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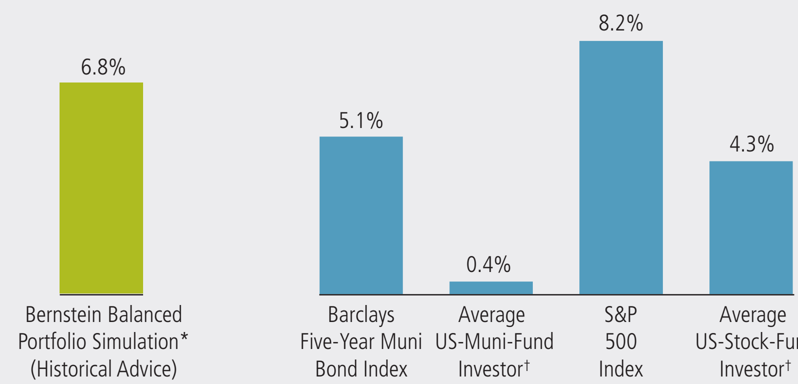
Planning, discipline, and comprehensive risk and tax management are critical for long-term success.

The Case for Integrated Wealth Management

Investor dissatisfaction with poor performance, high fees, and conflicts of interest are driving the wealth management industry in two seemingly divergent directions. We think there's a better way.

Display 1: Better Long-Term Outcomes from Not Chasing Hot Managers and Asset Classes
Annualized Returns (1993–2012)



Past performance does not guarantee future results.
*The hypothetical performance after fees of a taxable 60% stock/40% bond Bernstein Fully Diversified Portfolio Simulation is presented for illustrative purposes only. While the performance shown does not represent that of actual managed accounts, this simulation is designed to reflect the investment experience of a Bernstein client who followed Bernstein's investment advice during the period indicated. No representation is being made that an investor will, or is likely to, achieve a profit similar to the results shown here. Notes on Performance Statistics are available from your Bernstein Advisor upon request.
†The average US-muni-fund and US-stock-fund investor results come from the Dalbar study "Quantitative Analysis of Investor Behavior" (QAIB), 2013. See Note on Dalbar QAIB at the end of this paper.
Source: Barclays, Dalbar, Standard & Poor's, and AllianceBernstein

Most firms in our industry take an open architecture approach to wealth management, typically the "best-of-breed" version: They offer what they deem to be the best managers in each category in their recommended asset allocation. But in recent years, some firms have begun to give up on active management, in whole or in part. In effect, they have declared index funds the best managers for at least some asset classes.

Why, then, does Bernstein continue to offer what we call the integrated approach, which combines mostly proprietary, actively managed portfolios with customized investment planning, strategic and dynamic asset allocation, and both risk and tax management?

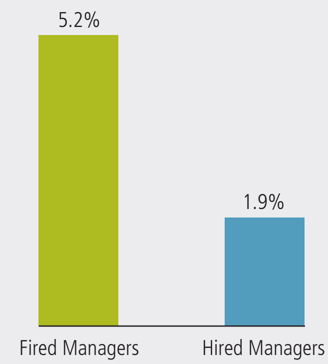
This paper describes the integrated approach to wealth management and illustrates why we believe it is likely to provide superior long-term outcomes for clients, as it has for the last 20 years (*Display 1*).

The Best-of-Breed Approach Leads to Chasing Performance

It's easy to understand the appeal of the best-of-breed approach. Who wouldn't want the best funds and managers? But open architecture only makes it *possible* for a firm or individual advisor to offer the best manager in each category; it does not mean that they actually choose the best managers or deliver better outcomes. Furthermore, not all managers are available to every firm or advisor.

Display 2: Chasing Hot Managers Can Be Hazardous to Your Wealth

Three-Year Cumulative Returns vs. Benchmarks After a Change in Managers*



Past performance does not guarantee future results.

*Amit Goyal and Sunil Wahal, "The Selection and Termination of Investment Management Firms by Plan Sponsors," *The Journal of Finance*, 2008. The study examined the selection and termination of investment managers by some 3,400 US institutional investors, representing public and corporate pension funds, unions, foundations, and endowments, over a 10-year period (1994–2003).

In practice, most money goes to the best performing and most highly rated funds, which often has disappointing results. One study, with the provocative title "The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?" found that US equity mutual funds with five-star Morningstar ratings beat their benchmarks by 4.3% in the three years *before* receiving that rating, but lagged their benchmarks by 5.3% in the subsequent five years.[1] (Morningstar subsequently changed its ratings methodology.)

Another study of institutional investors found that fired managers performed far better than the managers hired to replace them. The managers who were fired delivered an average cumulative premium to their benchmark of 5.2% in the three years after their dismissal, while the hired managers delivered a 1.9% cumulative premium over the same time period (*Display 2*).

Indeed, past performance isn't just a poor predictor of future results; it is often a negative indicator. That's because most investment strategies tend to work better under some market conditions than others. Even skilled managers' relative performance tends to be cyclical.

The challenge in manager selection is to distinguish cyclical downturns in performance from lack of skill, and to distinguish skill from luck. Industry professionals agree that it takes extensive due diligence into a manager's philosophy, investment process, and research quality to determine if a manager is seeking to exploit a verifiable pricing anomaly and has the skills and resources to do so over time. Due diligence should also include assessing whether a manager's past performance is consistent with his or her professed philosophy and process. Risk management, operations, and how the manager deals with any conflicts of interest are also critical areas to review.

But no matter how skilled someone may be at selecting managers, it is highly unlikely that *all* the managers he or she hires will perform well all the time—or at the same time. By definition, there's only a 25% chance of randomly picking a top-quartile manager in any category. The odds of doing so in each of five categories are 25% to the fifth power, or less than 0.1%. Even with skill, the odds of selecting top-quartile managers in each of five categories are very low.

Some best-of-breed firms seek to demonstrate their skill by showing the performance of the managers they now recommend to clients. Investors should ask to see the performance of the clients who invested with the managers whom the firm recommended in the past. Investors should also ask why the firm or advisor thinks managers who have outperformed recently will do so in the next few years, since history suggests they won't.

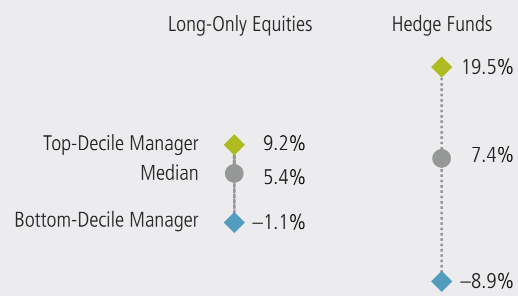
Integrated wealth management, by contrast, forces accountability for performance. Bernstein shows prospective investors the results of the component portfolios that we actually provided to clients over time, as well as the asset allocations our clients actually owned.

At Bernstein, we provide clients with proprietary portfolios in the

[1] *Matthew R. Morey, "The Kiss of Death: A 5-Star Morningstar Mutual Fund Rating?"* Journal of Investment Management, *2005. Based on a study of Morningstar rating and return data for more than 270 diversified domestic equity funds from 1990 through 2000.*

Display 3: Wide Dispersion of Alternative Investments Makes Broad Diversification a Must

Manager Performance Dispersion (1996–2011)



Past performance does not guarantee future results.
Please see A Word About Risk at the end of this paper.
Hedge funds may include, but are not limited to, global macro, currency, quantitative commodities, real estate, and real-estate-related investments; they are represented by the Lipper TASS database, as adjusted by AllianceBernstein to reduce biases. Long-only equities are represented by the Mercer database. See Note on Lipper TASS Database at the end of this paper.
Source: Lipper TASS, Mercer, and AllianceBernstein

traditional, long-only realm because we intimately understand the philosophies, processes, research methodologies, and disciplines that our managers use to deliver on their long-term investment objectives. This structure helps us resist the temptation to chase performance—a practice that leads many advisors at open architecture firms to buy high and sell low, and thereby dramatically reduces client returns.

In the alternative investment realm, however, Bernstein provides clients with access to broadly diversified portfolios that include both external and internal managers investing across a broad range of strategies. Our research has shown that returns vary much more widely within and across categories of hedge fund managers (*Display 3*), which makes it especially important to diversify broadly within and across categories when seeking to capture alpha, the idiosyncratic return from manager, rather than market, performance, that alternatives can provide.[2]

Index Funds Are Today's Hot Managers

But why bother offering active managers? Wouldn't investors be better off with low-cost index funds?

In recent years, there have been large flows from actively managed funds to stock index funds because index funds have delivered higher returns than most active managers. That is, many investors have chased the performance of index funds.

There was a similar big shift from active to passive funds in the mid-1990s, after a period when the index beat most active managers. Then, like now, many people said that active management wasn't worth its fees, particularly for US large-cap equities, the world's most well-covered and most liquid stock market. But active funds began to outperform again in the late 1990s, and the shift to passive US equities ceased for nearly a decade.

Stock index funds have their virtues: They can provide low-cost exposure to an asset class, and typically, they are easy to buy and sell. Hence, we use index instruments of various kinds in client portfolios when we need to shift asset class exposures quickly. Our firm also manages roughly $45 billion in index funds, mostly for institutional clients.

But traditional index funds are not necessarily safe, as many people believe: They can be highly concentrated, especially capitalization-weighted equity benchmarks, such as the S&P 500. As individual stocks appreciate, their weight in the index grows. Capitalization-weighted bond index funds are even riskier, since they give greater weight to a company or government if it adds to its debt load, which typically weakens its credit quality.

Smaller stock markets can be concentrated in just one or two hot stocks.[3] Even indexes representing the much bigger US and global markets can become concentrated in a favored sector, country, or theme (*Display 4, next page*). The technology sector ballooned to more than 29% of the S&P 500 in 2000. Over the next two years, the sector lost more than half its value. Similarly, Japanese stocks lost about

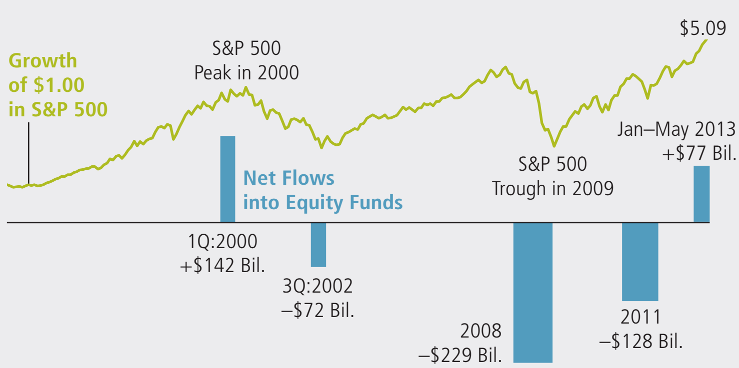
[2] *"Demystifying Hedge Funds: Taking a Rigorous Research Approach," Bernstein Global Wealth Management, October 2012*
[3] *Seth J. Masters, "Desperately Seeking Safety," Bernstein Global Wealth Management, January 2013*

Display 4: Market Indexes Are Prone to Concentration Risk

Component	Index	Long-Term Avg. Index Share	Peak Year	Index Share at Peak	Component Performance Two Years After Peak
Energy	S&P 500	12.4%	1980	30.0%	–51.1%
Japan	MSCI World	17.4	1989	44.0	–34.9
Technology	S&P 500	12.5	2000	29.2	–56.2
Financials	S&P 500	9.8	2007	22.3	–63.6
High-Dividend-Yielding Stocks	S&P 500	34.7	2012	44.0	?

Past performance does not guarantee future results.
Long-term average shares of S&P 500 from 1965 through 2012 and of MSCI World from 1973 through 2012
Source: FactSet, Morgan Stanley Capital International (MSCI), Standard & Poor's, The University of Chicago, and AllianceBernstein

Display 5: Chasing Hot Asset Classes Can Also Have Dire Results
1994–May 2013



As of May 31, 2013
Past performance does not guarantee future results.
Fund flows represented by total net new cash flow into US-domiciled equity funds
Source: Investment Company Institute, Standard & Poor's, and AllianceBernstein

a third of their value in the two years after their weight in the MSCI World Index peaked at 44% in late 1989.

Today's favorite market theme lies in so-called safety stocks—particularly, in the US, those with high dividend yields. At their peak in September 2012, stocks with high dividend yields had a 44% weight in the S&P 500, their largest weight since 1970 and far above their 35% average.

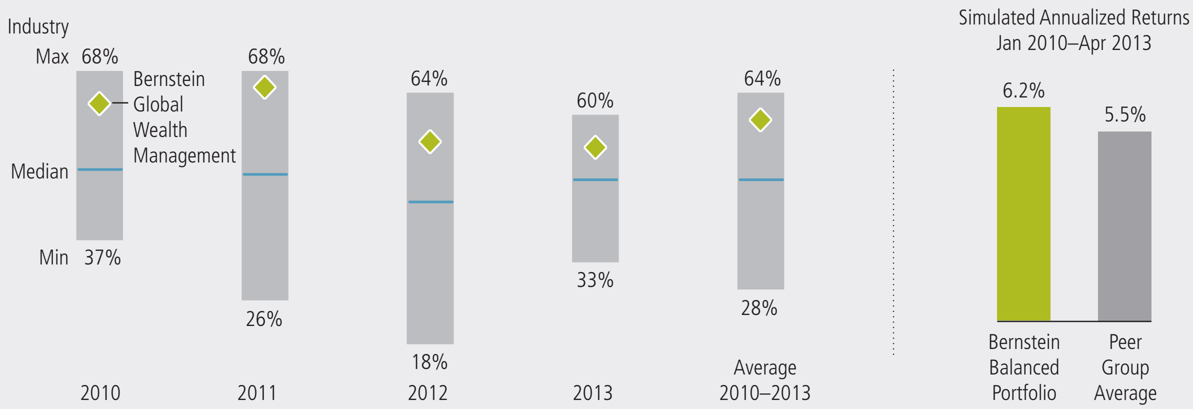
In recent months, the weight of stocks with high dividend yields has declined somewhat, partly in response to rising bond yields, to which they are more sensitive than most stocks. Still, their weight in the S&P 500 remains unusually large. As investors become less enamored of safety, or as bond yields rise (or both), stocks with high dividend yields are likely to lag the market, and active managers with less than the benchmark weight in such stocks are likely to outperform, possibly by a very wide margin.

Planning and Asset Allocation Matter Most

Despite the attention that manager selection typically gets, it is not the only driver of investor outcomes. On the contrary, asset allocation typically explains about 90% of the variability of results for diversified investment pools such as pension funds, a well-known study[4] has found. The reason is simple: In any one time period, asset class returns typically differ far more than the returns of traditional managers within any given asset class. Thus, the most important thing an advisor can do is to help clients find the

[4] *Gary P. Brinson, L. Randolph Hood, and Gilbert L. Beebower, "Determinants of Portfolio Performance,"* Financial Analysts Journal, *July–August 1986; Gary P. Brinson, Brian D. Singer, and Gilbert L. Beebower, "Determinants of Portfolio Performance II: An Update,"* Financial Analysts Journal, *May–June 1991*

Display 6: Consistent Higher Equity Allocations Helped Our Clients



As of April 30, 2013
The least common denominator was used by tracking high-level allocations to equity, fixed income, alternative investments, and cash. *Barron's* data in some cases were incomplete or incorrect, so each average was rounded to the nearest whole number to ensure percentages added up to 100. AllianceBernstein did not report to *Barron's* in 2010, so the recommendations from our Dynamic Asset Allocation (DAA) advice at that time were used; we also used the DAA recommendations in subsequent years when we did report to the *Barron's* survey.
Performance data do not represent past performance and are not a promise of actual future results or a range of future results. The simulated returns for the Bernstein Balanced Portfolio and for the Peer Group Average are presented for illustrative purposes only. The simulated returns for the Peer Group Average assume index returns for component asset classes held all year at the average asset allocation reported to *Barron's*. Asset classes are represented by the following benchmarks: Global Equities—MSCI ACWI; Fixed Income—Barclays US Aggregate; Alternatives—HFRI FOF Composite; Cash—Citigroup One-Month T-Bill. The simulated returns for the Bernstein Balanced Portfolio reflect our proprietary globally diversified stock and diversified intermediate-term taxable bond portfolios, as well as external diversified hedge funds. For more detail on these allocations, call your Bernstein Advisor.
Source: Barclays, *Barron's*, Citigroup, Hedge Fund Research, MSCI, and AllianceBernstein

asset allocation most suitable to their specific circumstances and goals—and help them stick to it.

An integrated wealth management approach focuses first and foremost on investment planning: helping clients identify how much capital they need to be highly confident that they will be able to support their spending goals for the rest of their lives, given the wide range of potential capital market outcomes. We call this amount the client's "core capital." Any additional financial assets are "surplus capital" that they can invest to support future generations or their philanthropic goals.

Once the asset allocation is set, systematic rebalancing is critical. For example, after a period of strong equity market returns, it's logical for clients whose assets now exceed their target equity allocation to rebalance their stock positions. An integrated approach monitors the long-term targets and rebalances as needed, perhaps adjusting modestly as a result of changing risk and return expectations.

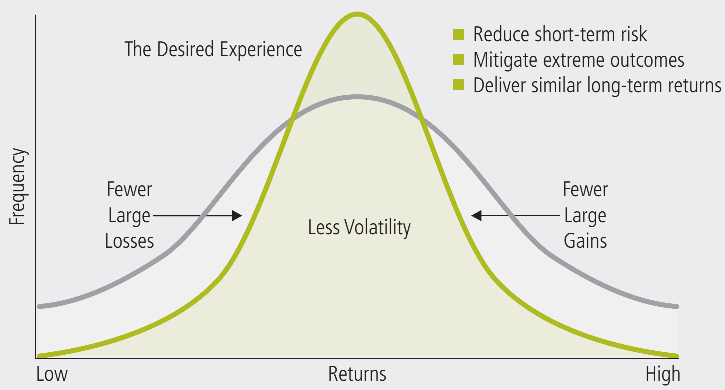
But most investors tend to chase the performance of whatever asset class has recently done best, just as they chase the best performing stocks and managers (*Display 5*). Taken together, this contributes to the large gap, shown in Display 1, between the returns of the average stock- and bond-fund investor and the returns for the indexes.

Needed: Conviction and Discipline

Most of the wealth management industry has accommodated investors' desires to flee equities in the wake of the 2008 crisis, despite the market's subsequent rebound. You can see this in *Barron's* annual survey of asset allocation recommendations for a typical balanced account. The average recommended equity allocation in the *Barron's* survey was below 50% every year, and as low as 44% in early 2012.

By contrast, our recommendations for clients with a comparable stock/bond allocation were in the top quartile in each year that *Barron's* conducted the survey, and in the top decile over four years (*Display 6*).

Display 7: Our Goal: Smooth the Ride



Source: AllianceBernstein

Our higher recommended equity allocation more than compensated for the below-benchmark returns that some of our equity services, like many other active equity managers, delivered in those years. Since the beginning of 2010 (the first year covered by the *Barron's* survey), the simulated annualized returns after fees for a Bernstein client with a 60/40 stock/bond strategic asset allocation who followed our advice were significantly higher than our estimate of the returns for investors who invested in the industry's average asset allocation through index funds.

An Integrated View Enhances Risk Management

Most open architecture firms in effect outsource risk management to the managers of the underlying portfolios, who typically focus primarily on benchmark risk: the degree to which the portfolio differs from the benchmark along various dimensions. These differences are the source of future performance relative to the benchmark, whether good or bad. Active managers, including our own, typically seek to limit the magnitude of such risks, to varying degrees.

While it is important to manage risk within component portfolios, it is even more important to manage risk across the portfolio as a whole. Our research suggests that dynamically adjusting the asset allocation as market conditions change can materially reduce volatility in an investor's overall portfolio values without reducing returns over the long term.[5] This approach aims to limit the frequency of extreme outcomes (*Display 7*).

Some open architecture firms do seek to manage overall portfolio risk. Their ability to do so, however, is constrained by their inability to see the holdings in the externally managed mutual funds more than once a month.

An integrated approach, by contrast, gives risk managers a real-time look at all the holdings clients have in proprietary portfolios. We have found this to be an enormous advantage. For example, it has helped us to change the character of clients' asset allocations by avoiding additional stock exposure in periods when the managers of the underlying portfolios were implicitly increasing market exposure by buying higher beta stocks.

An Integrated View Can Enhance Tax Management, Too

Even a sound asset allocation with excellent underlying managers may not provide the best client outcomes if too much of the gains go to pay taxes. As is often said, it's what you keep that counts. Effective tax management is crucial to building and maintaining wealth.

In the open architecture approach, the managers of the component portfolios might do some tax trading at year-end, based on the gains and losses they generated. The investor's advisor might also suggest trimming a component portfolio at year-end to harvest losses that offset gains in another component.

An integrated wealth management firm with proprietary portfolios can do far more. Having a real-time view into the proprietary portfolios' holdings makes it possible to take tax considerations into its analysis of each potential trade all year.

[5] *"Designing a Smoother Ride: Balancing Risk and Return Using Dynamic Asset Allocation," AllianceBernstein, January 2010*

For example, when analyzing potential trades in the US equity portfolio, it's important to evaluate the short- or long-term nature of gains and losses that they would create, and perhaps adjust the timing of the trades. Careful lot selection, along with knowledge of a client's tax rate and the value of his or her tax loss carryforwards, allows an integrated wealth manager to maximize the benefit of harvesting losses and offsetting gains across the client's overall portfolio, including the bond or international stock holdings.

Our experience indicates that an integrated tax management process can add 50 to 100 basis points to a typical client's after-tax return.[6] The visibility and information necessary to execute comprehensive tax management are simply not possible on open architecture platforms where most assets are managed outside an advisor's firm.

Clients Deserve the Best a Firm Has to Offer

At many firms, financial advisors are free to select securities and portfolio managers, and to make their own judgments about investment planning, asset allocation, and both risk and tax management. Their firms may provide them with tools to use, but there's no guarantee that the advisor will use them, or that he or she has the expertise needed to use them well.

Bernstein is different. Over the years, our research and investment professionals have built and refined state-of-the-art investment planning and asset allocation tools, portfolio management and tax-trading systems, and the valuation and risk management tools we use in our proprietary portfolios. Our investment professionals use these tools in an integrated and consistent yet customized way for all our clients.

Our financial advisors are experts, too. Their role is to understand each of their clients' circumstances and needs, and to marshal the resources required to help clients meet their specific goals, taking into account, if necessary, client investments outside of our firm. In this way, we take a team approach to ensure that every client who hires Bernstein gets the best we have to offer.

The fees for our integrated solution are all-inclusive and transparent. They cover investment planning and asset allocation, Dynamic Asset Allocation, risk management, tax management, and custody services, as well as management of the component portfolios. Often, they are lower than the fees for an open architecture account with a similar asset allocation, if the fees paid to the underlying fund managers and custodians are added to the fees paid to the open architecture firm.

Bernstein has always been different. Market concerns have changed many times since Bernstein's founding in 1967, and the services we provide have evolved to become more comprehensive over time. But our focus on fiduciary responsibilities to clients, our client service, and our research-based thought leadership remain the same.

This is Bernstein's integrated approach to wealth management. We think it is the way to better client outcomes. ■

[6] *The estimated annual benefit of 50 to 100 basis points is based on a simulated Bernstein Strategic Equities account managed in line with our standard practices.*

Note on Dalbar QAIB

The results of the Dalbar study "Quantitative Analysis of Investor Behavior" (2013) capture the dollar-weighted returns of stock funds, rather than the time-weighted returns shown by the indexes. Dalbar calculates investor returns as the change in assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs, annualized over the period.

Note on Lipper TASS Database

The Lipper TASS database includes the net-of-fee performance of individual hedge funds whose managers have elected to report to the database. In constructing our hedge fund, and fund of fund, indices, we included the performance of funds only after their managers decided to report to the database, and only for those funds that had at least $10 million in assets under management. We also included the performance of all funds in the database that are no longer currently reporting. Based on the above selection criteria, there were 4,766 distinct hedge funds in the database during the 1996–2011 periods. The indices are asset-weighted.

A Word About Risk

Investments in alternative strategies are speculative and involve a high degree of risk. Alternative investments may exhibit high volatility, and investors may lose all or substantially all of their investment. Investments in illiquid assets, foreign markets, and non-US securities and currencies and the use of leverage, short sales, and derivatives may create special risks and substantially increase the impact and likelihood of adverse price movements. Interests in alternative investment funds are subject to limitations on transferability and liquidity, and there is typically no secondary market for interests and none may develop. Alternative investment funds are usually not registered with securities regulators and therefore would be subject to little or no regulatory oversight. Performance compensation may create an incentive to make riskier or more speculative investments. Alternative investment funds typically charge higher fees than many other types of investments, which can offset trading profits, if any. There can be no assurance that any alternative investment fund will achieve its investment objectives. In addition to the risks discussed above, other risks may apply, which are described in more detail in the applicable offering document(s).

Index Descriptions

The Barclays Five-Year Municipal Bond Index is a market-capitalization-weighted index representative of the medium-term (four- to six-year maturity) tax-exempt bond market.

The Barclays US Aggregate Bond Index is a market-capitalization-weighted bond index designed to measure US investment-grade bonds of intermediate duration.

The Citigroup One-Month T-Bill Index is an unmanaged index representing monthly return equivalents of yield averages of the last one-month Treasury bill issue.

The HFRI Fund of Funds Composite Index is an equal-weighted performance index that includes over 650 constituent fund of funds that report their monthly net-of-fee returns to Hedge Fund Research, Inc., have at least $50 million under management, and have been actively trading for at least 12 months.

The MSCI ACWI (All Country World Index) is a free-float-adjusted market-capitalization-weighted index designed to measure the equity-market performance of global developed and emerging markets. It consists of 45 country indexes: 24 for developed and 21 for emerging markets.

The S&P 500 Index comprises 500 large-capitalization US stocks and is a common measure of the performance of the market.

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