AllianceBernstein®

THE HUNT FOR QUALITY

SEARCHING FOR DURABLE STOCKS IN UNCERTAIN TIMES

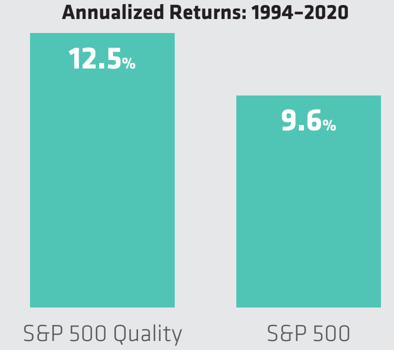
High-quality companies are always in style. In good times and bad, features that define resilient businesses and stocks underpin consistent and solid equity return potential. But to consistently find companies that meet the highest quality standards requires research, judgment and investing skill.

Walt Czaicki
SVP/Senior Portfolio Manager

The hunt for quality allows investors to tap equity return potential with smoother return patterns. Quality stocks with the right attributes tend to offer superior risk-adjusted returns, posting solid gains in rising markets and cushioning investors in a downturn. Over time, stocks with these characteristics have outperformed cap-weighted benchmarks, while also protecting capital during events as varied as the bursting of the technology bubble, the global financial crisis and the new coronavirus pandemic (*Display 1*).

The S&P 500 Quality has outperformed the broader market with less risk for more than a quarter of a century. But to position properly in crisis periods, quality control is crucial. Investors who concentrate on quality in their everyday stock-picking processes are better equipped to identify durable companies that have what it takes to get through uncertain times. And by holding stocks that tend to fall less than the market in a downturn, it's easier for a portfolio to recoup losses quickly and outperform in a future rebound.

DISPLAY 1: QUALITY STOCKS PROVIDE BENEFITS IN GOOD TIMES AND BAD



CRISIS	PERIOD	S&P 500 QUALITY RELATIVE RETURNS	S&P 500	DOWN-MARKET CAPTURE
Asian Crisis/Russian Currency Devaluation	1998	3.6%	–15.4%	77%
Tech Sector Crash	2000–2002	30.9	–43.8	29
Global Financial Crisis	2007–2009	6.5	–51.0	87
European Debt Crisis	2011	7.8	–16.3	52
Coronavirus Pandemic	2020	2.8	–20.0	86

Historical analysis and current forecasts do not guarantee future results.
The S&P Quality Index was launched in 2014. Data shown reflect back-calculated retroactive data by S&P, using its index methodology, since 1994. Right chart based on downturns of more than 10% in the S&P 500. Asian crisis/Russian currency devaluation from July 1, 1998 through August 31, 1998. Tech sector crash from April 1, 2000 through September 30, 2002. Global financial crisis from November 1, 2007 through February 28, 2009. European debt crisis from May 1, 2011 through September 30, 2011. Coronavirus pandemic from February 1, 2020 through March 31, 2020
As of March 31, 2020
Source: FactSet, S&P and AB

WHAT DISTINGUISHES TRUE QUALITY?

Capturing the superior risk-adjusted returns that quality stocks offer requires a forward-looking approach and identifying the right measures to pursue. We believe that sturdy balance sheets, high and stable profits and strong free cash flows are good ways to identify companies with the ability to withstand a recession and thrive when conditions improve.

Passive approaches use various measures to define quality, but they're backward looking. This presents a severe flaw in systemic crises, particularly the COVID-19 pandemic, in which the future will look nothing like the past. For example, companies that scored high on quality measures such as earnings growth and profitability in the past might not continue to perform well in the coronavirus recession, as rampant demand destruction unfolds in unpredictable ways.

THREE INTERCONNECTED FEATURES

To find quality today, investors need a discerning view of a company's underlying dynamics. By studying industry conditions, demand drivers and company business models, investors can assess quality using these three lenses:

+ **High and Stable Profitability**—This is usually a sign that a company has a differentiated and durable business, with a better chance of survival through a recession.
+ **Strong Free Cash Flow**—Good businesses generate excess cash, the lifeblood of economic activity, especially in a crisis when businesses are squeezed. This gives companies more financial flexibility to enhance shareholder returns.
+ **Healthy Balance Sheets**—Companies with ample cash and low debt levels have a healthier foundation to invest for the future and execute strategy without being subject to the moods of capital markets. They're also better positioned to withstand challenging conditions.

The three characteristics above are interconnected. Companies that generate consistent free cash flows are in a better position to cover debt-servicing costs—even when there's less cash to keep the business afloat. And low earnings volatility is a good indicator of a company's ability to perform through complex and changing business conditions.

QUESTIONS ON QUALITY

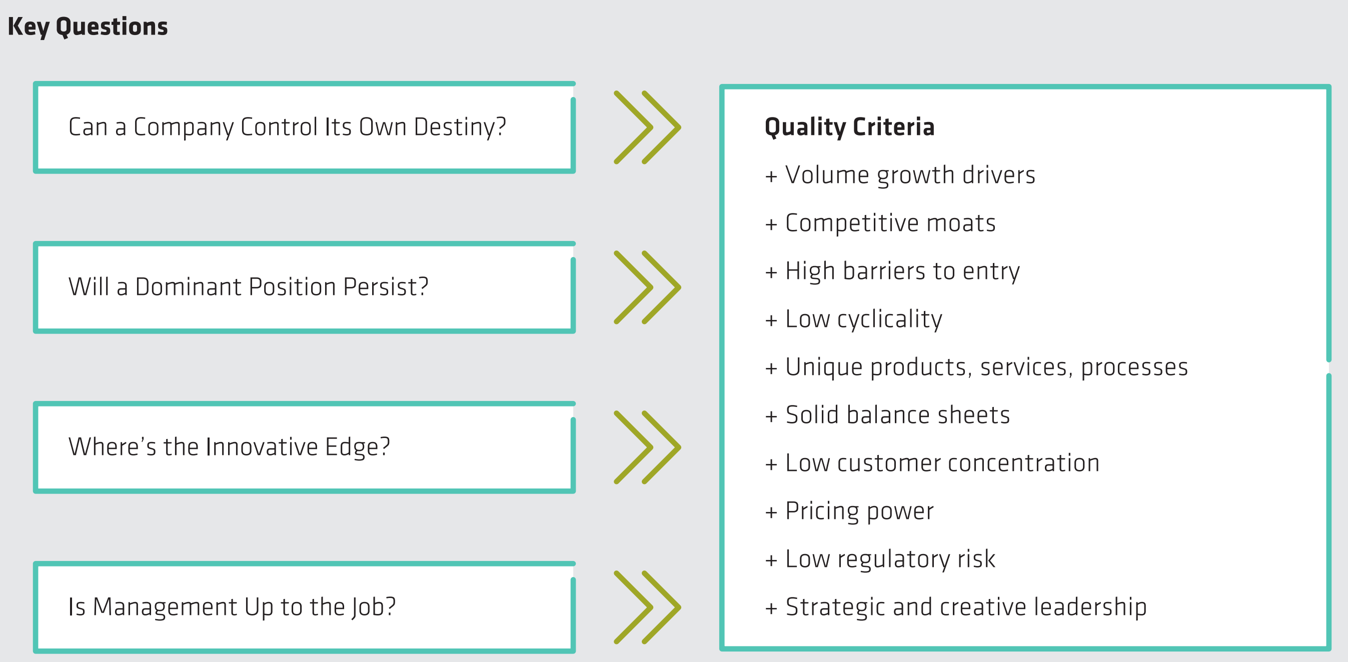
Companies with all three of these features have much more flexibility to navigate short-term market stress and take advantage of changes wrought by a crisis. The following questions can help guide investors to companies with high-quality fundamental businesses that can persist over time.

1. Can a Company Control Its Own Destiny?

In a volatile world, it often feels like companies are subject to forces beyond their control. The bursting of the tech bubble in 2000 dealt a huge blow to companies that had invested too eagerly in the dot-com boom. During the global financial crisis in 2008, credit markets froze up, leaving many companies starved of vital funding. The COVID-19 crisis is another extreme example of an exogenous shock to a wide range of sectors and industries all over the world. No business or CEO can control the effects of a widespread macroeconomic shutdown, a historic surge in unemployment and a global supply chain shock.

Yet, in any crisis, not all companies are equally vulnerable to unpredictable market forces. Some exercise a much greater degree of control over their fate by virtue of having fundamentally sounder businesses based on stronger leaders, better products, superior operating execution and more responsible financial behavior (*Display 2, next page*).

DISPLAY 2: HOW TO IDENTIFY COMPANIES WITH STRONGER FUNDAMENTALS



2. Will a Dominant Position Persist?

Dominant market positions often support sustainable growth. Wide competitive moats and high barriers to entry are key ingredients for a market-leading position. Yet it's important to make sure a company's products or services aren't being competed away. Does a new technology threaten to upend a successful incumbent? How might changing consumer and corporate behavior unsettle a dominant business model?

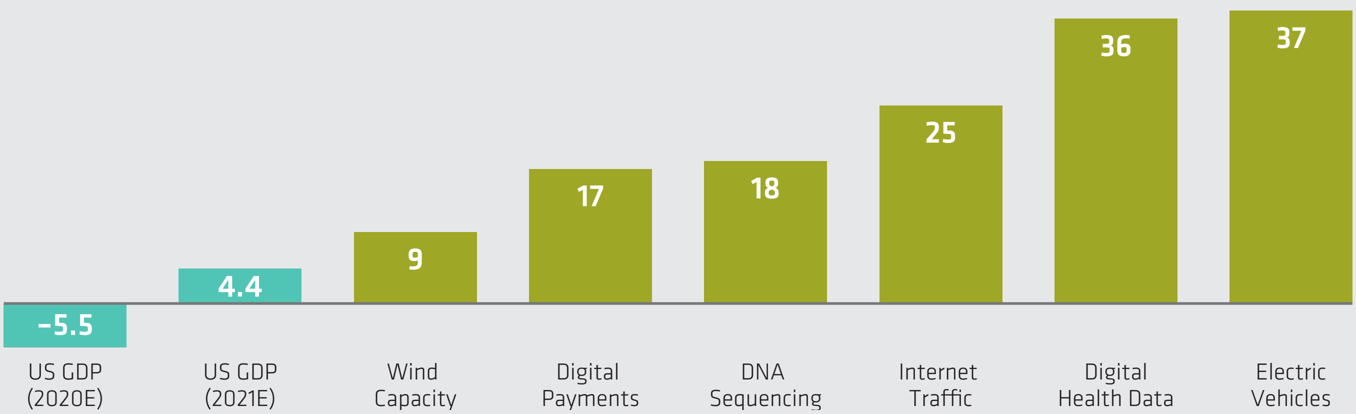
Downturns make these questions even more indispensable. When recession strikes, strong companies tend to get stronger while the weak get weaker or disappear. We believe this Darwinian dynamic will affect many companies and industries as the coronavirus crisis and its effects play out in the coming years. Companies with financial flexibility can benefit from consolidation opportunities as industries are reshaped.

The retail sector is a good example. As demand dries up, several weaker retail chains could fold, in our view. While that is unfortunate for their employees and shareholders, their revenues will go to the survivors. So, an earnings crunch can sometimes lead to stronger and more profitable business in the years ahead for companies that make it through.

Evolutionary trends can also foster the creation of new dominant positions. Companies that are favored in the aftermath of a big crisis might be different than those who led their industries before a downturn. For example, as the coronavirus crisis generates new markets for medical diagnostics and testing, new companies may emerge and gain prominence. In uncertain times, investors should strive to identify the fittest companies that are likely to survive—or those that may become stronger—and should be able to deliver robust earnings and returns when the markets eventually turn.

DISPLAY 3: SOME GROWTH TRENDS WILL PERSIST THROUGH A DOWNTURN

Projected Compound Annual Growth Rates (Percent)



Past performance does not guarantee future results.

US GDP estimate from AB economists as of March 31, 2020. Wind capacity 2019–2025; digital payments 2020–2024; DNA sequencing 2020–2023; internet traffic 2015–2020; digital health data 2018–2025; and battery electric vehicle units 2020–2025

As of March 31, 2020

Source: BCC Research, Cisco Systems, Global Wind Energy Council, IDC, Morgan Stanley, Statista and AB

3. Where's the Innovative Edge?

Innovation can fuel growth in many ways. It's not just about the internet or social networks. New technology and information systems allow companies to take advantage of massive data on customer behavior. Companies that recognize this potential and invest accordingly are using these tools to deepen relationships with customers—and to gain an edge over rivals who haven't.

By automating processes or upgrading machinery, manufacturers can improve productivity. Around the world, people are using less cash and increasingly shifting toward electronic payments. Internet traffic is mushrooming. Digital health data and electric vehicles are expected to proliferate at annual rates of 36% and 37%, respectively, in the coming years (*Display 3*). These trends won't be derailed by the coronavirus crisis, in our view, and may in fact be accelerated by the global increase in remote working, learning, shopping and healthcare.

In the healthcare industry, innovation is a powerful disruptive force. Robotics are changing surgical procedures. Treatments for Alzheimer's disease and cardiovascular disorders will help combat the physical and economic costs of demographic change.

Across industries, innovation supports pricing power. People are often willing to pay more for differentiated products and services, even in a tougher economy. Companies that command pricing power in a global downturn will have a clear advantage in delivering long-term profitable growth.

Above all, innovation is a cultural trait. Companies that are truly innovative should also be able to come up with inventive ways to confront the unexpected hardships created by the pandemic.

4. Is Management Up to the Job?

Quality companies tend to have sound leadership whose incentives are aligned with long-term economic value creation. When conditions deteriorate, experienced management can better steer companies through trickier business, financial and market environments.

Management talent matters even more as companies count the costs of COVID-19. Investors need to assess the executive ability to make differentiated strategic and tactical decisions that will influence the course of a company through the crisis. For example, companies must strike the right balance between cost cuts and maintaining a workforce that will be able to drive a recovery. Manufacturers must consider reconstructing global supply chains to enable production continuity when trade is shut down, even at higher costs and lower margins. And in an era of extreme uncertainty, communication with investors must be impeccable in order to provide credibility for the business outlook and inspire confidence in a recovery. Strong and insightful leadership could make the difference between companies that succumb to the coronavirus crisis and those that make it to the other side.

PERSISTENCE CREATES QUALITY PORTFOLIOS

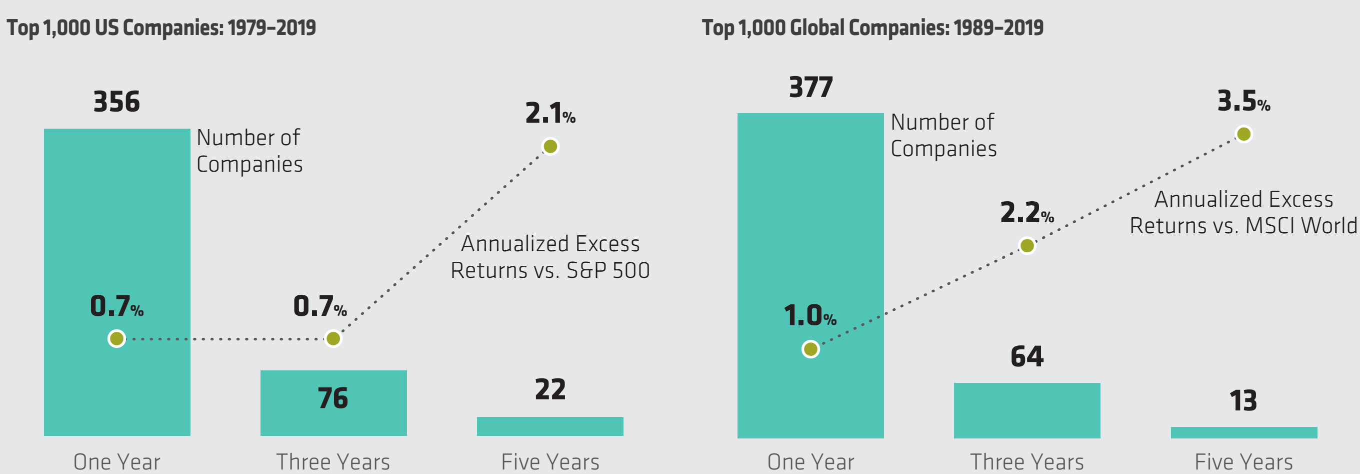
Following the guidelines above can help investors unearth real sources of quality stocks. But constructing a portfolio also requires a clear process. We believe the following two approaches are especially effective in finding companies with persistent quality for a portfolio with a long-term view.

Searching for companies with persistent earnings growth is a rewarding investment approach, in our view. Companies that are capable of growing earnings by at least 10% over a five-year period are extremely rare, but those that do typically deliver strong returns.

In fact, only 22 US companies were able to grow by 10% or more a year for five years straight on average between 1979 and 2019 (*Display 4, left*). These companies outperformed the S&P 500 by 2.1% a year. Global stocks exhibit similar trends (*Display 4, right*). By creating a high-conviction, concentrated portfolio with a small number of high-quality companies like these, we believe investors can enjoy the benefits of consistent earnings growth potential in their return streams.

DISPLAY 4: PERSISTENT EARNINGS GROWTH IS A REWARDING APPROACH

Companies Persisting with >=10% YoY Earnings Growth



Historical data for informational purposes only.

US universe consists of the top 1,000 companies by market cap each year from 1979 through 2018 with annual rebalancing. Global universe consists of the top 1,000 companies by market cap each year from 1989 through 2019 with annual rebalancing.

As of December 31, 2019

Source: Center for Research in Security Prices, FactSet, MSCI, S&P Compustat and AB

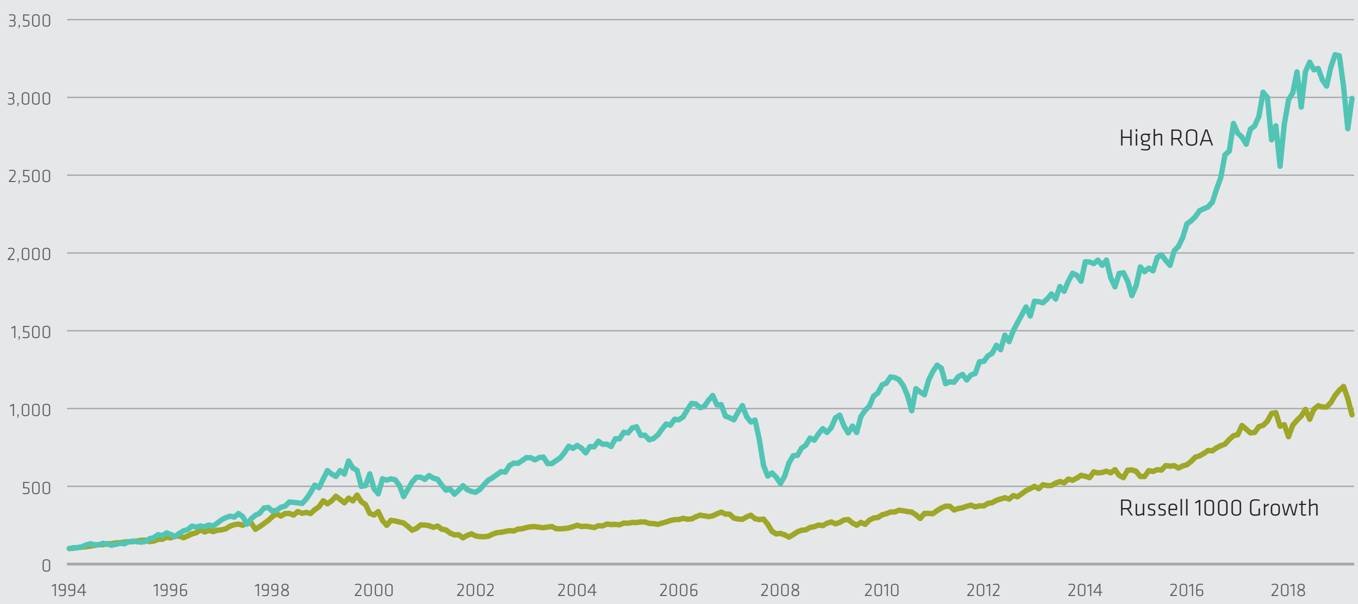
But earnings aren't always the best barometer to gauge a company's true economic prospects. Earnings can't tell you how skillfully a management team deploys capital or whether the company's profit streams are resilient.

So instead of looking purely at earnings, investors can focus on measures of business profitability, such as return on assets (ROA). By putting profitability metrics at the center of company research, we believe investors can discover whether a company is investing intelligently to generate its profits.

ROA provides a superior measure of economic performance. It tells you whether a company's investment returns exceed its cost of capital. In other words, it determines if a company's growth is sustainable or requires external financing. Ultimately, efficient and effective use of capital, and profitability, impact stock prices as companies with persistent profitability outperform by a wide margin over time (*Display 5*).

DISPLAY 5: HIGH PROFITABILITY AND STABILITY ARE POWERFUL QUALITY INDICATORS

Growth of US$100



Historical analysis and current forecasts do not guarantee future results.
Based on the Russell 1000 Growth universe, indexed to 100 on November 30, 1994. Returns shown are for the 20% of stocks in the universe with the highest ROA and highest EPS growth over trailing years.
Through March 31, 2020
Source: Russell Investments and AB

CREATING SMOOTHER PERFORMANCE PATTERNS

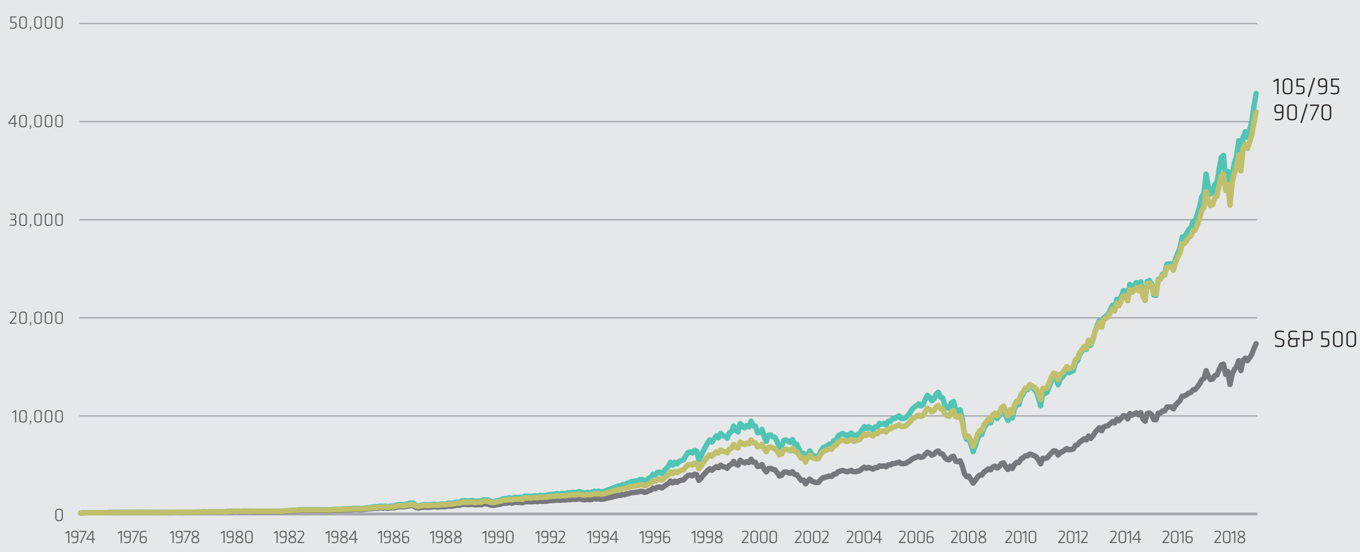
With a coherent process for finding quality companies, equity portfolios can offer investors compelling risk-reduction potential. Since high-quality stocks tend to fall less than low-quality stocks in a downturn, a quality portfolio is likely to lose less than the broader market in a correction.

What's more, when a portfolio falls less than the market, it can recoup those losses faster in a recovery. Portfolios can be measured by how much they fall versus the broader market in a downturn and how much of the gains they capture in rising markets. This is what's known as upside/downside capture. Our research shows that different upside/downside capture ratios have outperformed the S&P 500 since 1974. For example, as the olive line shows, a portfolio that captured 90% of the gains in a rising market and reduced losses to 70% of the market in down months outperformed the S&P 500 by a wide margin over time (*Display 6*). Similarly, a 105/95 upside/downside capture—that outperformed slightly in up and down markets—did much better than the broad benchmark over time.

In a time of unprecedented uncertainty, we believe that quality is the key to investing in equities. A well-defined focus on quality can provide a cushion for downdrafts that does much more than just dampen the pain from a falling market. It can actually help investors feel more confident to stay invested through market volatility instead of locking in losses by selling in a downturn. Allocations of hand-picked quality stocks based on methodically vetted businesses will provide a solid foundation for excess return potential as a healthier world fosters a healthier market.

DISPLAY 6: QUALITY STOCKS FOSTER BETTER UPSIDE/DOWNSIDE CAPTURE AND OUTPERFORMANCE

Growth of US$100



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 S&P 500 by 105% or 95% and all negative returns (less than 0%) by 95% or 70%; shown in logarithmic scale

Source: S&P and AB

IDENTIFYING QUALITY WHEN CORPORATE GUIDANCE DISAPPEARS

The COVID-19 shutdown prompted an unprecedented number of US companies to suspend earnings guidance in the first quarter of 2020. Equity investors searching for long-term quality should rethink the overly precise game of predicting short-term estimates.

By April 29, 141 US companies with market capitalizations greater than $2 billion had suspended guidance (*Display, below*), way beyond anything seen during the global financial crisis.

That's a problem for many market participants. Investors often ground their profit forecasts with company guidance, which tends to anchor their earnings expectations models to shorter-term periods, typically for the next quarter through the current fiscal year.

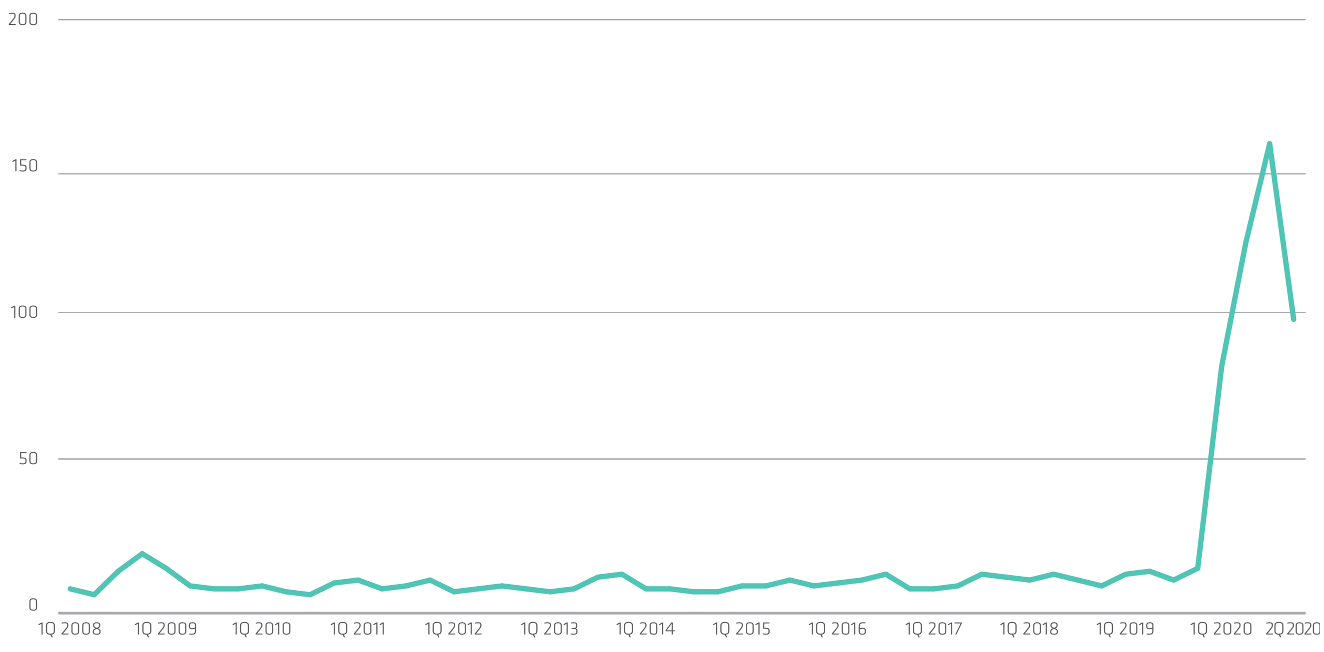
These models strive for precision. And companies play into this endeavor by setting guidance they aim to meet and even exceed; How else could it be explained that 70% of US companies have beaten quarterly expectations on average since the second quarter of 2013?

SHORT-TERM PROJECTIONS HAVE BEEN SHATTERED

The coronavirus destroyed any pretense of precision. Given the lack of guidance, the dispersion of earnings expectations became exceptionally wide by the second quarter of 2020 (*Display, next page, left*).

US COMPANIES ARE SUSPENDING GUIDANCE IN UNPRECEDENTED NUMBERS

Number of US Companies Suspending Forward-Earnings Guidance (Market Cap > US$2 Billion)



Based on US companies that have filed an 8-K form, used to notify shareholders of an unscheduled material event that could be of importance to investors
Through May 18, 2020
Source: AlphaSense, company filings and AB

This section is based on a blog entitled "How to Invest in Equities When Guidance Disappears," originally published on May 1, 2020, by Frank Caruso, CIO of US Growth Equities, and John Fogarty, Portfolio Manager of US Growth Equities.

RETHINKING APPROACHES TO EARNINGS FORECASTS

Relying on short-term measures like next quarter's earnings per share (EPS) provides false assurance. In fact, measuring a company's profit potential with only a single point estimate is arbitrary, in our view.

Because even if there was more certainty about the S&P 500's 2020 EPS, it's clear that profits during the year of a pandemic shock (*Display, below, right*) don't represent the market's long-term potential and should be normalized. In other words, the accuracy of estimates doesn't prove their validity.

Will 2021 be normal? Nobody knows. However, shifting out the forecast horizon by several years reduces near-term noise and anchors your perception of the worth of a business to its long-term fundamental success. We believe evaluation scenarios should be grounded by assessing a company's profit potential over the next 10 years.

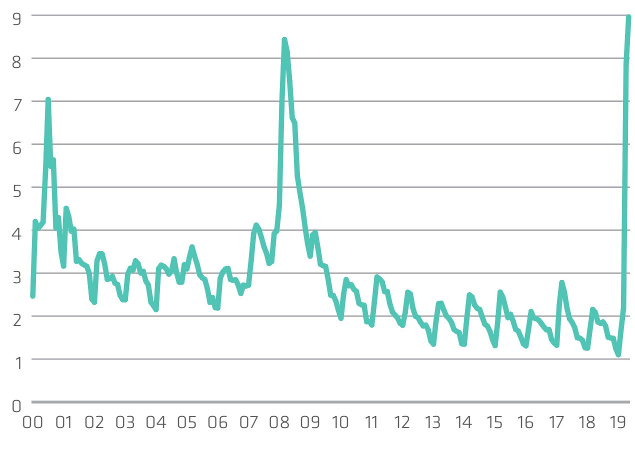
PRECISELY IMPRECISE: MODELING CERTAINTY TO COPE WITH UNCERTAINTY

Of course, this approach raises other uncertainties. But long-term investors shouldn't pretend to be precise. With so many unknowns over such a distant horizon, we think several probable paths of asset growth and profitability should be explored to underpin valuation estimates. This exercise informs a company's ultimate profit potential and provides insight into the drivers of today's profit model that must be rigorously monitored.

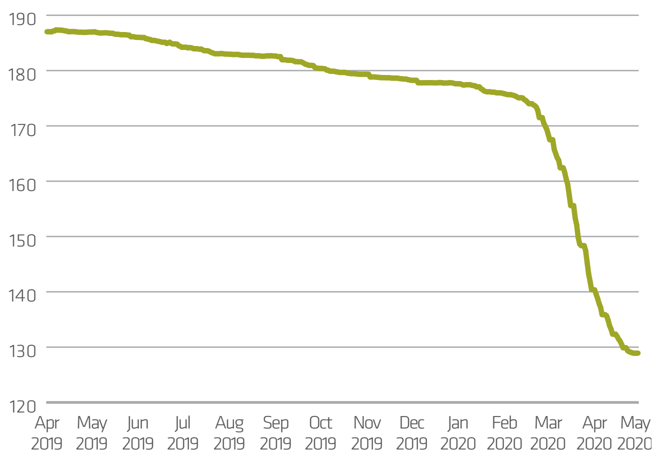
Investors shouldn't ignore current operating performance and challenges. But you don't need to accurately forecast near-term results to maintain a fundamental thesis and confidence. By looking further into the future, investors gain latitude to act differently amid heightened uncertainty and to identify attractively valued long-term assets with return potential rooted in real businesses rather than spurious expectations.

EARNINGS ESTIMATES: WIDE DISPERSION AND A SHORT-TERM HORIZON

S&P 500: Earnings per Share Dispersion*



S&P 500: Earnings per Share: 2020 Estimates (US Dollars)



Historical results and current analysis do not guarantee future results.

*Based on FactSet annual earnings estimates. Dispersion is calculated by taking the standard deviation of earnings estimates for every stock over the last 100 days, divided by the absolute value of each stock's median earnings estimate, multiplied by 100. For every period shown, the median dispersion value is used.

Left display as of March 31, 2020; right display as of April 21, 2020

Source: FactSet, S&P and AB

EVALUATING QUALITY IN A CHANGING WORLD

The coronavirus crisis is triggering dramatic changes in consumer and business behavior. Understanding how these changes will unfold—and how companies will be affected by the second- and third-order effects of the pandemic—is essential for investors. The issues differ by sector and industry, but asking the right questions is the first step toward developing conviction in companies that will provide investors with the quality needed to hold up in the crisis.

Healthcare: This sector is typically defensive and tends to perform well in an economic crisis. Indeed, healthcare shares performed much better than the broader market during the early stages of the crisis in the first quarter of 2020. However, some medical device companies, for example, may be negatively impacted as patients and hospitals delay elective procedures like hip and knee replacements in the near term. As hospitals reopen to these procedures, investors should consider what the recovery will look like for some of these companies.

Consumer discretionary: Retail companies with robust e-commerce platforms are likely to be better positioned to offset the loss of in-store foot traffic due to store closures than those with limited e-commerce capabilities as consumers shift their purchasing habits during quarantine. So, how does this affect the survivability of retail stores, many of which may have struggled with disruption from online retailers already? And how does this benefit accrue to those who have historically invested in their e-commerce capabilities?

Supply chains: Over the years, a tightly knit global supply chain has helped companies reduce manufacturing costs. However, this crisis has put a spotlight on the risks and opportunities in supply chains. Will this disruption lead to further capital expenditure to accelerate industrial automation? Or should companies look to diversify their supply chains and geographies?

Technology: As companies have been forced to let their employees work remotely, we're beginning to see a separation between those companies that have invested in technology and those whose infrastructure is lacking. Companies that have successfully implemented work-from-home policies may be able to hold fewer in-person meetings and more video conferences, or relaxed regular work-from-home rules after the pandemic has ended. For those that have underinvested, this might spur an increase in enterprise IT spending as companies play catch-up.

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