to 2011. Hedged, annualized, one-month returns in USD based on the Bernstein global large-cap universe of stocks, measuring the differences between the highest and lowest quintiles of the factors shown. Forward price-to-earnings and earnings revisions data start from 1976.*

†Stocks ranked based on four factors from upper display. Least attractive quintile returns were subtracted from most attractive quintile returns. Each factor's quarterly difference was equal-weighted before calculating the rolling three-year return spread.

Source: MSCI, Thomson I/B/E/S and AllianceBernstein

Our research on stability equities and long/short equities has unearthed an underappreciated truth: Focusing on risk management doesn't mean you have to sacrifice returns. Investors can find stocks that are less risky yet also have solid return potential. In other words, the risk anomaly that has been long overlooked can now be exploited in order to generate better risk-adjusted returns over time.

Stability Stocks Overcome Turmoil

As a first step toward cracking the risk conundrum, we set out to understand how different types of stocks behave under different conditions. We divided the market environment into two distinct types: periods of increasing volatility and periods of decreasing or stable volatility. When market volatility was falling or flat, value and growth stocks performed best, and outperformed a global universe of stocks by a healthy margin.

When volatility was rising, the premium of value and growth stocks was significantly muted (*Display 5*). In contrast, during these volatile periods, stability factors—return on equity, high dividend yields and low-volatility stocks—performed much better.

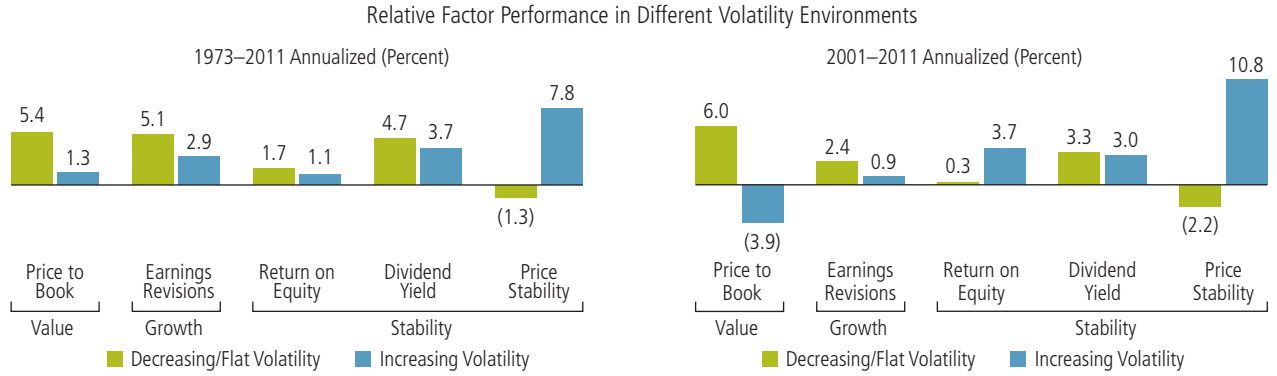
These patterns were even more pronounced when we compressed our analysis into a shorter period that had more intense volatility. For example, between 2001 and 2011, high-volatility periods accounted for 25% of all months. Once again, value and growth stocks performed well when volatility was lower, but were hit badly when turbulence increased. Yet stability stocks thrived when the going got rough. During periods of high and escalating volatility, stocks with high return on equity and high dividend yields did well. Those with better price stability—low-volatility stocks—were by far the best performers during times of duress, beating equity markets by 10.8% a year (see "A Prominent but Different Kind of Anomaly").

Dynamic asset allocation can be used to adjust equity exposures in response to changing risk and return opportunities. However, many plan sponsors can't do it fast enough because it takes time to secure approval to change an investment strategy from their boards of directors. Individual investors aren't always aware of how shifting market dynamics affect their money, especially during uncertain times. So we believe that having strategic exposure to equities with different risk and return characteristics is an effective way to navigate unpredictable markets.

Since traditional value and growth strategies have worked well for extended periods of time, we think they are indispensable to investors. But during periods when value and growth are challenged, keeping part of an allocation in stability equities should offer an added dimension of protection from heightened market volatility.

Display 5

Different Equities Have Different Return Profiles



As of December 31, 2011

Rolling hedged returns in US dollars based on the Bernstein global large-cap universe of stocks, sorted monthly by the factors in the display. Equal-weighted market returns were subtracted from the most attractive quintile of returns and averaged over different volatility environments. Increasing-volatility environment defined as months in which the volatility of the S&P 500 for the past 90 trading days is higher than that for the previous month, as well as the rolling 12- and six-month averages.

Source: Capital IQ, Center for Research in Security Prices (CRSP), Compustat, FactSet, MSCI, Thomson I/B/E/S, Thomson Reuters, Worldscope and AllianceBernstein

A Prominent but Different Kind of Anomaly

The low-volatility effect is as robust as other, more prominent anomalies found in low-valuation, small-capitalization and high price-momentum stocks. Since 1973, the least volatile quintile of global stocks delivered returns that were one-third higher than the market, with 20% less volatility and a Sharpe ratio more than 50% higher than the market, meaning they had better absolute return relative to risk.

But the low-volatility anomaly works very differently from its better-known counterparts. That's because it is a risk anomaly rather than a return anomaly. As such, it commands a distinct place on the efficient frontier[3] that shows the intersection of long-term average returns and volatility for hypothetical low-volatility, value, small-capitalization and high price-momentum portfolios (*Display*).

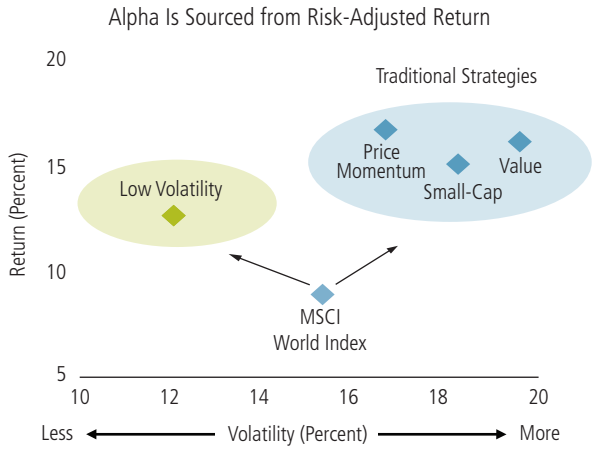
There is plenty of academic research underpinning low-volatility and traditional style equity strategies. The low-volatility anomaly was first identified in academic research in the early 1970s by Fischer Black and Myron Scholes, and reaffirmed by Eugene Fama and Kenneth French in 1993. Research by Andrea Frazzini and Lasse Pedersen (2010) shows that this anomaly also works across asset classes and spans almost every major market, including the US, the UK, Germany, Australia and Japan.

Value investing can be traced back to seminal research by Benjamin Graham and David Dodd (1934), who first identified the behavioral anomalies that created mispriced stocks on markets. Many subsequent studies confirm the efficacy of investing in growth equities or smaller stocks.[4]

A traditional long-only value, small-cap or price-momentum strategy seeks to deliver above-market returns at similar or incrementally higher levels of risk. In contrast, a low-volatility strategy, like the physician vowing to "first, do no harm," aims to deliver market-like or better returns at below-market risk. Its strong suit is its behavior in crisis markets. The least volatile quintile of global stocks held up far better than the overall market in six of the past seven major downdrafts.

Stocks in a low-volatility portfolio will usually look nothing like those in a typical style universe. We found less than a 10% overlap between the third of global stocks with the lowest volatility and portfolios with the lowest price/book value or highest earnings growth. Correlations between the relative returns of less-volatile stocks and other active strategies have been low historically, and even lower compared with those of median value, core and growth managers. ■

A Different Source of Alpha



Results represent top quintiles within the MSCI World Index as sorted by low price to book, low capitalization, high price momentum and two-year trailing volatility from January 1973 to December 31, 2011; Sharpe ratio includes cash; capitalization-weighted MSCI World Index, gross, in USD unhedged.
Source: MSCI and AllianceBernstein; see Important Notes on Simulations.

[3] *The efficient frontier is a concept in modern portfolio theory which refers to a set of portfolios that can generate the best possible expected return for its level of risk or the lowest level of risk for a given level of return.*
[4] *The key study documenting the existence of a momentum effect (growth) is Narasimhan Jegadeesh's and Sheridan Titman's "Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency,"* Journal of Finance *48, 1993. A common explanation for the momentum effect is that investors underreact to the release of firm-specific information. The size (small-cap) effect was first documented by Rolf Banz in "The Relationship Between Return and Market Value of Common Stocks,"* Journal of Financial Economics, *9, 1981.*

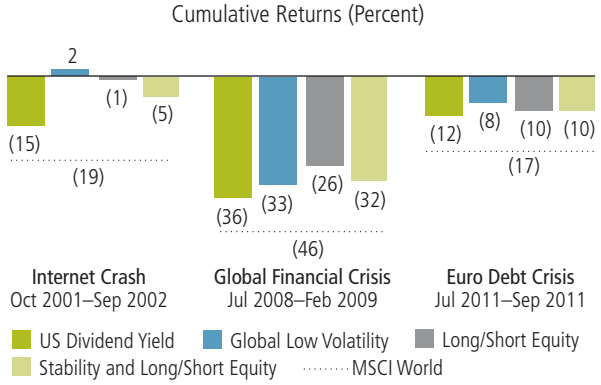
In fact, we back-tested the main stability and long/short strategies during three crisis periods. Each strategy individually helped protect against the impact of a market crash (*Display 6)* and, when combined in an allocation of stability equities, they significantly cushioned the blow. During the most catastrophic episodes, such as the Lehman Brothers collapse, it's impossible to steer completely clear of equity declines. Yet by mitigating the decline, an investor will have a much easier time recouping losses when the markets turn up again.

Getting More from Managing Risk

But protecting equity investments from turbulence is only part of the story. Less volatile equity portfolios can provide a more effective way to reduce risk while generating solid long-term returns that fit in with specific investing goals and risk appetites. Think about it as an inexpensive insurance policy against elevated volatility—helping to cushion your portfolio from market shocks while delivering a long-term return that is similar to or higher than that of the equity markets.

Display 6

Stability and Long/Short Equities Provide Downside Protection



Stability equity consists of the equally weighted monthly returns of US dividend yield, global low volatility and equity hedge. US dividend yield is based on the monthly median return for managers in the eVestment Alliance US dividend focus universe (used in this analysis because it is the largest and longest-running dividend yield universe). Global low volatility consists of the monthly returns of top quintiles within the MSCI World Index as sorted by two-year trailing volatility. Long/short is the Hedge Fund Research Equity Hedge Index that includes managers maintaining both long and short positions primarily in equity and equity-derivative securities.
Not intended to portray the results of any AllianceBernstein product. Periods of more or less than one year are annualized. The results reflect the deduction of estimated investment-management fees.
Source: Capital IQ, Compustat, CRSP, eVestment Alliance, FactSet, Hedge Fund Research, MSCI, Thomson I/B/E/S, Thomson Reuters, Worldscope and AllianceBernstein; see Important Notes on Simulations.

To help determine how this might work in practice, we've run some simulations of allocations that span traditional styles and stability stocks. In one simulation, we started with a typical equities structure, allocating 45% to US large-cap value and growth, 40% to international (EAFE) large-cap value and growth, and the rest to US small-cap and emerging-market stocks. A global universe of equity managers was used to simulate the performance of these different equities baskets.

Then we constructed another scenario, in which an investor shifted 33% of total assets toward a combination of equity-income, low-volatility and market-neutral strategies. When we simulated these scenarios over a 10-year period through 2011, we found that the equity allocation including stability stocks provided big improvements to the risk/reward profile (*Display 7*).

The allocation with stability stocks and long/short equity reduced risk and generated a slight increase in returns. Although the information ratio decreased slightly, the Sharpe ratio improved

Display 7

Stability Equities: Big Improvement in Risk/Reward Profile

2001–2011

	Standard Allocation	Add 33% Stability	Result
Volatility	17.6%	15.5%	12% Decrease in Risk
Return	5.8%	6.4%	Slight Increase in Return
Sharpe Ratio	0.19	0.26	37% Increase in Sharpe Ratio

As of December 31, 2011
Standard active allocation includes US Large Cap Value (22.5%), US Large Cap Growth (22.5%), US Small Cap Value (2.5%), US Small Cap Growth (2.5%), EAFE Large Cap Value (20%), EAFE Large Cap Growth (20%) and Emerging Markets Equities (10%). Simulation used the median of the deepest value and highest growth managers based on reported price/book and earnings growth.
Stability equity consists of the equally weighted monthly returns of US dividend yield, global low volatility and equity hedge. See footnote to Display 6 for further details of equity universe used for simulation. Not intended to portray the results of any AllianceBernstein product. Periods of more than one year are annualized. The results reflect the deduction of estimated investment-management fees.
Source: Capital IQ, Compustat, CRSP, eVestment Alliance, FactSet, Hedge Fund Research, MSCI, Thomson I/B/E/S, Thomson Reuters, Worldscope and AllianceBernstein; see Important Notes on Simulations.

significantly. In other words, the new scenario secured solid long-term absolute returns while dampening the volatility pattern. We also found that returns could be further augmented by combining this package with more exposure to strategies with higher return potential, such as emerging-market equities.

These simulations show some ways of turning the concept of equity risk on its head. Managing risk is no longer just a defensive tool; it can be a rewarding source of returns, too. We believe this can help investors discover more ways than ever to reduce risk and shed their fears of equity investing.

Overcoming Fear

Behavioral finance research shows that emotions can overwhelm a rational assessment of investment opportunities, leading people to commit the cardinal sin of buying high and selling low. For example, US investors pumped money into technology mutual funds in the first quarter of 2000, with fund flows peaking just before the market burst. By following trends, investors undermine their own performance. That's why there is a huge gap between the average performance of a mutual fund and the average performance of an investor in a mutual fund, according to a study by Dalbar in 2010.

The Power of Diversifying by Investment Time Horizon

All investors have different individual perspectives on how much risk they are willing to take and how much return they need. But no matter where they fall along this spectrum, investors can find equity strategies with a variety of time horizons that can provide another effective layer of diversification (*Display)*.

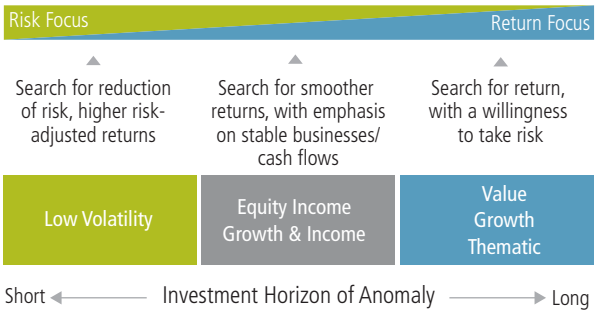
Long-horizon investing is focused on earnings dynamics that unfold over an extended period of three to five years. For example, when a company faces a challenge to its earnings, an investor may seek to determine whether earnings will recover over time because of restructuring actions, an economic recovery or a shift in an industry cycle, such as when overcapacity gets resolved. Value investors attempt to exploit a slump in share prices, when concerns mount about the potential of a long-term earnings recovery.

Similarly, an investor may try to assess whether earnings growth will be sustained or accelerate through market-share gains, innovative technologies or the creation of new markets (for example, the iPad), or the reacceleration of a cyclically depressed business. Growth investors tackle these long-horizon issues in their research.

Of course, there are many shorter-term factors that drive stock prices, too. Business momentum, for example, is a factor investors can use to capitalize on trends that unfold relatively quickly, by assessing whether earnings are in the process of recovering or accelerating. When conditions are volatile, and markets favor safer stocks, an investor may opt for companies with safer business models that have more predictable earnings streams. Dividends are another type of income stream that tend to be easier to forecast during turbulent times. Companies with more stable earnings flows tend to have share prices that are less volatile, and offer good protection from market turmoil.

With a combination of longer- and shorter-horizon strategies, an allocation can benefit when market volatility is benign and gain protection from unstable market conditions. ■

Meeting Client Needs Across the Risk/Return Spectrum



Source: AllianceBernstein

After four years of volatility, it's tempting for many investors to steer clear of stocks. By doing so, they're likely to sacrifice significant long-term returns—a risky strategy, as liabilities are extended and people need more money to support longer periods of retirement. In our view, equities with smoother return patterns and lower volatility may be the best antidote to these fears and can help investors regain confidence in equities.

Equity Approaches for Different Needs

Funding Liabilities

Many defined benefit pension funds, which offer fixed benefits upon retirement, are closing to new members (see "The Global Pension Challenge"). They can't rely on new participants to contribute to the asset pool. Their assets and income will steadily decline. And their payout liabilities to retirees are coming due.

The Global Pension Challenge

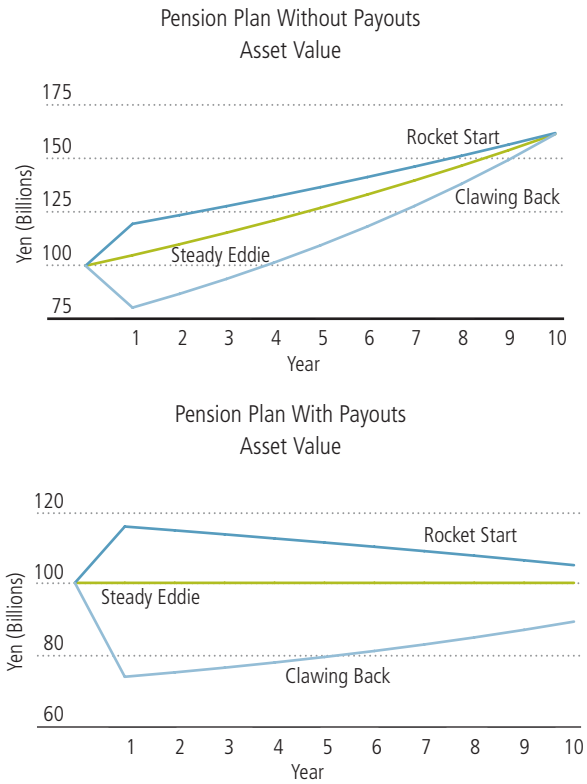
Pension funds everywhere are facing big challenges today. Many dilemmas are common across borders, although there are country-specific issues that require particular attention.

In Japan, for example, a rapidly aging population is challenging the viability of the current pay-as-you-go public pension system. The issue, however, is not limited to the state pension—corporate pension plans are faced with the same problem. Many are highly mature—the benefit payout is large relative to the inflow from contributions, with the ratio exceeding 100% at several major pension funds.

What does this have to do with risk? Risk alters the path of returns, which affects the outcome. Let's do some simulations, using a mature fund that has ¥100 billion in assets and generates an average annual investment return of 5% over 10 years. In the *top display*, we show a fund that has no payouts. Here, in the "clawing back" scenario, after a large loss in year one, the fund still ends up with an average return of 5% over the 10-year period. In "rocket start," after a bumper year at the onset, the average return dwindles to 5% over the full period. In the "steady eddie" scenario, it generates the same return every year. All three reach the same point, but take different paths to get there.

In the *bottom display*, the same fund pays out benefits of ¥5 billion a year. Since it needs to liquidate assets to pay benefits, there is a great disparity in the outcomes, even when the average annual return is the same. In the "clawing back" scenario, an early decline forces the plan to sell at the bottom, thus locking in a loss and making it harder to come back. That's why mature funds—and elderly people, in the case of individual investors—should consider taking smaller risks. With the right combination of equities, we believe pension funds can reduce risks without sacrificing returns in order to maintain funding levels. ■

The Path of Returns Matters



Source: AllianceBernstein

While it's natural for pension funds (and individuals) to de-risk portfolios as they mature in order to safeguard their assets for imminent payouts, fear of equities has tended to accelerate the de-risking process. For example, after closing to new members, a pension plan might veer away from a typical 60/40 mix of stocks and bonds, often by shifting 80% of assets toward liability-driven investment solutions (LDIs) and holding only 20% in equities. In our view, this is counterproductive. LDIs aim to match patterns of future cash flows and portfolio returns to liabilities. Often, pension funds load up on bonds that mature with cash flows. This makes sense for those with adequate funding. For those that don't have this luxury, low bond yields make it impractical to rely on fixed-income assets.

We believe that an allocation to stability equities can help. By providing a wider range of tools to tap the return potential of equities while mitigating risk, it would free up more ways to effectively match future liabilities. For example, by helping to reduce aggregate volatility, a pension could shift more assets toward equities. Alternatively, for those who don't want to allocate more to stocks, stability equities can free up a risk budget to seek more aggressive returns within an existing equities allocation. While it wouldn't solve everything—such as a pension fund's ability to maintain payments for retirees living longer—stability equities could help address funding challenges.

Time-Bound Events

Individual investors face similar dilemmas. For example, a woman near retirement might need to figure out how to cope without a regular paycheck, and might seek to maximize the value of a pension to buy an annuity. A person with a college savings plan might need to withdraw funds in five years. For both, an imminent time-bound event could augment fears of a sharp downturn in equity markets. Stability equities can help them stay in stocks by reducing their vulnerability to a major drawdown.

Long-Term Returns

In our view, investors with very long time horizons should be more focused on securing the best returns. As such, these clients should have the greatest appetite for equities strategies that deliver the highest returns over long periods, even at the cost of sharp spells of volatility along the way.

The reason is simple. When you focus on maximizing returns over decades, it's easier to absorb market shocks. This doesn't mean that stability equities aren't important for investors with very long time horizons. For such clients, equities with stability characteristics can diversify risk assets in an allocation, as their alpha is uncorrelated with traditional style strategies and optimizes the longer-term compounding return.

Conclusion: Going the Distance

The financial crisis of 2008 and the subsequent shock waves have changed the way investors think about equities. Before the crisis, it was much easier for investors to tolerate spurts of instability because history showed that these episodes tended to give way to prolonged periods of strong equity returns.

Not anymore. The sustained spell of poor equity returns and the crisis of confidence in stocks has created a major challenge. New approaches to equities are imperative.

In our view, we're still at the start of an evolutionary shift in equity investing strategies that will gather pace in the coming years. There are more ways than ever to tap equity markets. For some, value and growth strategies with long investment horizons may still be the right choice, especially after a few tough years of subpar returns—which are likely to presage a big opportunity. For others, strategies offering equity-like returns with less risk may be more appealing. However, we think the best approach for most will involve a combination of traditional style and stability equity strategies to suit diverse goals.

In future research, we will explore how investors can effectively allocate to different types of equities, and how to evaluate the efficacy of various strategies while moving away from cap-weighted benchmarks. We will also look at ways to incorporate both active and passive strategies in an equities allocation.

More knowledge is needed to promote new approaches to equities and to help investors overcome the trauma of recent years. But we believe that there is already convincing evidence that can help investors regain the resolve to invest in stocks, and to go the distance with an equity allocation designed to suit individual tastes for risk and the enduring quest for superior returns. ■

AllianceBernstein L.P.
1345 Avenue of the Americas
New York, NY 10105
212.969.1000

Sanford C. Bernstein & Co., LLC
1345 Avenue of the Americas
New York, NY 10105
212.969.1000

Investors should consider the investment objectives, risks, charges and expenses of any Fund/Portfolio carefully before investing. For copies of our prospectuses or summary prospectuses, which contain this and other information, visit us online at www.alliancebernstein.com or contact your AllianceBernstein Investments representative. Please read the prospectus and/or summary prospectus carefully before investing.

AllianceBernstein Investments, Inc. (ABI) is the distributor of the AllianceBernstein family of mutual funds. ABI is a member of FINRA and is an affiliate of AllianceBernstein L.P., the manager of the funds.

The information contained herein reflects the views of AllianceBernstein L.P. or its affiliates and sources it believes are reliable as of the date of this publication. AllianceBernstein L.P. makes no representations or warranties concerning the accuracy of any data. There is no guarantee that any projection, forecast or opinion in this material will be realized. Past performance does not guarantee future results. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. AllianceBernstein L.P. does not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by AllianceBernstein or its affiliates.

MSCI Note: MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

Important Notes on Simulations: Methodology Overview—Asset-allocation returns are based on the weighted-average return, rebalanced monthly, net of the average fee for each universe. The median monthly return was calculated based on the beginning-of-period valuation for each calendar year, using the cheapest half of the value universe by price/book value and the highest half of the growth universe for next-five-year earnings growth. Median returns for the eVestment EAFE Large Cap Growth universe were used through December 2005, as few managers reported valuation characteristics then, and linked to the median return for the highest-growth half of the universe beginning in January 2006. Asset-allocation results and those of the stand-alone Global Low Volatility Strategy are based on simulated or hypothetical performance results that have certain inherent limitations. The Global Low Volatility Strategy results do not include estimates of trading costs and market impact. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve returns or a volatility profile similar to those being shown.

AB
AllianceBernstein

12-1495
INS–6751–0612

www.alliancebernstein.com