Thank you for joining me today. Over the next half hour or so, I’ll offer AB’s assessment of the global economic and capital markets landscape. I’ll also offer our insights on the opportunities and risks we see globally.

As we introduced last year, our current theme in the CMO is “After the Beta Trade.” For years, investors have enjoyed strong returns across capital market sectors. Simply having market exposure, or beta, was very effective, with market returns generally accompanied by low volatility and dispersion.

But we think the great beta wave has subsided, and investors need to consider new ways to enhance expected lower market returns, with higher volatility and more return dispersion. We think active management and the right positioning are key.

First, let’s run through the big picture.
We continue to see modest global growth and low inflation, with the support of still-accommodative monetary policies. The US economy continues to expand, although the Federal Reserve has pushed back additional rate hikes over concerns about the pace of global growth—and has signaled even further caution following Brexit, the UK referendum to exit the European Union.

Collectively, major developed economies are on relatively solid footing. Emerging economies in aggregate are still growing faster than the developed world, but growth is lower relative to previous (commodity supercycle) years and the growth gap between the two groups has narrowed, with significant differences country by country.

Our After the Beta Trade theme seems to be playing out, with higher volatility and muted market returns. Key recent volatility drivers include concerns about the slower growth in China, the political and economic question marks for the UK and possible splinterings of other EU members, and general concerns over global growth. And while low oil prices had been a source of higher volatility over the past year, the more recent rise back to a more moderate price has actually dampened volatility and aided risk assets. We’ll go deeper into this shortly.

But the current uncertainty and easy triggering of spikes in volatility makes today a far cry from the multi-year beta trade driven by easy money policies and well-below-normal volatility. The days of autopilot investing are over.

Investors should focus on strategies to add alpha to enhance the likely lower market returns for the next several years. They should also consider downside protection to insulate against a potential setback. In equities, we expect modest returns, but there are opportunities for high-conviction active investors.

In bonds, we continue to advocate a balance of interest-rate and credit exposure, while being selective and going global. With alternatives, current asset valuations support using alternative strategies to incorporate downside protection combined with security-selection opportunities.

Let’s take a closer look at what’s been going on in the capital markets, which reinforces why we think investors need a new approach to building portfolios.
While US markets weren’t as challenged as in the first quarter, the second quarter ended on a wild swing from the Brexit vote – whipsawing from a plunge down for two days to nearly recouping all that ground three days later.

Amidst bouts of higher volatility, particularly in the final week of the quarter, assets were generally higher.

Credit continued its strong performance, with contributions from tighter spreads (despite some widening in June), and falling govt bond yields: -Global concerns have led the Fed to telegraph greater caution, and less likelihood of a rate increase at least until the very end of the year, the safe haven sovereigns were once again solid performers.

Munis performed well also, supported by similar macro winds—and generally they performed more steadily, as they are more insulated from global issues and continue to offer attractive fundamentals and technicals.

But this quarter held two big stories. The first was the rise in oil prices, and the puzzling picture it paints when juxtaposed with volatility.
It’s hard to believe that only two years ago [July 4, 2014 – WTI $104.06], the price of crude oil (the green line) was over $100 per barrel. At the same time, volatility (the blue line) was relatively close to its long-term average. But that volatility started to show spikes in late 2014, just as oil prices started to plunge in earnest—dropping roughly 40% in price in about six months.

In the past year, short-term equity volatility has spiked frequently. But volatility toned down just as oil prices began to rise off their January–February extreme lows of about $30 per barrel.

Historically, that high of a relationship between the two data sets is pretty strange. Long term, volatility and oil prices are non-correlated. Indeed, one would tend to think that if anything, meaningfully rising oil prices should add to volatility. But recently, they seem to have engaged in a rather abnormal, negative correlation, with volatility calming down through most of the rising trajectory of oil prices. This largely reflects an overall market belief that oil prices that are “too low” threaten negative outcomes in various places, notably the energy sector, financials, etc. A “Goldilocks” level of oil prices (not too high and not too low) therefore had the effect of lowering volatility. And to be fair, rising commodity prices in many areas imply more strength in demand than has been generally perceived, which would be a positive. However, that is of course not a long term recipe, as markets would most likely not view higher and higher energy prices as beneficial.

And likewise, just as oil and volatility have gone in opposite directions for most of 2016, oil and stocks have linked up much more closely with a correlation of 0.9 this year—again, far from the long-term negative-correlation these two typically display. Again, historically a rising input price/inflationary contributor/real profit reducer has tended to negatively impacted P/Es. But not recently. The important point is that rising commodity prices are not a long term salve to current market conditions, and higher volatility drivers exist in many parts of global markets today.

And almost as if on cue, in the last week of the quarter one of those possible volatility catalysts entered the spotlight: Brexit.
While oil was a dominant influence on the markets for most of the quarter, the UK referendum to exit the EU—or Brexit—was the big volatility catalyst at the end of the quarter.

The British pound has so far borne the brunt of the financial and market damage. Further downside is possible, but somewhat limited, because the currency is already hovering near all-time lows.

The big question mark is what will the longer-term implications be and how will they unfold. Much of that answer depends on two key factors that all EU members and any trade agreement affiliates such as Norway, or Switzerland, must abide by: Free movement of labor, and contribution to the EU budget.

The Brexit camp won the vote based on their disagreement with these two points. The UK may want to keep the single-market's free movement of goods, services (including financial services) and capital, but they want to limit immigration and the EU budget contribution requirements.

We see three possible options for the future:
1) The UK doesn’t actually leave. That’s unlikely to happen by another vote, but there are other ways to prevent an exit. Even so, there would need to be some restrictions on the movement of labor to appease the Brexit voters.
2) The UK and EU will work out a new agreement. That’s our base case scenario—a “soft Brexit”. The UK could enter the European Economic Area (EEA) and European Free Trade Agreement (EFTA) as an Associate Member, like a few other countries such as... Of course, the first volley of rhetoric from the euro area is currently uncompromising, but they’re just beginning the negotiation process, and no one starts negotiating from a soft position. So we do think this new agreement will be the most likely outcome.
3) The UK might leave without any agreement, but that’s the worst-case scenario for both the UK and the EU. That’s why the UK is hesitant to trigger Article 50 too soon, because it starts the clock on resolving all the departure issues.

With no agreement or even with a new, affiliate-type agreement, there will be a lot of uncertainty, and markets don’t like that. So we could see financial contagion impacting global markets and political contagion in further populist and nationalist movements among EU countries.

And in any event, we’ll see a continuation of QE in the euro area, at least through all the upcoming elections and referendums.
As you can see, overall, our ongoing themes of moderate global growth and low global inflation continue. However, there also continues to be expected divergence in macroeconomic performance and policy steps across key countries. Brexit of course adds to that, as the expected impact in Britain and the Euro-area is high, while in the US it is generally expected to be low, with impacts in different regions in countries falling somewhere in-between (noted in “the Latest”).

+ More broadly, our two larger out-of-consensus calls continue to relate to the world’s two largest economies: the US and China.
But even as slower growth projections are piling up around the globe, there are more than a few signs that the US economy keeps improving—slowly and with some hiccups, like May’s very low new jobs report. However, it’s worth noting that since the recovery started in the summer of 2009, the US economy has generated 13.4 million new jobs. That’s twice as many as the 6.2 million jobs created during the 2002–2007 economic expansion!

And that’s a major reason why the US drivers of income have been moving up meaningfully.

Aggregate Income

We hear a lot about the top line unemployment figures, but we don’t hear as much about some of the other employment metrics, such as average hours worked and hourly wage averages. These are unsung parts of job growth and, in effect, “equivalent” job creators. As you can see overall income continues to climb solidly, and job openings remaining at/near a record level speak to ongoing demand for labor. The important element to watch going forward is if the skills required in this record level of job openings correspond to the skills of existing job seekers.

Retail Sales

Retail sales have steadily climbed since the end of the 2008–2009 recession. In fact, they’re vastly improved over what they were before the Financial Crisis. More recently, there have been concerns around retail sales numbers that were mixed. However, this has been an area, particularly of late, where revisions have painted a better picture. Indeed, if revisions over the past 14–15 months are taken into account, retail sales have climbed by a very solid 4% over that period. That corresponds to more disposable income and improved consumer confidence (bolstered further by a still near-record-low household obligations).

The Wealth Effect: Strong New and Existing Home Sales

But perhaps the best example of the US economy moving solidly beyond just “being on the mend” can be seen in the rebound in home sales. Even with the switchback ups and downs of 2015, the progression continues to climb upward. And median home prices reflect this demand and diminished available inventory, climbing to the higher levels with the most recent release in the second quarter hitting a new high.
When China released its key activity data for May, it essentially confirmed that further economic weakness was on the horizon.

That was most noticeable with the renewed slackening of housing activity. And while there’s a noticeable slowdown in the growth of residential housing starts, there’s a surprisingly large downturn in the official land sales data—from April’s +8.4% year-over-year, to May’s –4.5% year-over-year contraction.

There’s usually a lag of six months between land sales and resulting housing starts. But that time-frame has grown shorter in the past several years. So we may soon see a further—and sharp—decline in housing investment.

Along with that, there is still an inventory glut in lower tier cities, which will add further downward pressure on the housing sector.

In addition, the rate of growth in total fixed asset investment has slowed sharply, and separating the private from the public sector reveals an even greater decline in private sector investment, while the classic Chinese fiscal policy stand-by of public sector infrastructure investment (middle visual) remains a sole high flyer in growth-rate terms in the economy.

And don’t expect a big recovery in private investment, as a perceived belief within the government is that China can’t further rely on the use of credit growth and liquidity-supported stimulus to kick-start the slowing economy.

Reserves of course continue to be one of China’s key policy assets (no pun intended!). There has been concern about the decline in reserves shown in the right side visual, but we believe that many of the factors leading to reserve decline are temporary (such as FX valuation change and related speculative money outflows). And while global trade challenges have clearly fed through to Asia overall and China specifically, from a trade balance perspective, some of the largest monthly readings have occurred in the more recent term, as slowing imports have outpaced slowing exports. Overall of course, while this may be additive on a trade balance/reserve level, it underscores the overall economic weakness we see in China, and underscores our below consensus growth forecasts.

From a capital markets perspective however, the largest theme for us remains the post beta trade world.
After years of strong market returns, as we introduced about a year ago, we think the “great beta trade” has likely concluded. Based on our return outlook, most asset classes will produce below-average returns in the years ahead.

The left chart shows two distinct stories: First, there was the steady growth of a 60% stock / 40% bond portfolio during the Beta trade—The start of the beta trade could be debated: QE2, post the sovereign debt challenges in the US and Europe (“Beta trade interruptus”), or with QE3, but any of those starting points yielded exceptional performance results with low volatility and fast market recoveries. We show the post-sovereign debt returns number here.

But since May 2015, almost as if on cue, the 60/40 portfolio had a rough go of it. The shaded section thus far corroborates that the great beta trade has largely ended, with v-bottom recoveries to new highs of the past replaced over the last 12 months or so by recoveries to the starting position. In essence, what replaced the great beta trade so far has been some extreme swings in the market, but almost no growth.

…and More of the Same Is Expected

And the right-hand chart shows our forecast for expected returns over the next 3–5 year period. That classic balanced portfolio allocation of 60% stocks and 40% bonds will likely only generate about 4%–5% in annual returns. That’s lower than the historical norm, and far below the pace of the Beta Trade.

However, one of the other key post-beta trade themes is increased alpha opportunity. Put simply, greater volatility means greater return dispersion amongst securities, implying more alpha potential for active investors. The actual lack of dispersions that was present during the beta trade may surprise you…
The chart on the left is an almost shocking way to show just how abnormal the markets have been during the Great Beta Trade. Let me explain:

All the of the green, purple, and orange markers represent the monthly volatility and return dispersion for the past 25+ years—over 300 months.

The 25-year average monthly dispersion is roughly 30%.

If we just look at the months that fall into that lowest left-corner square—when both volatility and dispersion are low, with dispersion specifically below 20—we get only 28 months out of that 300+ month total. And of those 28, six are in the lead-up to the Great Financial Crisis, with four of them in early 2007. Incredibly, all of the rest, the other 22 that are in purple...are all during the great beta trade.

Generally speaking, low dispersion means low alpha.

And not surprisingly, during that time of negligible volatility, negligible dispersion of returns, and supersized broad market returns US investors stampeded into passive investments. In 2005, less than 20% of US commingled vehicle/fund assets were passive. From the beginning of the great beta trade up to today, passive investing has grown to roughly 40% among investors, only underscoring the falling level of active investment.

We believe the conditions are set for this to change over the coming years. First, the orange markers denote dispersion over the past year. While not high versus history, it is well above the readings during the beta trade.

In addition to dispersion, a close cousin—correlation—is also trending toward more security differentiation. The right-hand display shows how correlations between stocks in the S&P 500 Index (S&P 500) have fallen from higher levels at the start of the year. Following 2015, where a substantial portion of the S&P 500’s returns were confined to the largest companies in the Index—namely Facebook, Amazon, Netflix and Google—such falling correlations provides a better set up for active managers; in particular those who employ high conviction in their approach.

Some might ask, though, whether the world of investing going forward will be the world of ETFs. Our response would be that the valuations of Company A versus Company B still matter—will always matter. And a lower return/higher volatility environment is one possible key catalyst of investor behavior change. Let’s look at some ways investors should approach investing in this environment.
The display on the left shows the relative performance of active US large-cap equity strategies in different return and valuation environments. As you can see, active managers have historically underperformed when markets are rising rapidly on the back of multiple expansion—precisely the environment we have experienced in recent years.

Add to this that many managers typically carry a bit of cash and international stocks, while having a small-cap bias, and you start to see why the past few years have been so challenging for active management.

So, we’ve just seen a cycle in which the deck was stacked against active managers. If historical patterns play out again, the hand for active management should be better as we move forward, due to the benefits of higher dispersions and lower correlations, coupled with market returns being driven more by earning growth versus multiple expansion.

On the right, we’re showing relative performance of five different active high-conviction strategies versus the S&P 500 Index. The five strategies we’ve focused on are geared to different factors: dividend yield, value, quality, low beta and momentum. As you can see from the light green bar, the relative performance of passive index strategies targeting these factors for the most part outperformed the S&P 500 Index over the last decade or so.

We focused on managers who reported holdings for at least three years and were in the top 20% of our high-conviction metric in each of these categories at least 60% of the time. Then, we identified skill by extracting managers who delivered above-median returns for the period in which they reported. In some years, that top-half manager didn’t beat the benchmark, but was still included in our universe.

To those who say, “why not just invest in a passive factor strategy?”, I highlight the darker bars, which show the excess returns of those skilled managers. Over this time period, skilled, high-conviction managers on average produced returns that could have reasonably outperformed their fees: 1.6% for value managers and 2.4% for low-beta managers, for example.
Some may be asking a question such as, “While high-conviction equity managers may have delivered in the past, what about now and in the future, as things are tougher today?”

Clearly, investors in US equities are facing tricky market conditions. Valuations are above the long-term average for many stocks, the economic recovery is tepid, and companies are struggling to increase earnings.

But if we look at the left-hand-graph, which compares the earnings yield of the S&P 500 (the aggregate earnings per share of the S&P 500 divided by the price level of the Index) to that of 10-Year Treasury Note, it shows us that there’s a large advantage to equities now.

And if you look at the table on the right, you can see that when similar such conditions (as shown on the left graph) have existed in the past, the outperformance of stocks, in most cases, versus the broad bond market has been substantial!

As the equity markets have grinded along recently, where have stock investors been drawn to in a meaningful way?
Year to date, equity markets have delivered substantial volatility among individual stocks, and at the sector level. Unlike 2015, investors have been enticed by higher-yielding sectors (e.g., Utilities and Telecom), and those that typically benefit from the potential of reflation/stronger global economic growth (e.g., Energy, Materials). This is shown on the left-hand display. The boxed numbers at the bottom are the average dividend yield for that sector. The sectors are shaded to correspond with three characteristics that are associated with them regardless of the economic environment. So for example, utilities offer relatively high dividend yields—come rain or shine. The dark green bars—utilities, telecomm and consumer staples—are the traditionally more defensive sectors that offer higher yields. Next, the aqua-colored bars shows sectors such as energy and materials that are typically beneficiaries of reflationary environments—that means times when commodity prices respond positively to the prospect of stronger demand for these goods and services due to the global economy expanding in a material way. In the case of financials, especially banks, this sector benefits from reflation due to the expectation of rising loan growth and profit margins. However, financials, year to date, have been weighed down mainly by persistently-low interest rates. Consequently, the more traditional growth-oriented sectors (in the lighter green) have lagged.

With that as a backdrop, those outperforming sectors in the first half of 2016 have now become expensive relative to their expected earnings growth rate. On the other hand, stocks in technology, consumer discretionary and healthcare sectors are now attractively priced—with solid, growth prospects. The chart on the right shows you the median forecasted full-year earnings growth for each sector this year and the accompanying PEG ratio—which in this case, is equal to the sector’s P/E ratio divided by its expected growth rate. Essentially, a low PEG ratio indicates that the stock or sector is undervalued relative to its growth prospects. Accordingly, the bottom-performing sectors to date actually have the most appealing low PEG ratios right now. That means you’re not paying a lot for the growth potential they can give you. But not every company in these low-PEG ratio sectors will fulfill the sector’s promise. So it’s important to be selective and use in-depth research to make the most of this opportunity. However, as interest rates have continued to drop, many equity investors have further sustained the march into stocks paying high dividends. Let’s have a closer look at the implications of this and why these market participants may want to exercise a fair amount of caution as they ponder allocating capital in this market segment.
Many investors have been playing defense by seeking refuge in higher-yielding dividend stocks. They are hungry for yield, which has led them to buy such stocks. In many cases, investors are paying up for companies offering high current yields over firms that have the ability to grow dividends over time.

Of the nearly 2,700 US Equity mutual funds and ETFs, investors have poured money into less than 20%—the highest-yielding funds. The rest have seen outflows. Investors want those high dividend paying stocks regardless of the fact that this cohort of equities are trading well above their average P/E ratio of 13.4.

We think investors are overpaying for stocks that act a lot like bonds. In fact, as the middle chart shows, today's P/E ratio is far above: almost double the long-term average.

And all those investors and investment flows heading in the same direction will quite likely cause a lot of traffic congestion with little room to maneuver, and a high chance for some unwanted portfolio "fender-benders."

We show what occurred to a widely-cited proxy for higher-yielding stocks, (i.e., the S&P High Yield Dividend Aristocrats Index), one year leading up to the Fed's indicated they were planning to take their foot off the "easing gas pedal" (or accordingly, taper from their accommodative approach), and one year following the Fed's intended course change, this index lagged the S&P 500 Index by nearly 5%!

This is only one example of what can happen to investors who venture into market segments where returns have been materially stretched. If you refer to the table in the lower-right hand side of this slide, you will see others.

Sectors can become highly concentrated, because most market indexes are capitalization weighted. That is, as stocks and sectors become more expensive, their weight in the index grows.

Some consequences when this has happened: the technology sector ballooned to more than 34% of the S&P 500 in 2000. Over the next two years, the sector's return was negative 73%. Financial stocks, in turn, tumbled roughly 70% in the two years after their index weight peaked in early 2007.

Today’s favorite market theme lies in stocks with high dividend yields (high-dividend-yielding stocks are defined here as stocks with yields 20% or more greater than the cap-weighted average for the S&P 500 Index). At their peak at the end of this quarter, these stocks had a 45.3% weight in the S&P 500, their largest weight since 1965 and far above the historical norm. What we don’t yet know is how high-dividend-yielding stocks will perform over the next few years.

Historically speaking, high-dividend-yielding stocks tend to hold up better in crises, when investors seek near-term safety, because they garner more of their return up front through dividend payments, rather than from future growth.

However, high-dividend-yielding stocks also tend to be highly sensitive to interest-rate risk, often because they are mature firms with high debt burdens. As a result, these stocks—and portfolios with outsized allocations to them—are likely to trade down with bonds if interest rates rise.

A tilt to high-dividend-yielding stocks thus increases the correlation of stocks and bonds in a portfolio, reducing the diversification benefit that provides real protection. Consequently, investors’ search for yield may be self-defeating.

In today’s market, we believe a selective, active approach, focused on valuation, profitability, dividend growers, and company fundamentals presents a more compelling opportunity set.
On the left, we’re looking at the top 1,000 companies in market cap over the last 35 years or so. How many maintained high annualized earnings growth rates of 10% or above annually?

Over one-year periods, a fair number of companies did it: 350 of the 1,000 companies we looked at. And those companies collectively outperformed the S&P 500 Index by about 1% annualized. Sustaining growth over a three-year period gets a lot harder: only 77 companies did it, but they beat the S&P 500 by 1.2% annualized. And over a five-year period, only 22 companies were able to do it, but they beat the S&P by a whopping 2.7% annualized.

And the market is pricing these companies very attractively right now, making persistent growth fairly cheap. On the right, we show the relative price/forward earnings ratio of high-persistent-return-growth stocks versus the market. Historically, these stocks sell at about a 15% premium to the market. Right now, they’re priced below this historical average. We think this is a great opportunity to pick up quality, profitable companies at cheap levels.

The key, of course, is using active management to identify and capitalize on good companies, while avoiding trouble spots.

One place where we’re seeing substantial opportunities with good companies is in the small-cap space, where valuations are more attractive today.
Small-cap stocks are a good case in point for highlighting the advantages of active management. Over the last 10 years, active small-cap managers have delivered higher returns with less risk than the Russell 2000, the benchmark US small-cap index. In fact, the median small-cap core manager generated an annualized return that was more than 200 basis points above the Index, with only two-thirds of the Index’s volatility. And there’s good reasons for that:

Information and coverage for the small-cap arena is much less efficient than for large-cap stocks. So the business models and prospects for smaller companies are not always well understood. Active managers add value by digging into the fundamentals and identifying fast-growing companies that the rest of the market has underestimated or overlooked. Think of it as finding a Netflix before video streaming takes off.

And an active approach works better for value-minded investors, too. With smaller companies getting less attention from analysts, their shares tend to get hit harder than large-cap stocks when markets get volatile. But a bigger price decline means more opportunity for managers to add value. They can uncover with companies are more likely to recover quickly from those companies that face steeper challenges. It’s just that kind of alpha that investors will need in the coming years.

The middle chart brings up another key benefit to an active approach in the small cap market. Namely, you want your small-cap allocation to be appropriately diversified, and not top heavy with one or another sector that might be getting bloated.

We see that now with a clutch of “safer” sectors that did well in the past year or so while there was a more general pullback in small caps. These safer sectors tend to deliver more stable earnings, so they bucked that trend. These included value-oriented sectors such as utilities and REITs, the so-called “bond proxies.” And in the growth space, Biopharma (which includes biotechnology and Internet-related names) also attracted sizable inflows.

These sectors did so well over the past few years that they now look overpriced relative to the rest of the small-cap market. So if you’re using a passive, index-tracking strategy in the small- and mid-cap arena, you’re pouring a lot of money into these pricey sectors. Biopharma (the green line) is above its long-term sector weight in the Russell 2000 Value Index. We think these sectors in the small-cap space have much less room to rise in the future. So investors who rely on passive vehicles for their small-cap allocation may miss a good share of any small-cap rebound because these indexing vehicles, by design, will have large positions in the most overvalued sectors.

A further reason to consider small-cap stocks now is that valuations for small-cap stocks are looking less expensive in comparison to large-cap stocks. The right-hand chart shows that, following the pullback in small caps over the past year, the relative valuations between large and small now give an edge to small-cap stocks.

So, outside of the “safer” small-cap sectors, the rest of the smaller-cap market looks attractive, and a skilled active manager can be choosy and zero in on high-quality, inexpensive stocks that have the most potential to deliver strong returns, while avoiding the pricey ones.

There’s potential for boosting investors’ returns by allocating some of their risk budget to small and mid-cap stocks. But again, the dynamic solution for the “lean years” that are apparently ahead of us, is to use an actively managed approach. Active managers can structure their small-cap portfolios so they benefit only from the risks that are being mispriced—the mispricings that get uncovered by great research in an area that very much requires that you do your homework. A passive approach can’t match that.
In addition to actively managed equities strategies, another attractive way for investors to deploy risk assets is via the high-yield bond market.

While yields have come down a bit since their recent peak in February 2016, high yield bonds still offer an attractive return profile versus passive equities. One good indicator of that is today’s yield-to-worst, which is a metric used to evaluate the lowest possible yield an investor might receive on a bond (incorporating provisions like call options), provided the issuer doesn’t default. It’s been a pretty reliable indicator of the type of annualized returns you can expect over the next five years. And it’s above 7% currently [7.27% as of 6/3016].

But High Yield not only displays attractive return potential, it also has demonstrated better downside protection, with much smaller drawdowns historically than a passive equity strategy. Since 1998, the average calendar year maximum drawdown for the S&P 500 was a drop of nearly 12%, while the comparable US High Yield drop is roughly half that.

But that’s not all…! High Yield tends to bounce back from those drawdowns a lot faster than the S&P. Over that 1998–2015 time period, it took the S&P over 16 months on average to recover its losses. In contrast, High Yield took less than 5 months on average. This is in part due to the consistent stream of high income that high yield bonds provide during bull and bear markets alike, which sets them apart from equities and even other bonds.

While that all sounds quite good, investors still need to exercise a bit of caution when investing in high-yielding credit markets today.
Most sectors in the US high-yield market are in the later stages of the expansion phase of the credit cycle, except for the energy sector, which is already in contraction. Leverage is picking up as are defaults in the energy space, and valuations—echoing the story we see in equities—are showing a growing degree of dispersion. So investors do need to be selective, and credit research is crucial.

The chart on the left breaks out high yield securities relative to how much their yield-to-worst is above or below the average yield-to-worst. There’s an interesting split between higher quality, tighter spread high-yield issuers and lower quality, wider spread issuers. While lower-yielding bonds offer less return potential, we still see opportunity in this segment because (1) there are fewer default concerns among these higher-quality issuers, and (2) demand should remain strong because these bonds’ yields are still attractive versus investment grade and government bonds. The story is quite different for those on the right-side—these are mostly CCC-rated and include a lot of high yield bonds from energy-focused issuers. These have higher yields, but that greater yield comes with greater default concerns. Here, our advice is to be very selective.

The need for selectivity shows up in the fundamentals, too. Another reason research is so important now is that leverage is picking up among many corporations, especially within commodity-related sectors. In the center chart, the bars show the general pickup in leverage, while the darker line toward the right side—we only have data for the most recent few years on this specific breakout—shows that the ratio of debt to EBITDA (earnings before tax, interest, depreciation and amortization) is actually stable for companies outside of commodities.

At the same time, the year-over-year revenue growth for ex-commodity companies is also improving. Revenue growth altogether for companies with high-yield debt issuance was negative on average for 2015. But when you strip away the commodity-related companies, the revenues remain positive—and improving—on average.

No doubt there are some segments of the HY market—commodity-focused and lowest rated bonds—that we suggest avoiding. Instead we see opportunity to look beyond corporate bonds and diversify into areas like emerging markets and securitizations as alternative sources of income.
Emerging market currencies have gotten so beaten up over the past several years that we’re now seeing some interesting opportunities. At the end of 2015, the EM currency index had dropped about 40%—primarily due to the punishing drop in commodities, but also the stronger US dollar. And while they rebounded a bit in the first half of 2016, the emerging market currency index is still down by over 30% since 2011.

So, not only are the valuations very compelling, but even without further appreciation, certain currencies are attractive, due to the “carry” or short term interest rate that they offer, as you can see in the cases of Brazil and Turkey in the right display—we favor short-term government bonds in these countries and are leaving the currency exposure unhedged.

We’re also looking at local-currency bond markets in countries where the roll is attractive, such as Colombia with its steeper yield curve. So here, we see opportunity in the intermediate and longer maturities, which is where carry and roll are attractive. “Roll” is the natural price gain a bond experiences as it moves closer to maturity, assuming interest rates don’t change. As the bond’s yield declines, its price rises.
Outside of Emerging Markets, we also see interesting opportunities among securitizations—such as Residential Mortgage-Backed Securities (RMBS), which include non-agency mortgages and agency risk-sharing transactions, and Commercial Mortgage-Backed Securities (CMBS).

Within residential mortgages, fundamentals remain strong as the real estate markets in the US continue to recover. And spreads remain attractive as the high-yield selloff spilled over to these markets. Default rates among US homeowners have come down, and we expect them to stay low. Also, the prices of housing have continued to increase, and with the US economy growing at a slow but steady pace, that's supportive of the mortgage market—as is the growing strength of the US consumer.

Mortgages also offer a nice diversification to other fixed income sectors like high yield corporates. For instance, at the turn of the year, when spreads on high yield widened significantly, spreads on mortgages and Credit Risk Transfer securities (CRTs) widened, but not as much. By the same token, when spreads on High Yield rebounded, spreads on CRTs haven't tightened as much.

Commercial Mortgage-Backed Securities are currently offering attractive valuations relative to similarly-rated corporates. Lately, investor concerns about the retail sector—in particular the dominance of internet retailers over brick-and-mortar retailers—have been driving CMBS spreads wider as shown in the right display. These concerns are valid, and highlight the importance of research, stress-testing and security selection. For example, we favor CMBS that were originated several years ago over those originated today, as underwriting standards were stronger and we expect these bonds to be more resilient. Within those vintages, we still see value.

Securitized credit offers diversification within fixed income risk assets. But as the past year has shown, investors should diversify their overall portfolio allocation by having an allocation not just to credit and equities but also to interest-rate risk.
The reason for having exposure to interest rates is to provide an offset to the risks of those high yielding bonds and also equities.

The left-hand chart shows the correlations of US bonds and global bonds (hedged to USD) to the S&P 500 Index since 1987. We used this period in order to capture as many historical stock-market crashes as we could in our data set, including the crash of 1987.

On average, overall correlations, as represented by the blue bars, are low for both US bonds and hedged global bonds—around 0.1, with a modest advantage to hedged global bonds. But one of the reasons we favor global (hedged) interest rate exposure (over US-only rate exposure) is shown in the “extreme” down markets for stocks. The green bars show that during periods when the return of the S&P 500 Index was more than one standard deviation below the norm, those times when we most need the diversification benefits, the US Aggregate became negatively correlated with equities, around –0.1. That’s good, but the hedged global bond correlation was even better, with a –0.3 correlation. That’s quite a nice improvement.

Let’s dig a bit further into the potential advantages of hedged global bonds, and look at the “up/down capture” compared with US returns. It’s pretty compelling.

In the center chart, we’ve sorted quarterly returns over a 25-year stretch into periods when the US Aggregate was positive and periods when it was negative. During those times when it was positive, it returned, on average 2.3%. The hedged global aggregate performed almost as well during those same quarters, capturing 96% of that performance. That’s the “up capture” part.

But it’s the “down capture” part where hedged global bonds excel.

When the US aggregate was negative, it returned, on average –0.9%. While the hedged global aggregate was also negative, it did better and was down only –0.6% on average. That “down capture” represents just 65% of the US bond decline.

What that means is that investors preserved more of their capital during down periods by globalizing, by allocating assets away from the US into other countries where rates weren’t rising as much, or where they were stable or even declining. This could be valuable defense if we see a period of negative returns in the US markets as rates eventually rise from today’s ultra-low levels.

Now a key concern when globalizing bonds is the fact that negative yields have become ubiquitous—more than one third of the Citigroup World Government Bond Index traded with negative yields as of 30 June 2016. But this is why we advocate currency hedging—given today’s interest rate differentials, hedging foreign currency back to US dollars can help make even low-yielding bonds of other countries more attractive. For example, the 10-year German Bund is negative but with the currency hedge, investors can significantly improve that yield to 1.31% and the yield on Portugal’s bonds, when hedged, rise from 3.01 to 4.45%. But be mindful, because the hedging relationships shift over time—sometimes to your benefit, sometimes to your cost. So it’s important to tack an active approach with your global bond investing.
When taxes are a concern, municipal bonds remain an attractive core bond option. There’s been a lot of hand wringing and headlines about the few trouble spots in the muni world, including Chicago and Puerto Rico. But we see those as outliers, and munis have pretty much been a “Steady Eddie” sector.

One potential source of concern for municipal bond investors is too much supply potentially pushing prices down. There’s a substantial amount of gross issuance in the muni market, but a sizable amount of the issuance is related to bond issues being refinanced to take advantage of relatively low interest rates today.

If we look at the change in net new issuance after refinancing has been accounted for in the left display, it’s actually been relatively low, especially when compared to the taxable bond markets as shown in the left display. And muni demand remains strong, as you can see in the middle display, which shows the fairly steady flows into municipal bond funds over the past couple of years.

And muni credit fundamentals continue to show strength, as we show on the right with the steady growth in federal and state tax revenues since the global recession. As US GDP has recovered and the economy has continued to expand, more jobs and more income translate into increased revenue, which bolsters state and municipal finances.

So, there’s a lot of opportunity for solid risk-adjusted returns in the municipal space, but we think active management is critical in navigating the market. For one thing, transaction costs are higher, so it makes sense to work with a professional investor who can trade most efficiently. Also, it can be difficult to source bonds, since the market tends to be fragmented. This takes legwork and relationships. What’s our assessment of muni opportunities today?
Munis remain attractive today on pound-for-pound basis versus most taxable bonds. But positioning along the muni yield curve can make a big difference in return potential, because the areas with the most value vary along the maturity spectrum.

In this display, we look at muni strategies to consider, with the combination of yield and roll at different maturity ranges grouped into short, intermediate and long-term. We’ve talked about the power of roll for some time. It’s the natural price gain a bond experiences as it moves closer to maturity, assuming interest rates don’t change. Roll varies considerably based on where you are on the curve.

We think credit exposure makes sense at longer maturities, simply because investors essentially have to take on longer-term bonds to access much of the available credit supply. By dipping down in credit quality in long bonds, investors get not only modest yield pickup, but lower interest rate sensitivity versus higher quality bonds. We still recommend some exposure to BBB-rated bonds, but have shifted some of that exposure to A-rated debt as relative value has become less compelling in lower quality bonds.

From a higher-grade perspective, we still see the “sweet spot” of the yield curve as intermediate maturities, in terms of combined yield and roll potential. For a 10-year A-rated muni bond, the combined potential of yield and roll amounts to about 3.4%.

Using roll may enhance returns, but there are risks associated with investing in bonds for a longer period of time, including interest-rate risk. Again, that’s why we focus on the “smart” part of the curve in munis. For instance, yield plus roll is about the same for a 10-year bond as a 30-year bond, which carries significantly more interest rate risk and volatility!

At the short end of the municipal bond yield curve, there are challenges with a lack of municipal supply and resulting low bond yields. At this range, investors’ tax brackets come into play, and in some cases taxable bonds may be a better—or at least equal—choice.

But there’s one more active investment arena that investors should choose to include among their portfolio allocations…alternatives.
We spoke earlier of volatility, dispersion and alpha opportunities. Well, hedge funds historically are one of the strongest beneficiaries of environments where alpha generation and downside protection are key.

The left hand chart shows that in times where dispersion rises above that historical average of roughly 30%, long/short equity managers can provide substantial excess return.

However, just calling yourself a hedge fund manager doesn’t necessarily mean you have the skill to survive for the long term. Recent hedge fund closures underscore this. The last six years have seen a rise in hedge fund liquidations that are almost as many as the new launches. And with 2015 and the first quarter of 2016 seeing more closures than launches, the net total is negative.

So the key is to find seasoned hedge fund managers with clear, high conviction strategies.

Let’s take a look at some of the major alternative strategies and the opportunities they can provide for investors today.
With **Long/Short Equity** strategies, the key is choosing the Winners. It’s about seeking companies growing on the topline, shorting faltering stocks. Long/Short has certainly been challenged in the choppy markets we’ve experienced over the past year, and they’ve underperformed, relative to the broader market. While this isn’t unprecedented, it has been extreme recently. But it’s good to bear in mind that prior periods of underperformance have been followed by years of strong returns.

**Global Macro** strategies can make an opportunity from spiking volatility. So the current environment is actually more favorable than it’s been in recent years. That’s because geopolitical risks are mounting; central bank policies are diverging; market volatility is increasing; and heavy sovereign debt is combining with slower global growth. Global Macro managers can create opportunities from all of these factors.

The key to **Relative Value/Credit** strategies is avoiding the losers. The way to do that is to invest long in bonds with a positive risk bias while shorting bonds at risk for default. Liquidity is a risk that cannot be avoided, but solid in-depth research can help. US High Yield has rallied significantly since spreads widened meaningfully in 2015.

With **Event Driven** strategies, the point of interest currently is that merger arbitrage spreads are widening. Event driven didn’t fare well in 2015, because hedge funds piled into M&A despite the slow pace of successful deals. That’s a bad combination. However, we have a positive outlook on the space. Spreads are wide and many deals are expected to go through in the coming months.
In a way, the Great Beta Trade period was a type of “free lunch” for many investors. But, sadly, there really is no free lunch. And many index investors will discover that the time to pay up for that free lunch is beginning.

So during this new time of moderate growth, modest index returns and high volatility, what can investors do?

With equities, be active. Be concentrated, seek downside protection, embrace large-cap and secular growth. Favor dividend growers rather than getting squeezed in crowded trades with the highest dividend yielders. And consider small cap stocks, because they’re attractively priced now.

With fixed income, remember to be balanced. With the high-grade, rate sensitive part of the bond spectrum, combine global core and US core to improve diversification. Focus on the intermediate part of the yield curve and be mindful of negative sovereign debt yields that can be improved by hedging currencies.

With the high-income, credit-sensitive areas, again, use a global multi-sector approach. High yield is still attractive despite the recent strengthening. But be mindful to underweight energy. Diversify by considering securitized assets, emerging market local bonds and currencies. And manage liquidity risk—the changing cost of security transactions across markets.

Alternatives require investors to be selective. Diversify across strategies and focus on strong up/down capture potential in the world of rising volatility. Include relative value credit and long/short equity, and capitalize on today’s wide merger-arbitrage spreads. And along with finding opportunity in volatility, take advantage of macroeconomic events.

Thank you. I’d be happy to take your questions now.
A Word About Risk

The information contained here 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 here 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 L.P. or its affiliates.

Important Risk Information Related to Investing in Equity and Short Strategies

All investments involve risk. Equity securities may rise and decline in value due to both real and perceived market and economic factors as well as general industry conditions.

A short strategy may not always be able to close out a short position on favorable terms. Short sales involve the risk of loss by subsequently buying a security at a higher price than the price at which it sold the security short. The amount of such loss is theoretically unlimited (since it is limited only by the increase in value of the security sold short). In contrast, the risk of loss from a long position is limited to the investment in the long position, since its value cannot fall below zero. For example, a strategy to mitigate leverage risk, a strategy will always hold liquid assets (including its long positions) at least equal to its short position exposure, marked-to-market daily.

Important Risk Information Related to Investing in Emerging Markets and Foreign Currencies

Investing in emerging-market debt poses risks, including those generally associated with fixed-income investments. Fixed-income securities may lose value due to market fluctuations or changes in interest rates. Longer-maturity bonds are more vulnerable to rising interest rates. A bond issuer’s credit rating may be lowered due to deteriorating financial condition; this may result in losses and potentially default, or failure to meet payment obligations. The default probability is higher in bonds with lower, noninvestment-grade ratings (commonly known as “junk bonds”).

There are other potential risks when investing in emerging-market debt. Non-US securities may be more volatile because of the associated political, regulatory, market and economic uncertainties. These risks can be magnified in emerging-market securities. Emerging-market bonds may also be exposed to fluctuating currency values. If a bond’s currency weakens against the US dollar, this can negatively affect its value when translated back into US-dollar terms.

Bond Ratings Definition

A measure of the quality and safety of a bond or portfolio, based on the issuer’s financial condition, and not based on the financial condition of the fund itself. AAA is highest (best) and D is lowest (worst). Ratings are subject to change. Investment-grade securities are those rated BBB and above. If applicable, the Pre-Refunded category includes bonds which are secured by US government securities and therefore are deemed high-quality investment grade by the advisor.

[Read to audience]
Index Definitions

Following are definitions of the indices referred to in this presentation. It is important to recognize that all indices are unmanaged and do not reflect fees and expenses associated with the active management of a mutual fund portfolio. Investors cannot invest directly in an index, and its performance does not reflect the performance of any AB mutual fund.

- **Barclays Global Aggregate-Corporate Bond Index**: Tracks the performance of investment-grade corporate bonds publicly issued in the global market found in the Global Aggregate. (Represents global corporate on slide 2.)
- **Barclays Global Treasury: Euro Bond Index**: Includes fixed-rate, local-currency sovereign debt that makes up the Euro Area Treasury sector of the Global Aggregate Index. (Represents euro area government bonds on slide 2.)
- **Barclays Global Treasury: Japan Bond Index**: Includes fixed-rate, local-currency sovereign debt that makes up the Japanese Treasury sector of the Global Aggregate Index. (Represents Japan government bonds on slide 2.)
- **Barclays Investment Grade CMBS Index**: Designed to mirror commercial mortgage-backed securities of investment grade quality (Baa3/BBB-/BBB- or above) using Moody’s, S&P and Fitch, respectively, with maturity of at least one year.
- **Barclays Municipal Bond Index**: A rules-based, market value-weighted index engineered for the long-term tax-exempt bond market. (Represents municipals on slide 2.)
- **Barclays US Aggregate Bond Index**: A broad-based benchmark that measures the investment-grade, US-dollar-denominated, fixed-rate, taxable bond market, including US Treasuries, government-related and corporate securities, mortgage-backed securities (MBS [agency fixed-rate and hybrid ARM pass-throughs]), asset-backed securities (ABS), and commercial mortgage-backed securities (CMBS).
- **Barclays US Corporate High Yield Index**: Represents the corporate component of the Barclays US High Yield Index. (Represents US high yield on slide 2.)
- **Barclays US Treasury Index**: Includes fixed-rate, local-currency sovereign debt that makes up the US Treasury sector of the Global Aggregate Index. (Represents US government bonds on slide 2.)
Index Definitions (continued)

- **J.P. Morgan Emerging Market Currency Index**: A tradable benchmark for emerging-market currencies vs. USD.

- **MSCI EAFE Index**: A free float-adjusted, market capitalization-weighted index designed to measure developed-market equity performance, excluding the US and Canada. It consists of 22 developed-market country indices. (Represents EAFE on slide 2.)

- **MSCI Emerging Markets Index**: A free float-adjusted, market capitalization-weighted index designed to measure equity market performance in the global emerging markets. It consists of 21 emerging-market country indices. (Represents emerging-markets debt on slide 2.)

- **MSCI World Index**: A market capitalization-weighted index that measures the performance of stock markets in 24 countries.

- **Russell 1000 Index**: A stock market index that represents the highest-ranking 1,000 stocks in the Russell 3000 Index, which represents about 90% of the total market capitalization of that index.

- **Russell 2000 Index**: Measures the performance of the small-cap segment of the US equity universe. It is a subset of the Russell 3000 Index representing approximately 5% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. (Represents US small-cap on slide 2.)

- **S&P 500 Index**: Includes a representative sample of 500 leading companies in leading industries of the US economy. (Represents US large-cap on slide 2.)

- **STACR 2014-CN3**: A securitization designed to provide credit protection to the Federal Home Loan Mortgage Corporation (Freddie Mac) against the performance of an approximately $32 billion reference pool of mortgages.

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