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Bernstein Value Equities

Extension Strategies: Maximizing Today's Alpha Opportunity

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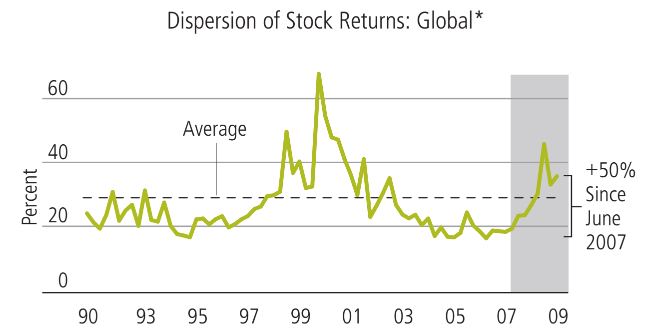
The past year's brutal stock-market sell-off has left valuations as attractive as they've been in a generation. It has also created a more fertile environment for active investing. As the current crisis ultimately runs its course, and investor anxieties ease, we expect fundamentals and valuation to reassert themselves as critical drivers of absolute and relative returns. When asked for our best idea for capturing the eventual market and value recovery, we point to equity extension services, which offer broad market exposure and employ limited shorting to maximize the return potential from stock selection.

As we wrote in our January 2009 white paper, *No Time to Be Passive—Get Active Now*, the soaring volatility and panic selling since the onset of the global credit crunch in mid-2007 have produced significant market distortions that active strategies are designed to exploit. Return dispersion, or the standard deviation of individual stock returns around the market average, has surged in the US and globally (*Display 1*) from the unusual lows during

Display 1

Return Dispersion Has Surged from Unusual Lows



Through March 31, 2009

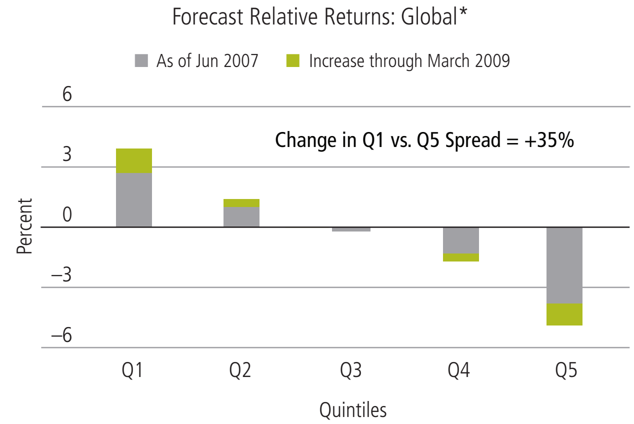
**One-month standard deviation of quarterly net returns of stocks in the Bernstein global large-cap universe; annualized and hedged to US dollars.*

Source: Center for Research in Security Prices (CRSP), Compustat, MSCI, Worldscope and Bernstein the years preceding the crisis, when a relatively benign economic and corporate-profit backdrop fed investor complacency about the risks of owning stocks. Though the range of stock returns has narrowed somewhat in recent months, it remains historically high outside of the late 1990s technology bubble.

In turn, valuations among stocks have widened dramatically. We see this in our measure of excess return potential between the most attractive and least attractive quintiles of global stocks, which has widened to 8.8% today from 6.5% in June 2007 (*Display 2*). This reflects our expectation that the most attractive stocks can outperform the market by 3.9% and the least attractive stocks can underperform the market by more than 4.8%, underscoring the large relative return opportunities from both our positive and negative views for stocks. The improvement has been even more pronounced in the US, with the spread between the most and least attractive quintiles rising to 11% from 7.7% since June 2007.

Display 2

Active Return Potential Has Improved Dramatically

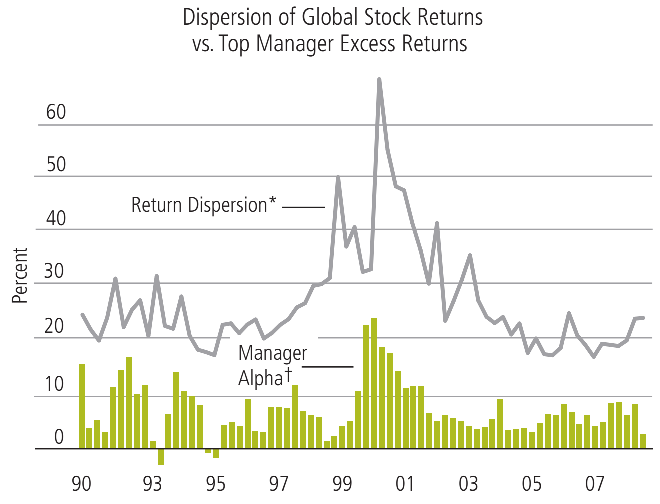


**Forecast returns by quintiles of attractiveness based on Bernstein's global edge model, versus the universe as a whole*
Source: Bernstein

As our research found, manager alpha tends to be greatest when return dispersion is high and lowest when return dispersion is low (*Display 3*). We also found that the forecasting tools used by active managers to select stocks are more effective when return spreads are wide (*Display 4*) because wider spreads provide a bigger margin for forecast error, increasing the odds of selecting winning stocks. Wider spreads also mean bigger potential payoffs for taking active risk.

Display 3

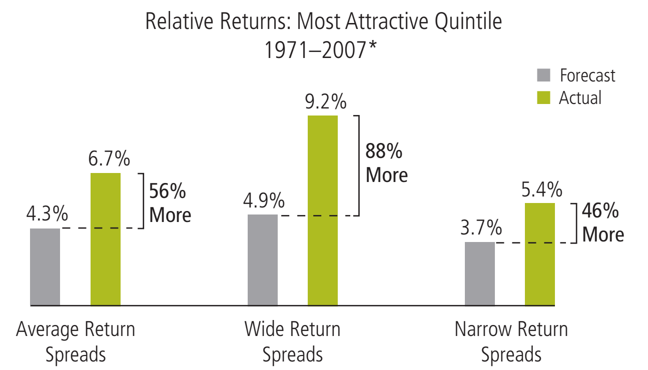
Manager Alpha Is Greatest in Divergent Markets



Through December 31, 2007
**One-month standard deviation of quarterly net returns of stocks in the Bernstein global large-cap universe; annualized and hedged to US dollars.*
†Excess returns of the 25th-percentile managers in the eVestment global large-cap equities universe versus MSCI World Index
Source: CRSP, Compustat, eVestment Alliance, MSCI and Bernstein

Display 4

Forecast Efficacy Improves as Spreads Widen



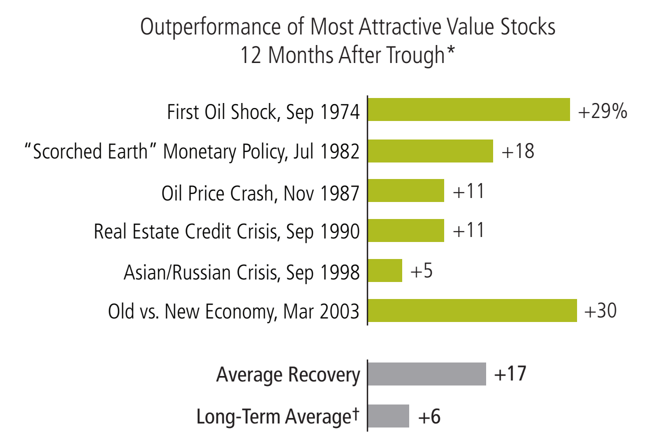
**Based on the returns of the most attractive 20% of stocks in the Bernstein global large-cap universe versus the universe as a whole from 1971 to 2007. Recent performance does not materially change results shown. Spread environments were defined by dividing the historical range of spreads in expected returns between the top and bottom 20% of stocks into thirds: the highest third represents wide return spread environments, the middle third represents average return spread environments and the lowest third represents narrow return spread environments. Data shown do not represent the return history of any AllianceBernstein portfolio.*
Source: Bernstein

The opportunity looks particularly compelling for value-oriented strategies. Amid the wholesale flight from risk, investors punished value stocks, perceiving them to be most vulnerable to the credit crunch and deepening economic distress. Value factors such as price/book value and price/earnings have lagged the market significantly, diverging from their long-term history of outperformance. However, as risk aversion abates, we expect valuation distortions to correct, driving a strong value recovery.

Rebounds from crises have proved quite lucrative for active managers but particularly so for value-oriented strategies. In the recoveries from the six bear markets since 1971, the most attractively valued global stocks based on book value and trailing earnings—the same metrics that have trailed the market during the current crisis—outperformed by an average of 17% in the year following the trough, far outpacing their historical average premium of 6% (*Display 5*).

Display 5

Value Stocks Typically Outperform in Market Recoveries



**The difference in hedged relative returns of the most attractive 20% of stocks in the MSCI World, based on the average of book value/price and trailing earnings/price factors, versus the index; in US dollars*

†1971–March 31, 2009

Source: Compustat, MSCI, Worldscope and Bernstein

Why 130/30 Now?

The recent significant improvement in outperformance potential between the most and least attractive segments of the market bodes well for all active value strategies but is particularly advantageous for extension strategies. By design, this approach can capture more of this valuation spread by exploiting both positive and negative views of stocks while also offering full exposure to the eventual market and value recovery.

Extension strategies increase return potential in two ways. First, they allow managers to invest more capital in their best ideas, amplifying the performance of these positions. Second, managers can benefit more from underperformance of the least attractive stocks by selling them short rather than simply not owning them. This is important because the vast majority of stocks in the indices commonly used as benchmarks have very small weights. Thus, in an extension strategy, the total dollars committed to the manager's best ideas increase, and the active weight and expected return of the extension portfolio will be higher than a comparable long-only portfolio. (For more details on how a 130/30 strategy works, see the sidebar on page 6.)

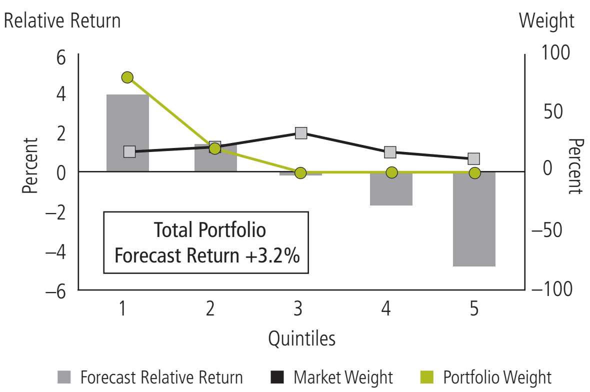
To dimension today's 130/30 opportunity, let's compare how manager skill is captured in a hypothetical long-only portfolio with one that allows shorting. For illustrative purposes, we've plotted forecast relative returns and market weights for both portfolios by quintiles of attractiveness for a global stock universe.

In the long-only portfolio, a manager applies his insights about relative returns by putting 80% of the portfolio into the most attractive quintile of stocks, the remaining 20% into the second-most attractive quintile and avoiding the last three quintiles. This results in a 60% overweight in the most attractive quintile, a market weight in the second-most attractive quintile and significant underweights in the last three quintiles. Based on our long-term forecasts, this portfolio is expected to outperform by about 3.2% annually (*Display 6, next page, top*).

Now suppose we can sell short 30% of the capital, concentrate it all in those stocks we find least attractive, and then invest the proceeds to add to positions in stocks we find most attractive (*Display 6, bottom*). This portfolio's overall active exposure increases as the deviation between the market weight and the portfolio weight in the first and fifth quintiles rises still further. Because it captures research insights more effectively, this portfolio's expected return is 5.8%, or 260 basis points higher than that of the long-only portfolio.

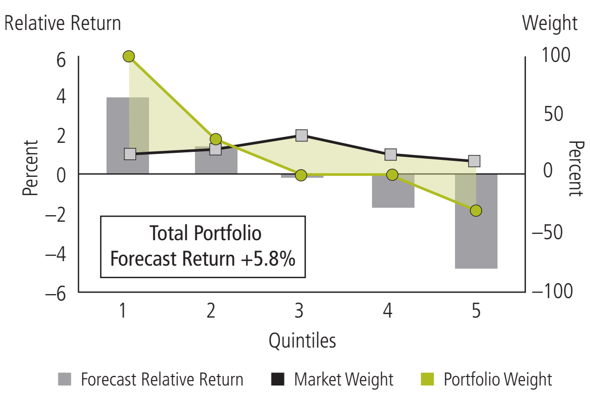
Display 6

Long-Only Impedes Implementation of Negative Views



For illustrative purposes only

Shorting Allows More Insights to Get into the Portfolio



For illustrative purposes only

Expected returns relative to a global universe of stocks with market capitalization greater than $2 billion; equal-weighted

Source: Bernstein

In mid-2007, before the global credit crunch struck, the global extension portfolio's expected outperformance was 4.1% and its advantage over a long-only portfolio was 190 basis points.

Owing to the even sharper postcrisis widening of forecast return spreads in the US, we would expect a hypothetical US 130/30 portfolio to outperform the market by 8.0%, up 320 basis points from mid-2007; for a long-only portfolio, the outperformance potential is now 4.7%, a 220-basis-point improvement from mid-2007.

Other Advantages

Equity extension services are levered strategies and, therefore, sometimes compared with certain equity hedge funds that take both long and short positions. There are a number of distinct advantages that 130/30 strategies offer over such alternatives, some of which have become more salient in light of the recent market dislocation. These include:

- The ability to invest in highly liquid, marketable stocks
- No redemption restrictions for separately managed accounts, while allowing twice-monthly redemptions for commingled accounts
- Full transparency, offering independently calculated net asset values and independent custody
- Clear fee structures

Using 130/30 to Intensify Value Equity Exposure

After the past year's market crash, many investors are significantly underweight in their target equity allocations and probably even more so if they had allocations to lagging value equities. For those plans, the benefits of rebalancing appear particularly compelling. As we noted earlier, value stocks tend to outperform in market recoveries. Given current low stock valuations and the historical outperformance of stocks versus bonds, the potential upside from rebalancing appears as high as ever. Meanwhile, the risk of underperformance versus their benchmarks also looks high for plans that allow too much style drift.

Bernstein has been a long-standing proponent of disciplined rebalancing, but recognizes the importance of weighing the benefits of systematically buying low and selling high against the reality of transaction costs.

A thoughtful approach to rebalancing is even more imperative today because the ongoing dislocation in capital markets has dramatically increased the transaction costs associated with selling certain fixed-income securities, which would typically be sources of funding for rebalancing to equities. Furthermore, yield spreads on many credit instruments are unusually high today, making the expected-return trade-off versus equities more challenging. In a similar vein, some investors have large allocations to relatively illiquid asset classes such as venture capital and private equity. In most cases, rebalancing away from these investments is near impossible, and many illiquid funds are calling for further capital from investors to take advantage of current opportunities.

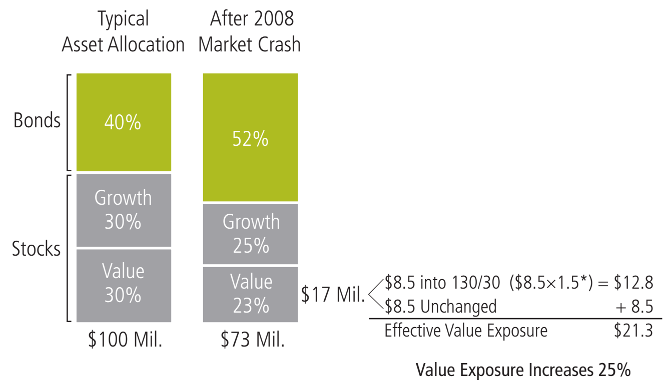
Rather than take money from fixed income or other asset classes, some investors may want to consider shifting a portion of their existing value equity allocation into a value 130/30 strategy. Because the dollar-for-dollar value intensity of a 130/30 strategy is greater (about 1.5 times) than a long-only service, this approach would bring the portfolio's effective exposure to value factors closer in line with the target allocation without requiring it to redeploy funds from other asset classes.

To see how this could work, consider a hypothetical $100 million portfolio with a typical allocation of 40% fixed income and 60% equities, evenly divided between long-only growth and value mandates (*Display* 7). As a result of the recent market collapse, let's assume that portfolio assets now total $73 million, with value equities now constituting 23% of the total ($17 million), or 7.5 percentage points below its policy allocation.

Instead of selling fixed-income assets to restore its value allocation weight, this plan could shift half (or $8.5 million) of the existing long-only value investments into a 130/30 value strategy. Doing so would increase the portfolio's effective exposure to value factors by about 5.5 percentage points, to 29% of the portfolio. Shifting more than half of the existing long-only assets would fully restore effective value factor exposure to the 30% policy allocation. Transaction costs are minimized, not only because one avoids forced sales of illiquid or attractive

Display 7

Increasing Value Intensity Without Selling Bonds



For illustrative purposes only

**Assumes value-factor exposure is one and a half times greater than in a long-only portfolio*

fixed-income instruments but also because a substantial portion of the existing long-only value portfolio would serve as the foundation of the new value equity extension portfolio and, hence, would not need to be sold.

Conclusion

Timing the market rebound and reassertion of fundamental value as a driver of relative performance is an imprecise exercise. Seizing the potential of this moment requires that investors overcome the very behavioral biases that produced this opportunity in the first place—that is, the human tendency to extrapolate the recent past into the future. But the investment opportunity on the other side of the turn is so compelling that we believe it is worth the wait.

Furthermore, to the extent that equities remain under pressure but investors become less panic-driven and more discriminating, the stock-selection opportunity is large, offering potential downside protection. Disciplined, research-based strategies such as 130/30 extensions, which can capture both the attractiveness of the equity markets and the wide gap in relative valuations across stocks, are likely to be particularly productive going forward. ■

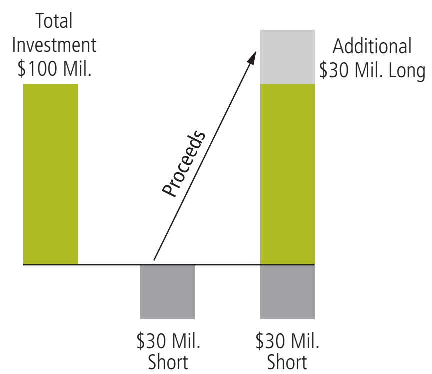
How a 130/30 Portfolio Works

Extension strategies have become the generic term for traditional long-only services that have been unconstrained to allow short selling while still tracking performance relative to a benchmark. Long-short extension portfolios range from 120/20 to 140/40, offering an optimally determined level of additional potential alpha at various levels of risk. Whatever the degree of shorting, these strategies will always provide 100% net market exposure—that is, the amount shorted is matched by an increment of equal value on the long side.

In *Display 1*, we show the structure of a 130/30 extension strategy, the most common configuration. The portfolio starts out with an initial investment of $100 million. Under this structure, the portfolio can short up to 30% of the portfolio, or $30 million. That short sale generates proceeds of $30 million that can then be invested in additional long positions. The result is a portfolio with $160 million of exposure to the manager's best ideas, both long and short.

Display 1

The Mechanics of a 130/30 Portfolio

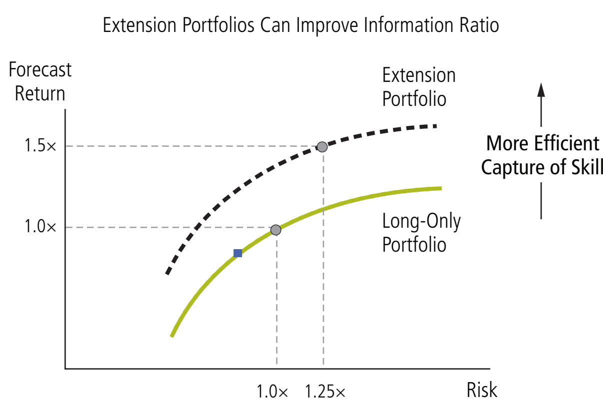


Extension services differ from so-called pure alpha or market-neutral strategies, which invest 100% of assets long and hold 100% short in offsetting positions, so that market exposure or risk is effectively eliminated and, hence, performance is independent of the overall market environment.

The theoretical appeal of unconstrained strategies is that they extend the efficient frontier (*Display 2*): they can potentially realize higher excess returns versus a long-only portfolio without a commensurate increase in risk versus a benchmark or they can produce the same excess return with less relative risk. Research shows that the information ratio, or the ratio of a portfolio's excess return (or alpha) relative to its tracking error (risk versus the benchmark), increases as one moves from a long-only portfolio to the various versions of an extension portfolio, albeit at a declining rate.

Display 2

130/30: Better Source of Risk-Adjusted Return



Extension strategies resolve one of the biggest impediments facing long-only strategies—that is, the inability to fully implement negative research insights in active weights. In a long-only portfolio, the most aggressive stance an active manager can take on a potential underperformer is not to own it. The size of that negative bet can be only as large as that stock's weight in the benchmark. This is limiting because most of the stocks in the indices commonly used as benchmarks have very small weights. For example, roughly 96% of the almost 2,000 stocks in the MSCI World have a weight of less than 0.25%. Without the ability to short, it is difficult to significantly underweight the vast majority of stocks in the index.

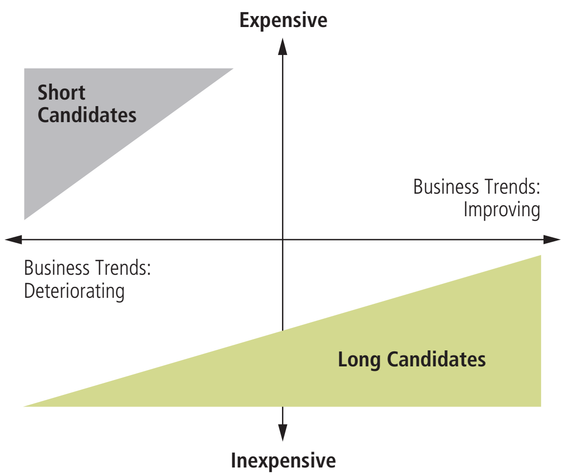
Extension Strategies Offer Greater Diversification

Extension strategies are better sources of risk-adjusted return than long-only approaches because they have greater scope for diversification. This is most evident in the higher number of positions. In addition to shorts, extension services have the capacity to hold more long positions. For example, a typical Global Strategic Value account held 83 longs at the end of 2008, while the extension version of that service held 112 longs and 45 shorts. But because the extension strategy has more capital to work with than does a long-only strategy, it can construct a more diversified portfolio without diluting the commitment to our best ideas.

Moreover, shorts and longs have different characteristics. In our own research, we assess our long and short investments on the basis of two broad dimensions: valuation and business trends (*Display 3*). The ideal long candidate is typically attractively valued and enjoys improving business trends. However, in many cases, we would also be willing to trade poor current business performance for a good price that compensates for the risk entailed.

Display 3

Longs and Shorts Have Different Characteristics



When looking for short candidates, we're reluctant to make too many trade-offs. The ideal short sale would be richly priced but also show evidence of business deterioration that bullish investors are ignoring. The shareholders of the best short-sale candidates have their perspective anchored in a company's past success—which drives its rich valuation—and are not looking forward for potential trouble. High valuation is a necessary but not sufficient condition for a short sale. Integrating the differing characteristics of longs and shorts helps to diversify risk.

Shorting also gives managers a more efficient way to neutralize or offset the unwanted risk of single-stock or sector concentration, while taking larger long positions in favored stocks. For example, the manager of a portfolio with large positions in certain retailers may not want to take on significant exposure to the consumer sector as a whole. By shorting other less attractive consumer stocks, the manager could reduce or eliminate the unwanted sector concentration risk while maintaining the risk he does want—that is, the exposure to the characteristics that prompted his long retail investments in the first place.

In an integrated long-short portfolio, the shorts merely need to underperform the longs to add absolute return. For example, consider a 130/30 strategy in which the longs have appreciated 20% and the shorts have appreciated 10%. The integrated portfolio's return would be 23% (1.3% x 20% minus 0.3% x 10%). In this example, the 30%/30% portion of the long-short portfolio adds 3% absolute return. And this calculation works regardless of the performance of the overall market. ■

About the Authors

Joseph Gerard Paul
Global Head—Diversified Value Services

Mr. Paul was appointed Global Head of Diversified Value Services in 2009. Prior to this appointment, he was CIO—Advanced Value Fund, CIO—Small and Mid-Capitalization and co-CIO—Real Estate Investments. Previously, he was director of research for the Advanced Value Fund for two years. In this role, he was instrumental in the genesis of the Advanced Value leveraged hedge fund. Mr. Paul joined Bernstein in 1987 as a research analyst covering the automotive industry. He was named to the *Institutional Investor* All-America Research Team every year from 1991 through 1996. Before joining Bernstein, Mr. Paul worked at General Motors in marketing and product planning. He earned a BS from the University of Arizona and an MS from the Sloan School of Management of the Massachusetts Institute of Technology.

Morgan C. Harting, CFA
Senior Portfolio Manager—Value Equities

Mr. Harting joined the firm in 2007 as a Senior Portfolio Manager. Prior to Bernstein, he was a senior director at Fitch Ratings, serving on credit committees for sovereigns, corporates and banks. Earlier, he was a senior manager at KPMG Consulting in the business strategy practice and an analyst at Standard & Poor's. Mr. Harting earned a BA from Wesleyan University, as well as an MA and an MBA from Yale University, where he was a graduate teaching fellow in international economics.

Kent Hargis
Senior Quantitative Strategist

Mr. Hargis joined the firm in October 2003 as a Senior Quantitative Strategist within the value-equities unit. His efforts focus on the firm's quantitative return and risk-control strategies within the global portfolio management process. Prior to joining the firm, Mr. Hargis was chief portfolio strategist for global emerging markets at Goldman Sachs. From 1995 through 1998, he was assistant professor of international finance in the graduate program at the Darla Moore School of Business at the University of South Carolina, where he published extensively in academic and practitioner journals on various international investment topics. Mr. Hargis earned a PhD in economics at the University of Illinois in 1995, specializing in international finance, econometrics and emerging financial markets.

AllianceBernstein

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