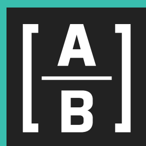
APRIL 2014



BE MORE AGILE

A FLEXIBLE APPROACH TO EQUITY INVESTING

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IN THIS PAPER: Investors want reliable returns and, with bond yields near all-time lows, equities are an obvious choice. But investors are also wary of the risks. We believe that a flexible portfolio that adapts to current market conditions can deliver a better risk reward trade-off.

Almost all the clients we speak to are looking to limit their downside risks—whether they are high-octane hedge fund investors looking for annual returns above 10%, or pension funds willing to settle for high single-digit returns with lower volatility.

To maximize return opportunities, we think investors should take advantage of both alpha and beta. But, to control risk, we believe that they should be flexible about how much beta exposure they take and the type of alpha exposure they choose—in other words, be more responsive to the prevailing investment environment.

Beta refers to returns earned from passive equity-market exposure. (The STOXX Europe 600 Index—a reasonable proxy for European equity-market beta, generated about 20% last year.) Alpha refers to returns generated from active management, over and above the broad market return.

ALPHA OPPORTUNITY IS ATTRACTIVE…

We think that current market conditions are particularly favourable for active managers, largely because there is wide dispersion in asset prices.

For example, using a valuation metric such as price to book value, the gap between the cheapest 20% of stocks and the most expensive 20% was well above its long-run average by late 2013 (*Display 1*).

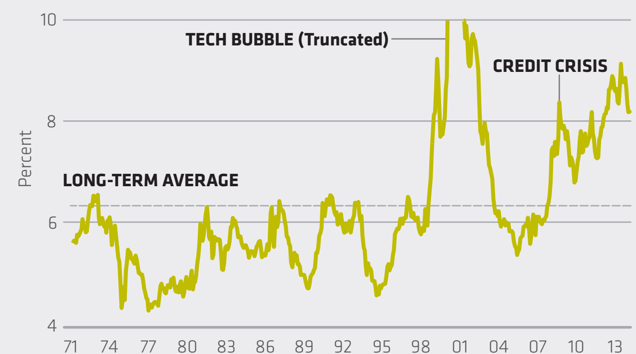
Wide spreads between the cheapest and most expensive stocks imply that there are potentially higher rewards for successfully identifying winners and avoiding losers. In this kind of environment, strong fundamental research can give asset managers an edge.

…BUT PURE ALPHA CARRIES RISK

Alpha has its limitations. Active managers don't always get it right, and excess returns can be "lumpy". If investors depend on active management for their entire target return (for example in a market-neutral hedge fund) this may place unrealistic expectations on the asset manager. Historically, even the best active managers have seldom averaged more than about 2% to 3% a year in the long run.[1]

DISPLAY 1: WIDE GAP BETWEEN CHEAP AND EXPENSIVE EQUITIES OFFERS OPPORTUNITIES

Spread Between 20% Cheapest and 20% Most Expensive European Stocks*



Historical analysis does not guarantee future results.
Through December 17, 2013
*Refers to European large-cap stocks. Represents the ratio of the most expensive quintile to the cheapest quintile of stocks based on price/book. Data are smoothed on a three-month basis.
Source: Bloomberg, FactSet, MSCI and AB

So, for example, if an investor required a return of 9% a year, chances are that the manager would have to employ three to four times leverage and consistently pick more winners than losers. And if the manager made a loss, three times leverage would mean three times the pain. In effect, the investor would be eliminating equity-market (beta) risk only to replace it with two other risks: the risks associated with leverage, and the risk of failing to find a manager who can deliver sufficient alpha.

We believe that it makes more sense to let beta, rather than leverage, help provide the momentum to reach clients' return targets.

1 Source: eVestment Alliance. Assumes the median manager is selected each year.

Investors should take advantage of both alpha and beta returns to maximise opportunities

HISTORICALLY, BETA HAS GENERATED LONG-RUN VALUE...

Historically, equity-market exposure has added value for investors. €100 invested in the STOXX Europe 600 Index in 1995 would have been worth almost four times that sum by late 2013 (*Display 2*). That's an average annualized return of more than 8%.

So, going back to our earlier example of an investor with a 9% annual return target, beta could historically have been a big help in achieving that target. And, used in conjunction with an alpha-seeking strategy, taking advantage of beta returns could have avoided the need for leverage.

DISPLAY 2: EQUITY MARKET EXPOSURE HAS BEEN VALUABLE BUT VOLATILE

Growth of €100 Invested in STOXX Europe 600 Index (July 1995–December 2013)

This is a hypothetical example and is not meant to represent the performance of any AB product.
Through December 31, 2013
Growth of €100 is calculated using monthly data.
Source: Bloomberg and AB

...BUT BETA ON ITS OWN CAN BE VOLATILE

The downside is that passive exposure to the market can be volatile in the short and medium term. STOXX Europe 600 investors may have made a 145% return in the 2003–2007 bull market, but they suffered peak-to-trough losses of more than 50% during both the technology bubble and the credit crisis. And the euro-area crisis brought a new set of challenges after that.

So, while we think that investors should take the opportunity to earn beta returns, we also think that they may be letting themselves in for volatile absolute performance if they tie themselves rigidly to equity beta—for example a passive account, an exchange-traded fund (ETF) or a long-only active mandate.

A BETTER WAY TO COMBINE ALPHA AND BETA

Display 3 (see page 4) summarizes the range of approaches that investors might take to reach their return targets.

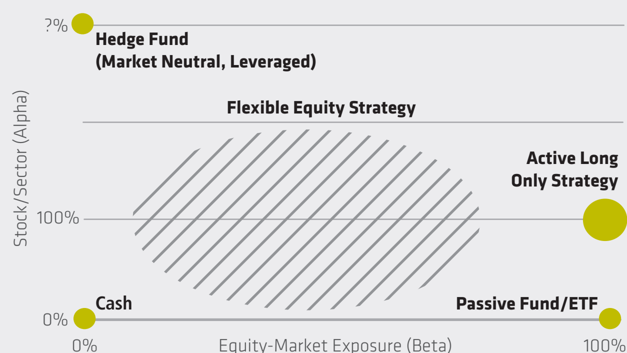
On one end of the spectrum is an all-alpha approach that amplifies active management returns using leverage, such as a hedge fund. At the other end of the spectrum is a purely passive, all beta approach such as an exchange-traded fund (ETF). Returns to an active long-only strategy would be largely beta-based, with some alpha added.

We suggest that a better approach might be closer to the middle: a combination of active management and equity-market exposure. We think that the key is to take a flexible approach to beta, adjusting the portfolio's exposure depending on the market environment.

There are three relatively simple ways to make a portfolio more aggressive or defensive in response to prevailing conditions. One is to vary equity-market exposure, another is to use more or less aggressive sector selection, and a third is to pick individual stocks to suit the environment.

DISPLAY 3: FLEXIBLE EQUITY STRATEGY—ALL OF THE ALPHA WITH LESS OF THE BETA

Exposure to Return Drivers



For illustrative purposes only
Source: AB

1. FLEXIBLE BETA: HOW MUCH MARKET EXPOSURE SHOULD YOU HAVE?

Equity beta can generate attractive returns, but there have been times when equities felt like the wrong asset class to be innotably in 2008, when stocks plunged and investors stampeded intogovernment bonds. We have seen a growing recognition of this as more investors have moved into dynamic asset allocation strategies in recent years.

One of the simplest and most cost-effective ways to vary a portfolio's risk exposure to fit prevailing market conditions is to use derivative contracts such as index swaps and futures to hedge some beta. This offers downside protection against stock-market falls.

For example, an investor places €100,000 in an actively-managed equity portfolio and takes a short equity-index position with a notional value of €50,000. This amounts to all the alpha but only half the beta. Assuming the manager beats the index, the investor earns alpha on the full €100,000. If the market rises 10%, the investor earns roughly 5%. If the market falls 10%, the investor is protected from roughly half of that decline.

In a stable scenario where the risks are well understood and the outlook is positive, the investor may want to pursue the return opportunity aggressively. In that case, he or she might opt not to have any equity-market hedge in place, in other words capturing all of the alpha and all of the beta.

In a very uncertain, high-risk scenario, the expected return from alpha, too, might be less attractive. So the investor might opt for zero net exposure and limit the actively managed amount, for example €50,000 invested and a €50,000 short position. That would mean just alpha in conservative amounts and no beta at all.

The simpler derivative instruments such as index swaps and futures are a relatively cheap, highly liquid and transparent way to buy protection for a long equity portfolio. An approach of this type does not carry as much downside risk as strategies that use financial leverage or that take short positions in individual stocks. And it is not necessary to take an overall net short position: the minimum net exposure is zero

2. SECTOR SELECTION: HIGH- OR LOW-BETA INDUSTRIES?

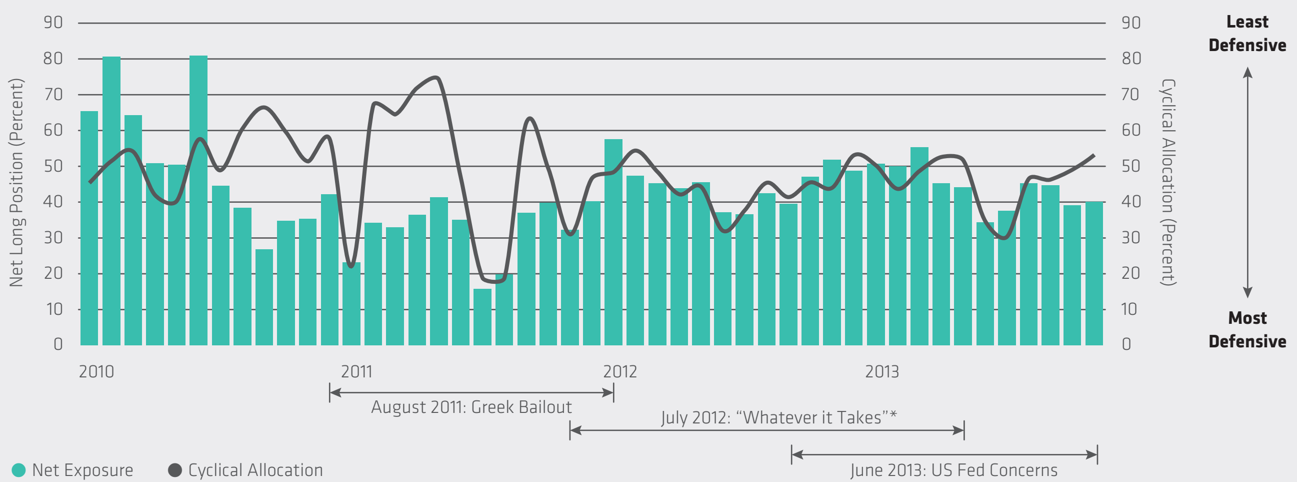
In addition to varying their net equity-market exposure, investors can be flexible by using sector selection to make a portfolio more or less aggressive. Given that share prices in some sectors or industries fluctuate more relative to the broad market—so-called high-beta sectors—it makes sense to shift allocations between sectors.

In a boom, investors might want to step up their exposure to economically sensitive industries like banking, mining or construction, and in a bearish environment they might skew their allocation to defensive, low-beta sectors like health-care, consumer staples and utilities.

This is easier if the manager is pursuing an absolute return objective rather than being constrained by a benchmark. For one thing, the

Vary your portfolio's risk by using derivative contracts to hedge some beta

DISPLAY 4: FLEXIBLE APPROACH—ACTIVE MANAGEMENT IN AN CHANGING ENVIRONMENT



Historical analysis does not guarantee future results.
From February 1, 2010 to December 31, 2013
*Refers to the speech by Mario Draghi, President of the European Central Bank, pledging to preserve the euro.
Aggressive/defensive position is the allocation to cyclical and financial equities as a percentage of the long equity position. Net equity-market exposure is calculated by subtracting the short exposure (i.e., the derivative beta hedge) from the long exposure, excluding cash or cash equivalent.
Chart shows the positioning of the European Flexible Equity Strategy (inception of strategy—January 25, 2010; inception of the European Flexible Equity Portfolio—January 31, 2011).
Source: AB

absence of a benchmark allows more freedom to steer clear of unattractive sectors and stocks.

3.SECURITY SELECTION: FAIR- OR FOUL-WEATHER STOCKS?

Once investors have decided on the appropriate sector breakdown, they can decide which stocks are going to be best for their purposes.

If the priority is downside protection, investors may want to focus on large-capitalization companies that are market leaders with globally diversified customer bases. They might diversify by holding larger numbers of stocks, with smaller position sizes.

If the priority is to maximize return opportunities in a rising market and the risk environment seems relatively benign, the investor may be inclined to take bets on smaller, more speculative companies or, for example, pursue opportunities in emerging markets.

Particularly in high-risk environments, continuous monitoring is important to ensure that the portfolio's exposure remains appropri-

ate. Large or unusual moves in individual security prices could be a result of company-specific factors, but they may also signal that adjustments are needed. In this respect, rigorous bottom-up company research has an important role to play.

FLEXIBLE EQUITY INVESTING IN ACTION

How might a flexible approach have looked over the past few years? *Display 4* shows how flexible alpha and beta were used to position the European Flexible Equity Strategy portfolio from February 1, 2010 to December 31, 2013. The left scale shows the amount of net equity-market exposure and the right scale shows the proportion of the portfolio that was allocated to cyclicals and financials ("aggressive" stocks).

Net market exposure varied from a maximum of about 80% in 2010 to a minimum of about 15% in August 2011. The proportion of the portfolio invested in more aggressive sectors and stocks ranged from a fifth to three quarters.

This reflected changing market conditions from relatively benign to much more volatile and uncertain. In 2010 the post-credit-crisis rally was still going strong, with quantitative easing by the US Federal Reserve providing a sustained tail wind for global risk assets. But in the years that followed there was more uncertainty about the global outlook and there were several shocks including unrest in North Africa and the Middle East, the 2011 Japanese tsunami and the escalation of the euro-area sovereign debt crisis. All this led to high volatility in the equity markets.

MORE AGILE APPROACH APPEARS TO ADD VALUE

We first put our flexible equity strategy into practice on February 1, 2010. From that date to December 31, 2013, it returned about 7% annualised, compared with 11% for a pure beta strategy.[2] Much of pure beta's performance came from the strong rally in 2012/13. 2011, however, was a different story.

Because our strategy reduces exposure when volatility is rising, we expect it to experience less extreme lows than a pure beta approach. From 2010 to 2013 the strategy lost less than 4% in its worst month, compared with a maximum loss of more than 10% for the broader market. In the difficult conditions of 2011, the flexible approach performed strongly, losing just 2.6%, while the market fell by 8.6%.[2]

2 **Past performance is no guarantee of future results.** European Flexible Equity Strategy annualised return February 1, 2010 to December 31, 2013 was 6.59% excluding fees, 5.24% after fees. For 2011, return was (2.6)% gross and (3.15)% net. Loss in worst month was (3.35)% excluding fees and (3.67)% after fees. The STOXX Europe 600 Index was used as a proxy for beta returns.

IN SUMMARY

On their own, we believe that pure alpha and pure beta strategies can be some-what blunt instruments in achieving investors' desired risk/return trade-off. We believe investors should try to get the best of both worlds by using both alpha and beta, tailoring their portfolio exposure to the prevailing risk and return environment. This can be done using beta hedging, sector selection and stock selection. But the success of the strategy depends on a disciplined approach, rigorous research and manager skill.

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Market Risk: All investments involve risk. The market values of a portfolio's holdings rise and fall from day to day, investments may lose value. **Derivatives Risk:** Derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market.

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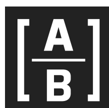

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