



THE UPSIDE OF LESS DOWNSIDE

HOW DEFENSE WINS IN EQUITIES

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IN THIS PAPER: Soaring stock prices thrill investors, but it's the disciplined, less glamorous efforts to *not* lose money that build lasting wealth. It's possible to get downside protection and still beat the market over time. Here's how.

TURNING LESS INTO MORE

It's a deeply ingrained investing maxim that risk and return go hand in hand: to get more return, you must accept more risk. So, for some investors, it may seem counterintuitive that the opposite is also true: you can take less risk and still beat the market over time. It's a different way of defining investment success that leans on downside defenses in the pursuit of long-term goals.

Following the extended postcrisis bull runs in bonds and equities, the future returns of many traditional investing strategies are unlikely to pack the same punch. Investors are realizing that they'll need to take more risk to meet their long-term goals, including adding equity exposure.

That's a troubling proposition for a large and growing group of investors. Whether an individual saving for retirement, a pension plan facing funding gaps, or an insurance company dealing with stiffer capital requirements and asset/liability-matching challenges, investors are much more risk-sensitive today. They can't tolerate wild market swings, let alone the prospect of losing money. They need their investments to go the distance.

That's where strategies that expressly target downside-risk protection come in. These solutions get their performance power from the simple mathematics of lower risk drag and compounding. Stocks that lose less in market downturns have less ground to regain when the market recovers, so they're better positioned to compound off those higher returns in subsequent rallies. Over time, this gentler return pattern can end up ahead of the market.

“Offense sells tickets, but defense wins championships.”

—Bear Bryant, legendary US college football coach

THE ADVANTAGES

Because these smoother-ride equity strategies focus on buffering market shocks, they offer several advantages:

- + They help investors to stay the course in equities, preventing the tendency to buy high when markets boom and sell too quickly when they slump—and miss out on future recoveries.
- + They help shield against the corrosive effects of risk drag, which is particularly important for investors who need to start spending their money.
- + They provide flexibility in budgeting portfolio risk and allowing for increased allocations to return-seeking strategies.

Given these characteristics, we view smoother-ride strategies as attractive choices for a core equity allocation. An active, multifaceted approach that combines built-in downside defenses with the traits of high fundamental quality and attractive valuation is an effective way to tap this potential. And investors can use these strategies in various ways to drive better long-term outcomes.

PICK YOUR POISON: RELATIVE VS. ABSOLUTE RISK

Risk is a slippery concept. It means different things to different people and over different periods of time. Since the introduction of the capital asset pricing model (CAPM) in the mid-1960s, equity risk has largely been defined in relative terms, most often versus a cap-weighted index, such as the S&P 500 Index or the MSCI World Index. This mind-set is deeply rooted in convention: it's how investors are taught to think about risk and what they read in the headlines, amplified by the pervasiveness of market indices.

Investors view relative risk through the lens of the information ratio—defined as relative returns divided by their volatility, or tracking error. This statistic gives investors an easy way to gauge the performance of their portfolios and the skill of their asset managers.

But the preoccupation with relative risk also creates perverse effects. Since risk-taking is measured versus a benchmark, active managers have a strong incentive to stick closely to that benchmark. Frustrated with paying high fees for benchmark-like or worse performance, many equity investors have been turning to low-cost, passive, cap-weighted index-tracking strategies or exchange-traded funds (ETFs).

Going passive solves the relative-risk issue, but raises other challenges. Keep in mind that passive indices organize their holdings

based on a single metric: market capitalization. But there may be more compelling reasons than size for choosing one stock over another, such as earnings growth, low valuation or price momentum. Under what logic, for example, does it make sense to own equally weighted positions in, say, ExxonMobil and Amazon.com? They each represent 3% of the S&P 500, but they have nothing in common except for their enormous market caps.

Whether benchmark-hugging portfolios are managed actively or passively, they can become overexposed to that benchmark's riskier excesses—and to the full magnitude of inevitable market downdrafts. And benchmarks are backward-looking: a portfolio that's tethered too closely to a benchmark will also be tethered too closely to yesterday's winners.

But, in our view, the biggest flaw in focusing on relative risk is that it doesn't solve the real problem: having enough money to meet your long-term goals. You can't spend relative performance.

THE RISK THAT REALLY HURTS

After the market turbulence of the past decade, investors of all types are now paying a lot more attention to the absolute pattern of portfolio returns.

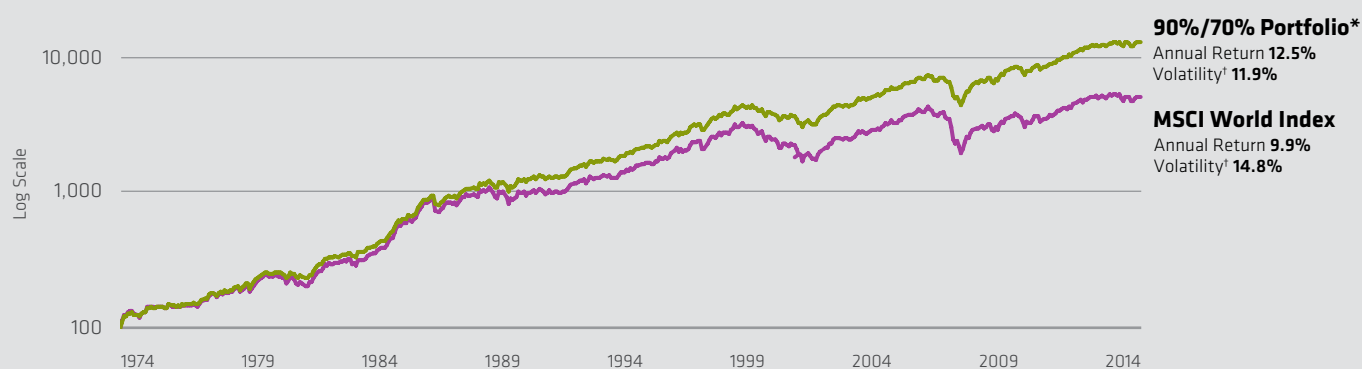
This heightened risk aversion is rooted in the demographic changes and harsher macroeconomic conditions that have evolved since the global financial crisis. The world population is aging, swelling the ranks of people worried about having enough money for a retirement that could last several decades. Ultralow bond yields are driving income-starved investors to riskier assets to boost returns, but gyrating equity markets make many investors wary.

Market meltdowns are particularly damaging for investors in the post-accumulation phases—retirees living off their nest eggs and defined benefit plans in the run-off stages—especially if these sell-offs happen in the early withdrawal stages.

This low-yield, low-return environment has also left many public and corporate pension plans struggling to fill large funding gaps, while insurance companies grapple with stiffer regulatory and asset/liability-matching challenges. Earning investment income is tough today—and it's probably going to stay that way.

DISPLAY 1: GET DOWNSIDE PROTECTION AND STILL BEAT THE MARKET

Growth of US\$100



Through June 30, 2016

Past performance does not guarantee future results. Returns shown are for illustrative purposes and not representative of any AB fund. It is not possible to invest in an index

* Performance calculated by multiplying all positive monthly returns (0% or greater) of the MSCI World Index by 90% and all negative returns (less than 0%) by 70%; shown in logarithmic scale

† Annualized standard deviation

Source: MSCI and AB

THE ANTIDOTE: THE INVESTING NIRVANA OF UPSIDE/DOWNSIDE

For investors who need their investments to stand the test of time, we point to a concept that has been gaining currency lately: upside/downside capture. While the phrase is relatively new to investing conversations, the concept is pretty simple.

Upside/downside capture explains how preserving capital in the near term can actually drive outperformance over the long term. Imagine a hypothetical global stock portfolio that captured 90% of every market rally and fell only 70% as much as the market during every sell-off. What would the long-term returns of this portfolio look like?

You'd be forgiven if you thought it would underperform. It wouldn't. As *Display 1* illustrates, this smoother-ride portfolio would build up

capital of nearly US\$13,000 over the period examined. That's more than 2.5 times the capital generated by the MSCI World Index.

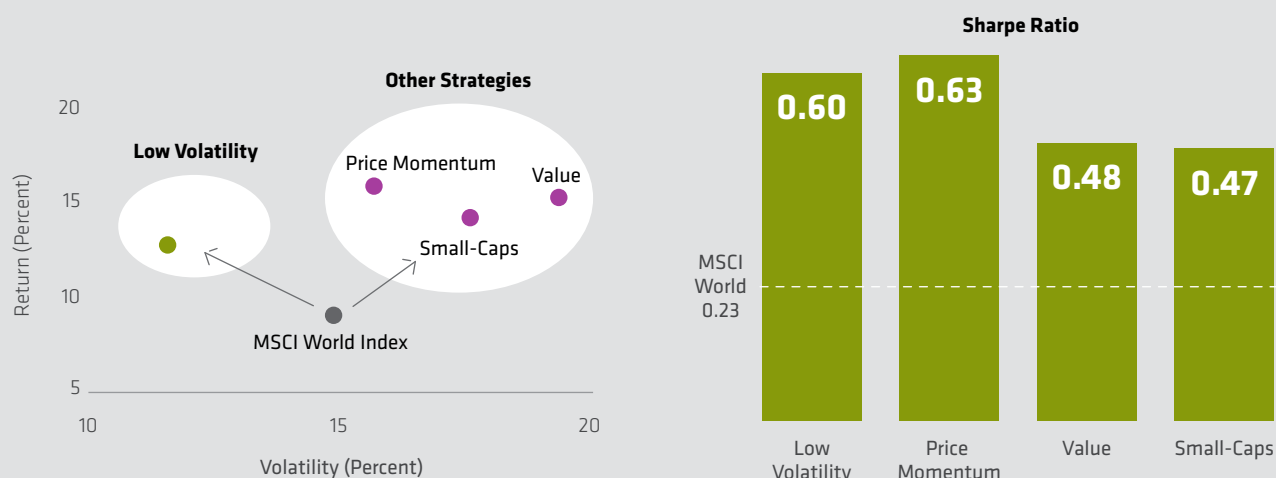
WHAT'S THE CATCH?

In our view, achieving a 90%/70% upside/downside spread comes as close to investing nirvana as investors can get: having downside protection and still beating the market over the long term.

But here's the rub: this performance potential doesn't come for free. To get the full benefits of this approach, investors must accept that its performance will differ significantly from that of the market. The tracking error of the hypothetical upside/downside capture portfolio would have been an annualized 3.1% over the period examined. That divergence is easy to overlook when the portfolio is holding up in a crumbling market; the true test comes when it's trailing in a roaring market rally. Investors must keep their eye on the long-term prize.

DISPLAY 2: THE PARADOX OF LOW-RISK STOCKS

Efficient Frontier and Sharpe Ratios



As of June 30, 2016

Results represent top quintiles within the MSCI World Index as sorted by low two-year trailing volatility, high price momentum, low price/book value and low capitalization since January 1, 1973; Sharpe ratio includes cash; capitalization-weighted MSCI World Index, gross in USD, unhedged

Source: MSCI and AB

Research going back to the early 1970s shows that lower-risk stocks, as measured by beta, performed much better than the CAPM would predict. By focusing on absolute risk (a.k.a. the Sharpe ratio), the long-term returns of strategies with less volatile stocks have matched or outperformed the market and more aggressive equity strategies over four decades (*Display 2*). Based on Sharpe ratios, lower-risk stocks have delivered significantly more return per unit of risk.

Investors also need to bear in mind that it's incredibly hard to strike the right 90%/70% upside/downside balance. Our guiding principle: target profitable and resilient business models at attractive prices.

But simple checklists won't do. Finding these companies takes skill, research, and a wide-ranging, responsive view of risk and return. That flexibility allows the portfolio to pivot when opportunities arise (sometimes in unexpected places) or when the world throws curveballs.

DURABLE BUSINESSES ARE EVERYWHERE

You may think that only companies in traditional safe-haven or defensive sectors—consumer staples, healthcare and utilities—would make the grade in this type of portfolio. But standout business models are everywhere.

DISPLAY 3: SOURCES OF SUSTAINABLE PROFITABILITY

NETWORK EFFECT	➤ First-mover and scale advantages create winner-take-all economics
INTELLECTUAL CAPITAL/BRAND	➤ Barriers to entry allow for premium pricing
COST LEADERSHIP	➤ Efficiencies generate consistent profitability across economic cycles; often a result of scale
HIGH SWITCHING COSTS	➤ Recurring revenue streams lead to predictable profitability
FAVORABLE REGULATION/ NATURAL MONOPOLY	➤ Limited competition enables steady profitability
CAPITAL DISCIPLINE	➤ Focus on cash flows and prudent management behavior promotes value creation

For illustrative purposes only
Source: AB

So what are some examples of resilient business models? We look for companies that enjoy well-defended competitive advantages that enable them to maintain high and predictable profitability for longer than the market is giving them credit for. The sources of this sustainable profitability can vary—from an entrenched network effect to a difficult-to-replicate service, a beloved brand or a low-cost production process (*Display 3*). These companies are also strong cash generators and good stewards of capital, which gives them control over their own fates.

Examples include tech-savvy disruptors like Google and online travel-information provider Amadeus, which are profiting from strong network effects built on their formidable leads in both the collection of data and the ability to analyze and monetize it.

But durable businesses can even be found in industries suffering from massive technological disruption. While traditional agency models struggle for relevance in the digital age, advertising powerhouse WPP, information-services provider Equifax and insurance broker Marsh & McLennan are reaping the benefits of their large investments in data analytics and other services. These investments have revitalized the companies' value as intermediaries in their respective market niches.

Meanwhile, as e-commerce continues to upend traditional retailing, dollar stores and off-price apparel chains are thriving. They've crafted sustainable business strategies focused on encouraging strong customer loyalty and frequent store visits—dollar stores through their convenient neighborhood locations and low, everyday prices on small-pack basic items, and off-price apparel retailers

Staying alert to valuations tilts the odds further to the upside.

through their ever-changing designer-brand assortments and “treasure hunt” appeal. Both gain from the efficiencies of superfast inventory turnover.

RESILIENCY ADDS A SAFETY NET

Some of the stickiest business models in technology are concentrated in software, particularly in the enterprise arena, where software is often used for mission-critical operations. Once it's installed, the costs of switching become prohibitive, erecting a strong barrier to entry. For example, Fiserv, a provider of online banking, payments, data analytics and core account processing, has formed strong outsourcing partnerships with small and midsize financial companies looking for ways to reduce their regulatory compliance costs.

It's important to actively monitor companies for firm-specific risks that might threaten their fundamental stability and/or increase price volatility in the short term. This extra scrutiny helps weed out companies that may be headed for uncharacteristic periods of erratic stock performance. These risks could include an unexpected acquisition, a shift in top management or new regulatory requirements.

VALUATION SEALS THE DEAL

But identifying these high-quality, shock-resistant companies isn't enough. To tilt the scale even more to the upside, the next step is to determine whether those characteristics are being fully appreciated by the market. Staying alert to valuations is another way to improve return potential and avoid expensive, vulnerable pockets of the market.

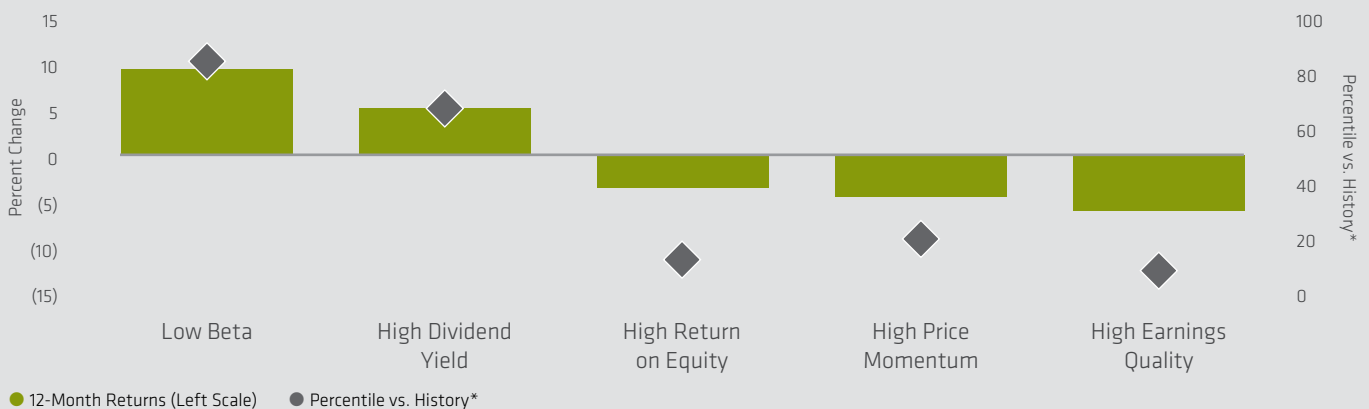
As reflected in the flows into passive investing vehicles, investors have been gorging on richly valued high-dividend-yielding stocks and other bond-proxy equities this year.

In the US, five of the 10 top-selling equity ETFs through the end of June were “high dividend” and “low volatility” funds. Excluding those top 10, ETFs saw outflows.

As a result, the stocks in these “safety trade” categories have clocked some of the best performances in decades, while those of many other traditional return drivers have rarely performed as badly (*Display 4*).

DISPLAY 4: THE PASSIVE “SAFETY TRADE” HAS BEEN UNUSUALLY POPULAR LATELY

Top-Quintile 12-Month Returns vs. Percentile History



As of June 30, 2016

Past performance does not guarantee future results. Returns for the top quintile of US stocks for each factor shown

* Percentiles of returns are relative to history since 1979.

Source: Morningstar, MSCI and AB

This binge on safety stocks has pushed valuations to new heights. Low-beta stocks are now trading at some of their highest valuations in the past 25 years, while the multiples on high-quality and low-valuation stocks remain reasonable versus their history (*Display 5, top*).

The MSCI World Minimum Volatility Index, the most commonly used proxy for low-beta stocks, is currently near its all-time high based on current earnings (*Display 5, bottom*). This valuation is the consequence of ultralow interest rates and increased risk aversion. But what if conditions change?

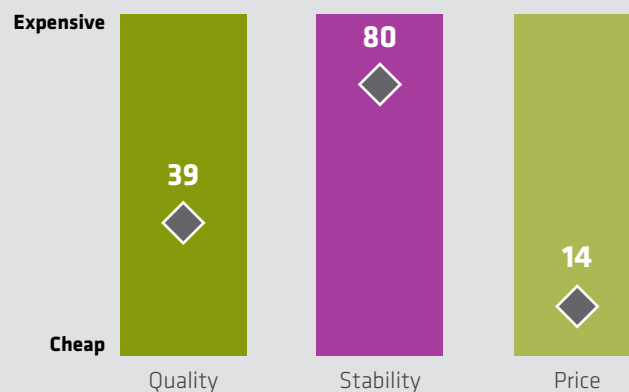
The MSCI World Minimum Volatility Index is also concentrated in “bond proxy” sectors, such as utilities, which adds unintended interest-rate sensitivity. Tapping low volatility passively may limit investors’ upside potential or expose them to greater downside risk when rates rise. That’s an especially important consideration in an era when broad market performance is likely to be more subdued. As a stand-in for safety at any price, some may say that the index is all shield and no sword.

PIVOT TO PRICE

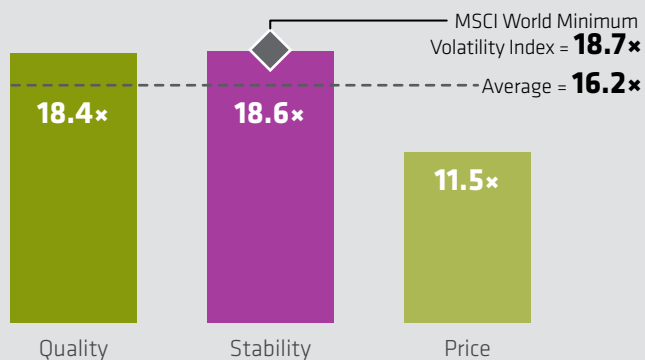
It’s not easy to build a portfolio that can capture more upside during market rallies than it loses during downturns over time. In our view, the secret to delivering on the 90%/70% nirvana potential lies in the intersection of quality, stability and attractive valuation. It also requires the ability to nimbly adjust exposures as insights into fundamental attractiveness and risks change.

DISPLAY 5: SAFETY AT ANY PRICE?

MSCI World Index Price/Forward Earnings, 1990–Present Percentile Rank vs. History



Price/Forward Earnings, August 2016



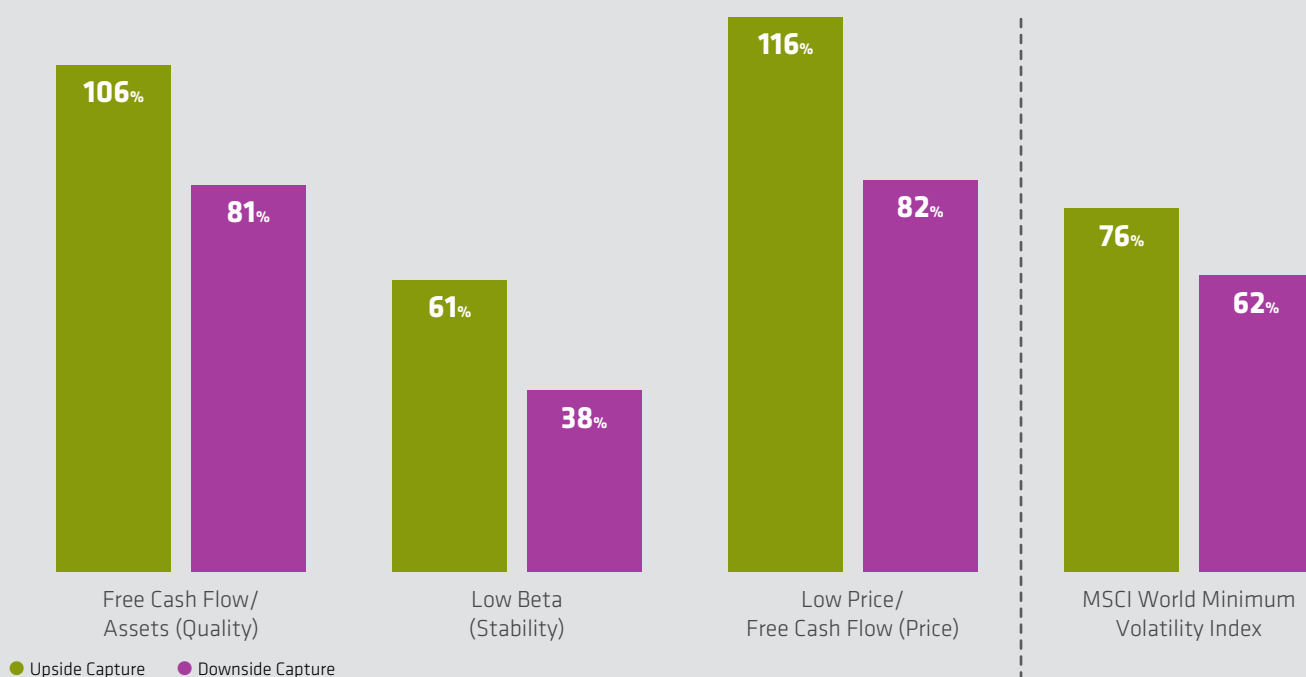
As of August 31, 2016

Quality represented by the highest quintile of free cash flow to asset ratios of the MSCI World Index, stability represented by the lowest quintile of beta, and price represented by the lowest quintile of price/free cash flow to asset ratios of the MSCI World Index

Source: FactSet, Morningstar, MSCI, S&P Compustat, Worldscope and AB

DISPLAY 6: INVESTING NIRVANA—AT THE INTERSECTION OF QUALITY, STABILITY AND PRICE

Upside/Downside Capture Since 1989



As of June 30, 2016

Past performance is not a guarantee of future returns. Percent of MSCI World Index (hedged) returns for each factor quintile in all up and down markets since January 1, 1989. Quality represented by the highest quintile of free cash flow to asset ratios of the MSCI World Index, stability represented by the lowest quintile of beta, and price represented by the lowest quintile of price/free cash flow
Source: MSCI and AB

TAG-TEAMING TO WIN: QUALITY + STABILITY + PRICE (QSP)

Our research shows that combining built-in downside defenses and traits of high fundamental quality can produce better risk-adjusted returns than focusing on either factor alone. A strategy that dynamically focuses on these attributes benefits from their inherent countercyclical, tag-teaming features: when one faces headwinds, the other lends support. As shown in *Display 6*, high-quality stocks

have fully participated in all market rallies since 1989. Low-beta stocks, meanwhile, tended to hold up better in market downturns. The attention to attractive valuations helps arbitrate between the two, by taking account of shifting fundamental and macroeconomic conditions. (Emerging markets are particularly ripe for the QSP investing approach; see the sidebar on page 11.)

Display 7 shows the counterbalancing interplay between quality and stability in rising and falling interest-rate environments.

HOW TO USE RISK REDUCTION TO LIFT RETURNS

As noted earlier, smoother-ride equity strategies benefit investors in three ways:

- + They prevent the counterproductive tendency of investors to time the market.
- + They reduce the effects of risk drag.
- + They free up risk budgets, allowing them to be used for reducing overall portfolio risk or boosting return potential.

HANGING TOUGH WITH EQUITIES

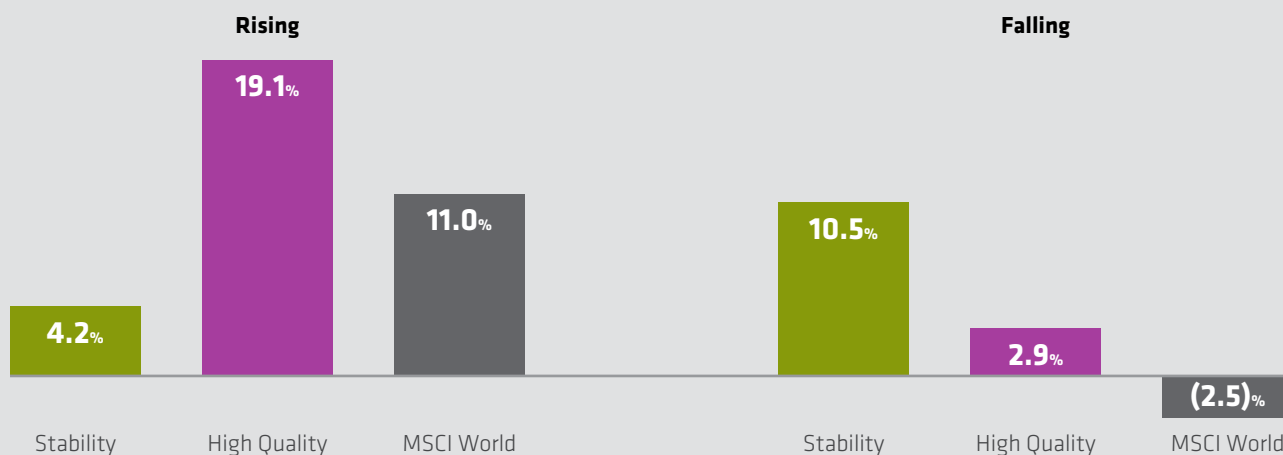
When markets turn unruly, investors may be tempted to rush for the exits. But history teaches us that this response (and most efforts to time markets) tends to be costly. Investors risk locking in losses and missing out on the market's eventual recovery.

Another issue: If you sell, where do you go? Returns are harder to come by across all asset classes today. AB's capital-market engine expects global equities to deliver an annualized return of roughly 6% over the next 10 years—much lower than the 10% average over the past 30 years. Still, these modest equity returns are much higher than our expected return of investment-grade bonds (of roughly 2%).

The history of downturns has much to teach us. According to a long-running study by DALBAR, over the past 25 years through 2015, surveyed investors earned slightly more than 4% annually, less than half the S&P 500's average of nearly 10%. The study links this huge performance gap to investors trying to time the market during downturns, a perennial pitfall. People who flee the market when they're scared and reenter when they feel confident typically miss the best buying opportunities: they sell low and often buy high. Investors who stay the course, on the other hand, are usually rewarded.

DISPLAY 7: QUALITY AND STABILITY TAG-TEAM THROUGH DIFFERENT RATE CYCLES

Average Annualized Returns When 10-Year Treasury Yields Were...



January 1, 1989, through July 31, 2016

Past performance is not a guarantee of future returns. Based on average monthly returns of the quintile of global stocks associated with low one-year beta (stability) and high free cash flows to asset ratios (high quality). "Rising" periods depicted represent the third of months with the largest rise in 10-year US Treasury yields since 1989; "falling" periods represent the third of months with the largest drop.

Source: MSCI and AB

COMBATING THE CRUELITIES OF RISK DRAG

A cruel math governs equity returns: if a stock falls by 50%, it needs to rebound by 100% to make up the lost ground. The steeper the fall, the harder it is to climb back. Big price swings, compounded over time, can be a major drag on long-term performance.

We see this risk drag at work in *Display 8*, which compares the performance of an initial \$100 investment under three different patterns of returns. All of the return patterns average 6% per year over a five-year span. The end result for both of the more volatile paths is the same, but the consistent return path's final destination is better.

If you don't need to tap into your money for a long time, you can ride out the inevitable market squalls. But the stakes are much higher for investors in the post-accumulation stages—whether they are retirees living off their savings or plan sponsors paying claims from their pension funds. Risk drag reduces both the expected value of

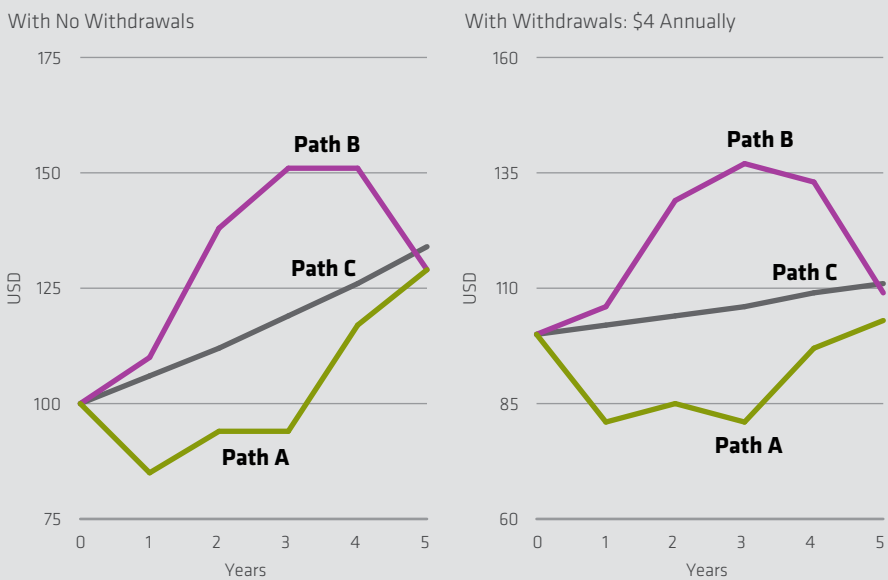
those funds and the chances that there will be enough money to meet future needs.

In the most basic sense, the problem comes from differences between the steady timing of withdrawals and the unpredictable swings in the fund's investment value. High volatility increases the chances that you'll be taking money out when the portfolio is down, which forces you to lock in your losses.

The impact can be particularly damaging if the downdraft happens early in the withdrawal period, as the middle line chart of *Display 8* below shows. When an investor takes out \$4 a year, the \$100 investment fares much worse under Path A, which suffers a 15% drop in the first year, than it does under Path B, which sees the 15% drop take place in the last year. And both A and B do worse than the steadier Path C. Clearly, the pattern of returns matters—and the gentler the ride, the better.

DISPLAY 8: VOLATILITY IS A DRAG, ESPECIALLY FOR INVESTORS IN DRAWDOWN STAGES

Return Scenarios for \$100 Investment

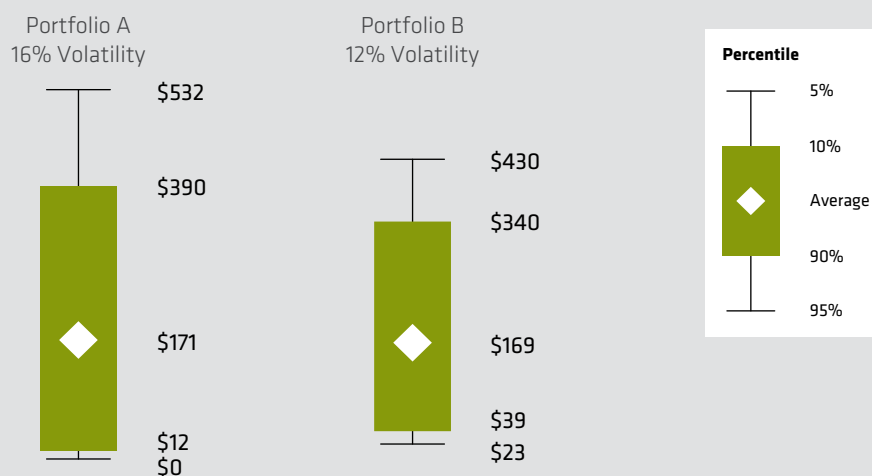


Three Return Scenarios			
Year	Path A	Path B	Path C
1	(15)%	10%	6%
2	10	25	6
3	0	10	6
4	25	0	6
5	10	(15)	6
Average	6%	6%	6%
CAGR	5	5	6

For illustrative purposes only
Source: AB

DISPLAY 9: TAMING VOLATILITY CAN REDUCE THE CHANCES OF RUNNING OUT OF MONEY

Monte Carlo Simulation of a Portfolio with a Starting Value of \$100



Chance of Running Out of Money **1 in 17** **1 in 98**

For illustrative purposes only

This analysis was based on the outcomes of a Monte Carlo simulation applied to a geometric Brownian motion model of equity portfolio returns that simulated 50,000 random paths of 20 years of monthly returns, producing a probability distribution of outcomes. The analysis assumed a constant annualized expected return (6%) and a constant return volatility (12% or 16%). The portfolio value was \$100 at the start of each 20-year random path, and \$4 was deducted from the simulated portfolio value each year in 12 equal monthly payments.

There is no guarantee that the returns presented will actually be realized.

Source: AB

Taming volatility can also help ease many investors' biggest fear: running out of money. To calculate the probability of this, we ran two equity portfolios through a random Monte Carlo analysis for a 20-year period. For both portfolios, we assumed a \$100 initial investment and withdrawals of \$4 a year. To isolate the risk drag associated with withdrawals, we also factored in a compound annual return of 6% for both portfolios. Volatility was different, though: it was set at 16% for Portfolio A and 12% (a 25% reduction) for Portfolio B.

As *Display 9* illustrates, both portfolios ended the 20 years with about the same average balance. However, the range of probable outcomes for the less volatile portfolio was much narrower, and its downside potential was dramatically lower. In 90% of scenarios, Portfolio B ended up with a balance of \$39, three times higher than

that of Portfolio A. Just as important, the probability of running out of money was one in 98 of the possible scenarios for the lower-risk portfolio versus one in 17 for the riskier portfolio.

More volatility isn't always bad. Investors could get lucky and end up with more money, as we see in the simplified example above. But they could also end up with less money—or, worse, outliving their funds. In the absence of a crystal ball, we believe that investors in the post-accumulation stages are better off with a plan that will temper the impact of market ups and downs. They'll be more likely to stick with equities, allowing them to catch opportunities in upswings, help preserve more of those gains in downturns and reduce the chances of ending up with the worst-case scenario.

EMERGING MARKETS ARE RIPE FOR THE QSP APPROACH

Emerging equity markets have an important role to play in a well-diversified global portfolio by providing access to countries that make up a significant and growing share of the global economy. These countries are also home to many of the world's most dynamic, fast-growing companies.

But macro conditions have grown harsher in the developing world over the past several years, and dramatic changes are rapidly unfolding. What worked in the past is unlikely to work in the years ahead, and investors can no longer treat these markets as one homogenous bunch. We believe that future success in this asset class requires a risk-aware approach focused on identifying pockets of strength—even in weak economies—and catching nascent trends before they become obvious to others.

PRIMED FOR ACTIVE

These markets lend themselves to an active investing approach. Emerging-market equities are less transparent than developed stocks, and news tends to travel more slowly in these countries than it does in the developed world. As a result, developing-market stocks are more prone to overreactions and mispricings: but are also much richer in opportunities for attentive stock pickers to exploit.

In storm-prone emerging markets, however, defense counts more than offense. So investors must be especially vigilant about avoiding excess volatility. For years, the conventional thinking was that volatility was part and parcel of being an emerging-market investor. Since those risks were fully understood and accepted, the thinking went, active emerging-market managers didn't have

to control for them. Many professional investors merely track the ups and downs of a benchmark and call that risk control.

We see things differently. In our view, the key to success in emerging stocks is to hold on to as much of your gains as possible over a full market cycle. That means being proactive and thoughtful about absolute—not relative—risk.

NEW ERA, NEW GAME PLAN

One way to do that is by maintaining a consistent tilt toward companies with stable cash flows, good capital stewardship and/or lower sensitivity to the business cycle. Another way is to be ever watchful for looming macro risks. We think that country-specific economic insights are more valuable for avoiding risk than for selecting stocks or return potential. This risk-aware approach is akin to constantly buying downside protection, in our view.

In times of increased economic turbulence, earnings quality and consistency become paramount. Examples include the beneficiaries of enduring lifestyle trends, companies in newer low-cost manufacturing centers that are gaining from China's waning status as a source for low-cost labor, and up-and-coming technology innovators.

In the face of the likely economic squalls ahead, we believe that combining active, high-conviction investing with a greater sensitivity to risk is the best strategy. When it comes to getting the most out of allocations to emerging-market equities, there's no contradiction between finding returns and reducing risk.

FREED UP RISK BUDGETS

Being active doesn't always mean accepting higher risk. Because a QSP strategy tends to work best when other active approaches are less effective, it offers diversifying benefits that can be used as a source of uncorrelated alpha or for more efficient risk budgeting.

You may reasonably ask: What good does lower risk do? Well, in a total portfolio, this risk reduction can be used to enhance returns by:

- + Pairing with an allocation to more aggressive but higher-return equity strategies
- + Allowing a shift from bonds into higher-returning equities

Either way, the portfolio gets higher return potential without adding to overall risk (*Display 10*). And because of this lower absolute risk, we believe a portfolio that targets less volatile, high-quality companies is a more efficient way to access the extra return of equities than passive, cap-weighted approaches. These passive strategies contain their underperformance to the cost of their fees but do nothing to guard against downside risks.

DISPLAY 10: ACTIVE DOWNSIDE-PROTECTION STRATEGIES CAN BE USED IN MANY WAYS

Pair QSP with High-Return Equities		Shift to QSP from Bonds		Assumptions			
	100% Passive	65% QSP/ 35% High Return	50% Bonds/ 50% Passive	40% Bonds/ 60% QSP	Returns	Volatility	
Return	5.8%	7.1%	3.9%	4.8%	Passive Equities	6%	15%
Volatility	14.6	15.1	8.2	8.0	QSP Equities	7	13
Return/Risk Ratio	0.39x	0.47x	0.47x	0.60x	High-Return Equities	8	20
					Bonds	2	6

More Return
Same Risk
More Return
Same Risk

This analysis is for illustrative purposes only and is based solely on the set of return and volatility assumptions listed. It is not intended to represent any particular portfolio or strategy, and is not a guarantee of any future results. We have assumed no diversification benefit between a quality/stability/price equity portfolio and a high-return equity portfolio, though it has been observed in practice. Correlation between bonds and passive is assumed at 0.11, in line with returns of the S&P 500 Index and the Bloomberg Barclays US Aggregate Bond Index since 2001; correlation between the quality/stability/price stock portfolio and the bond portfolio is assumed at 0.9, based on the MSCI USA Factor Mix A-Series Index and Bloomberg Barclays US Aggregate Bond Index since 2001.

Source: Bloomberg Barclays, MSCI, S&P and AB

CONCLUSION: THE BIG PICTURE

Anxiety about losing money runs far deeper today than it did before the market traumas of the past decade. Traditional diversification and equity-benchmark-sensitive strategies turned out to be less effective than investors expected in limiting losses during the market collapse of 2008. Today, with return expectations low and the need for riskier assets to meet long-term goals, investors want downside protection that works when they need it to.

The demand for a more effective, shock-resistant equity strategy has given rise to alternative solutions that focus more intently on absolute risk and return. Against this backdrop, more investors are turning to approaches that seek to capture the paradoxical outperformance tendencies of high-quality, less volatile company fundamentals.

We think a strategy that explicitly targets a 90%/70% upside/downside capture is the way to go. It's not easy to carry out this type of strategy, but by actively trading off between the fundamental traits of quality and stability, and remaining sensitive to valuation, we believe it's possible to construct a portfolio that can prosper in rallies and weather periodic bouts of volatility. A smoother journey that's easier on the nerves can help keep equity investors on course when turbulence strikes and ultimately improve their odds of getting to their desired investment destination.

But to harness the full benefits of this strategy, investors must be willing to free themselves from the tyranny of benchmarks and adopt a new way of defining investment success that leans on absolute risk and return potential in the pursuit of long-term goals.

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