VALUE'S NEW HOPE

WILL THE PANDEMIC EXIT BE THE CATALYST?

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IN THIS PAPER: Market trends in early 2021 have raised hopes that a sustainable recovery for value stocks is under way. However, after a decade of underperformance, many investors are understandably skeptical. To gauge the opportunity, we analyze the scale and causes of the extreme dislocation in equity valuations from several perspectives. By determining what it would take for value stocks to stage a sustainable comeback, we then evaluate the potential payoff for investors who are willing to initiate, expand or rebalance allocations to value stocks today.

FIVE CATALYSTS FOR A VALUE REBOUND

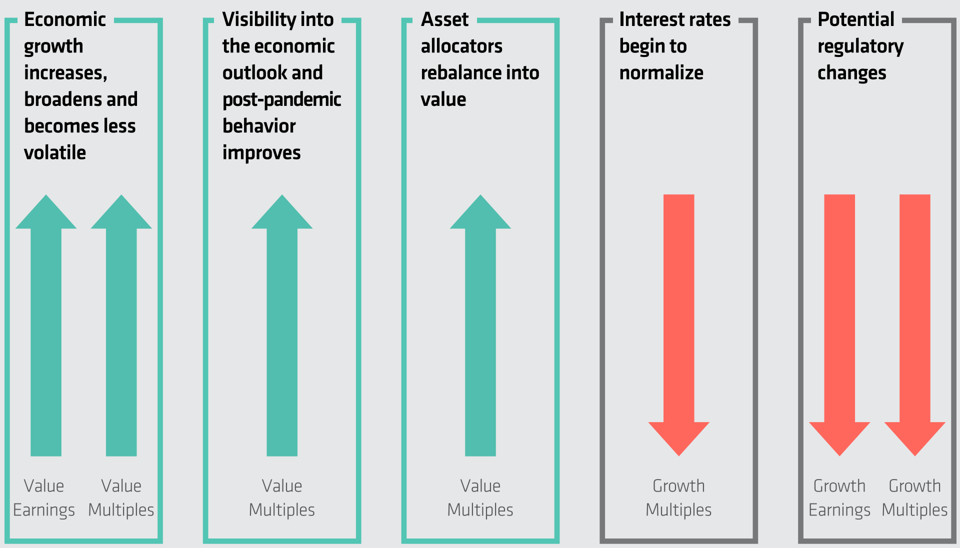
Across industries and around the world, value stocks are trading at near record discounts to growth stocks. It's tempting to conclude that bargain-basement prices alone represent a screaming buy signal.

But after a decade of poor performance for value, investors wonder whether the deep discounts reflect a new and permanent reality—the imminent death of value investing. Or, perhaps, value stocks offer pent-up performance that may signal outstanding recovery potential.

In our view, the dramatic effects of the pandemic may be a catalyst for change, as five key developments (*Display*) could foster an unwinding of the extreme divergence of value and growth stock valuations in the coming years. COVID-19 has produced the ultimate value controversy, severely punishing many companies that are struggling with uncertain long-term prospects, but also creating what we believe is an unprecedented recovery opportunity for investors willing to initiate or expand allocations to value stocks today.

HOW MIGHT VALUE WIN?

Recovery from the Pandemic—Moving Toward Normal



Past performance and current analysis do not guarantee future results.
Source: AllianceBernstein (AB)

Investors in value stocks have always been contrarian thinkers. But never as much as today, amid growing challenges to the investing style after a decade of underperformance and a painful 2020. To be a dedicated value investor in 2021 requires swimming against a wave of popularity for growth stocks and defying performance headwinds of historic proportions.

Critics of value investing have plenty of ammunition. Perhaps market conditions in the 21st century have created a permanent advantage for growth companies. Maybe investors' behavioral biases, which trigger opportunities in companies facing controversy, no longer drive mispricing anomalies in misunderstood stocks. Some traditional value metrics don't seem to work anymore. And with interest rates still near historic lows, the hurdles to a value winning streak look especially high.

But writing off value investing today is a mistake, in our view. This is not simply because return patterns shifted in value's favor beginning in the fourth quarter of 2020, providing a glimpse of the rebound potential. Rather, we believe that a continuation of the powerful forces that have driven the value-growth divide in recent years is untenable. In fact, COVID-19 has produced the ultimate value controversy, severely punishing many companies that are struggling with uncertain long-term recovery prospects. We believe that an unprecedented value opportunity now prevails across sectors, industries and regions.

To gauge that opportunity, we will analyze the scale and causes of the extreme dislocation in equity valuations from several perspectives. By determining what it would take for value stocks to stage a sustainable comeback, we can then evaluate the potential payoff for investors who are willing to initiate, expand or rebalance allocations to value stocks today.

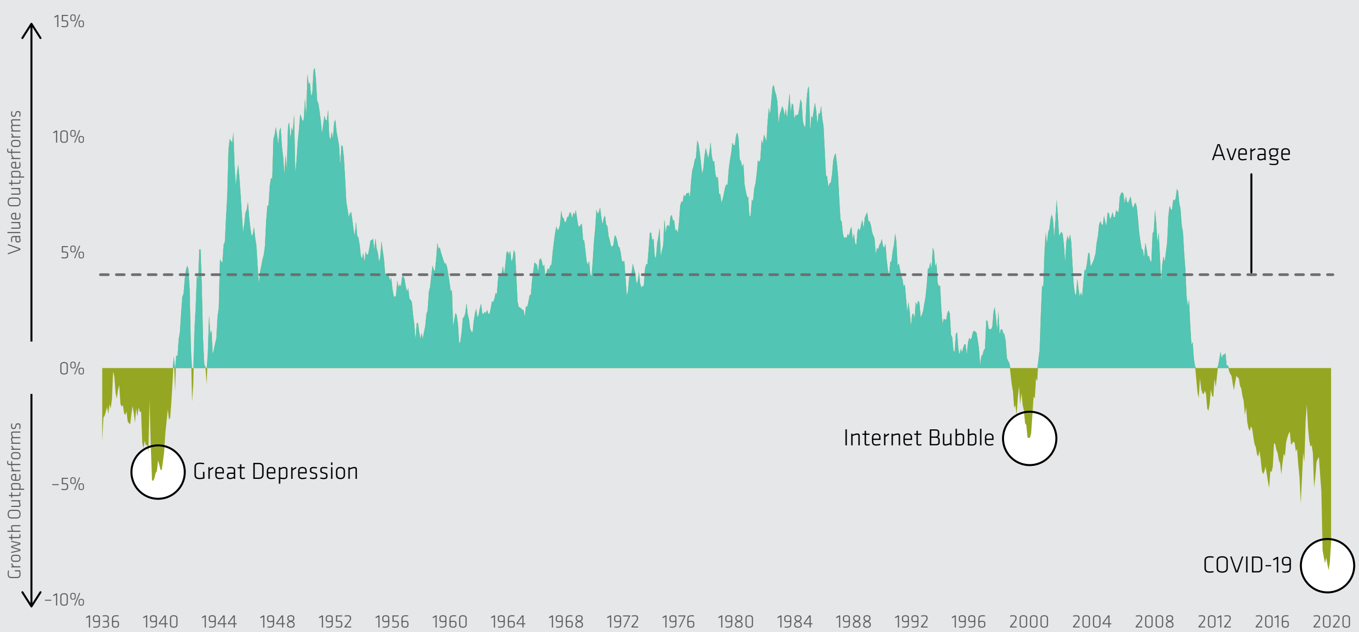
VALUE'S WEAKNESS IS UNPRECEDENTED

It's no secret that value stocks have had a rough ride in recent years. Yet the sheer scale of the underperformance simply has no precedent in modern market history.

In the past, value stocks delivered consistently strong returns over time. In the US market, where the longest data history is available, the cheapest 30% of stocks, based on price/book value, outperformed the most expensive 30% of stocks by an average of 4.1% annualized on a 10-year rolling basis since 1936. But by late 2020, as the COVID-19 pandemic devastated economic growth, the trailing 10-year returns for the cheapest cohort of stocks underperformed the most expensive stocks by about 8% (*Display 1*). This lost decade

DISPLAY 1: PANDEMIC PUSHES VALUE STOCKS TO HISTORIC SLUMP

10-Year Rolling Average Relative Return*



Past performance and current analysis do not guarantee future results.

* Return of the lowest-priced 30% of stocks relative to the highest-priced 30% of stocks, based on price-to-book, using the Fama French database of US stocks from June 1, 1936, through October 31, 2020.

Through October 31, 2020

Source: Center for Research in Security Prices, FactSet, MSCI and AB

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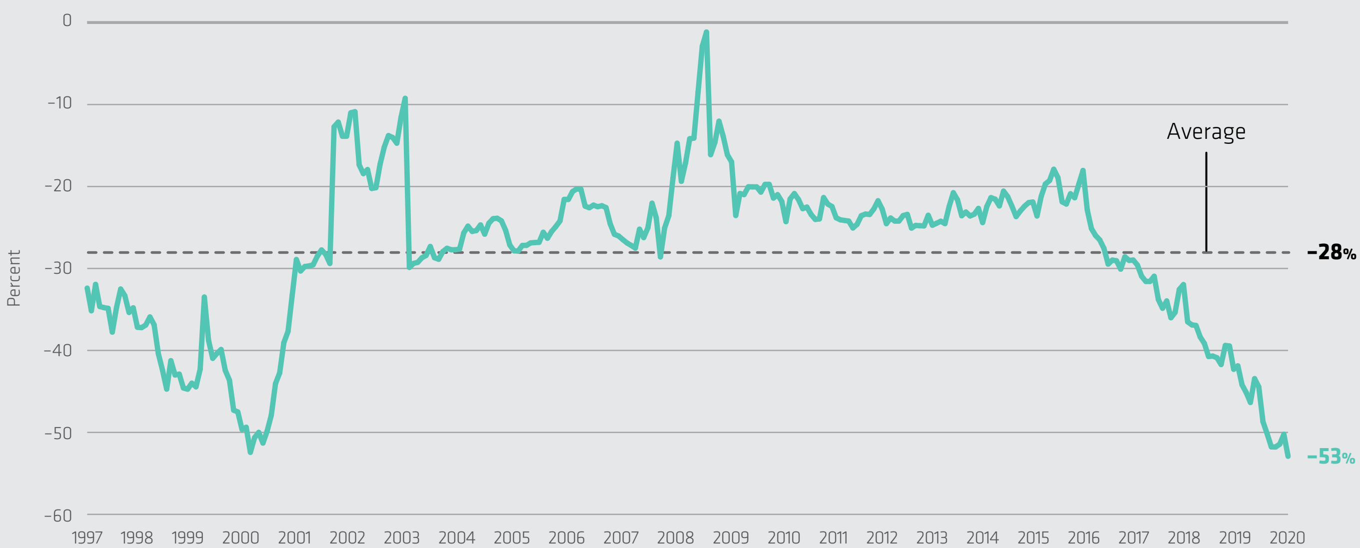
DISPLAY 2: GLOBAL VALUE STOCKS TRADE AT A RECORD DISCOUNT TO GROWTH

MSCI World Value Index vs. MSCI World Growth Index. Price-to-Forward Earnings Discount*



Past performance and current analysis do not guarantee future results.
***** Price to forward earnings (next 12 months) since January 1997
Through December 31, 2020
Source: FactSet, MSCI, Thomson Reuters I/B/E/S and AB

was by far the worst period on record for value, well beyond the poor performance seen during the internet bubble of 2000 and even the Great Depression of the 1930s.

As a result, value stocks were left trading at a historic discount compared to growth stocks. Based on price/forward earnings, the MSCI World Value Index was 53% cheaper than the MSCI World Growth Index (*Display 2*) by the end of 2020. That's nearly double the 28% average discount that global value stocks have traded at since 1997 and a deeper discount than at the peak of the dot-com bubble in 2000—a period followed by several years of supercharged value outperformance.

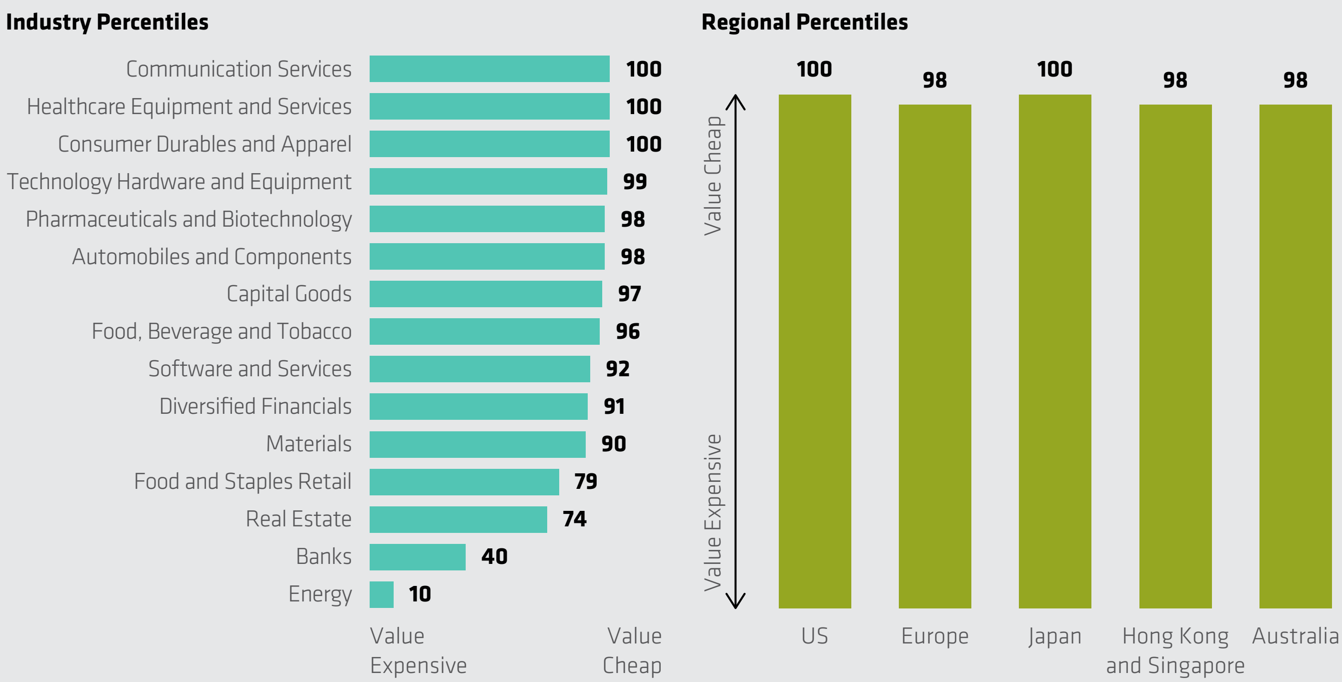
The underperformance of value has been widespread. In industries as diverse as consumer durables, healthcare equipment and telecom services, value stocks are cheaper than they've been, relative to growth stocks, at any time since 2001 (*Display 3, left*). The same is true of US and Japanese value stocks, while in Europe, Hong Kong and Australia, value stocks are very close to their lowest relative valuations since the bursting of the dot-com bubble (*Display 3, right*).

It's tempting to conclude that value's bargain-basement prices alone represent a screaming buy signal. But that would be too simplistic, given the persistent underperformance. As experienced value investors know all too well, cheap stocks can get cheaper, and extreme discounts may signal a value trap. Sometimes a stock is cheap because the company's earnings have become permanently impaired.

For investors, the deep discounts present a conundrum. Do they reflect a new and permanent reality that investors are ignoring—the imminent death of value investing? Or do these discounts represent pent-up performance in value stocks that may signal outstanding recovery potential as market conditions turn?

DISPLAY 3: VALUATION DISCOUNTS PREVAIL ACROSS INDUSTRIES AND GEOGRAPHIES

Price/Forward Earnings Discount Percentile (2001–2020)*



Analysis is provided for illustrative purposes only and is subject to revision.

* Discount percentile based on the price-to-forward earnings ratio of the MSCI World Value Index relative to the MSCI World Growth Index from January 1, 2001, through December 31, 2020.

As of December 31, 2020

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

UNDERSTANDING THE VALUE-GROWTH PERFORMANCE GAP

To answer those questions, we first need to understand how we got here. Let's start by looking at returns over the past six years, when value's underperformance was most pronounced. By disaggregating the sources of growth stocks' outperformance, we can start to evaluate the forces at play.

From January 2015 through December 2020, global value stocks trailed global growth stocks by 9.5% per annum. Over the six-year period, that adds up to an astonishing cumulative gap of 92% in favor of growth stocks (*Display 4*).

But to understand what's really going on, you need to look beneath the surface of that performance. In the absence of multiple expansion, a stock's return is determined by dividends paid plus earnings growth. Normally, we would expect the difference in earnings growth and dividends to explain a large portion of the performance differential between value and growth stocks.

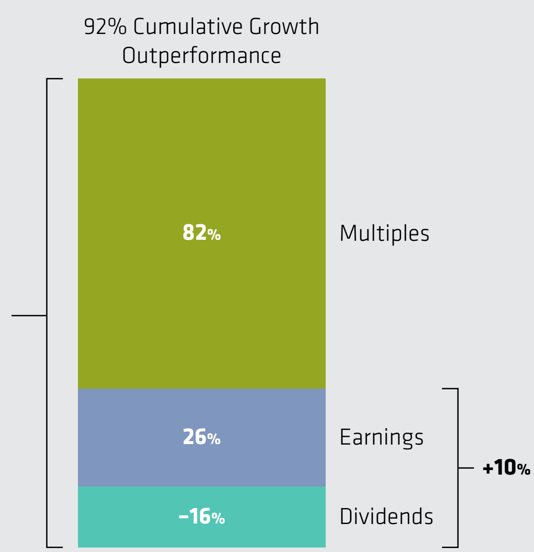
Not this time. Our research shows that only 10 percentage points of the return gap between value and growth stocks since 2015 were driven by the difference in earnings and dividends. Multiple expansion accounted for the remaining 82 percentage points of the performance differential.

DO MULTIPLES MATTER?

Many investors don't seem to care about multiples. After all, does it really matter where returns come from if you can enjoy a profitable bonanza by investing in growth stocks? We think it does. In our view, understanding the sources of historical returns is crucial for evaluating the outlook—because in some conditions, multiple changes can quickly reverse.

DISPLAY 4: GROWTH OUTPERFORMANCE DOMINATED BY MULTIPLE EXPANSION

	Annual Returns*	Cumulative Returns*
Growth	14.6%	126%
Value	5.1%	34%
Difference	**+9.5%**	**+92%**



Past performance and current analysis do not guarantee future results.

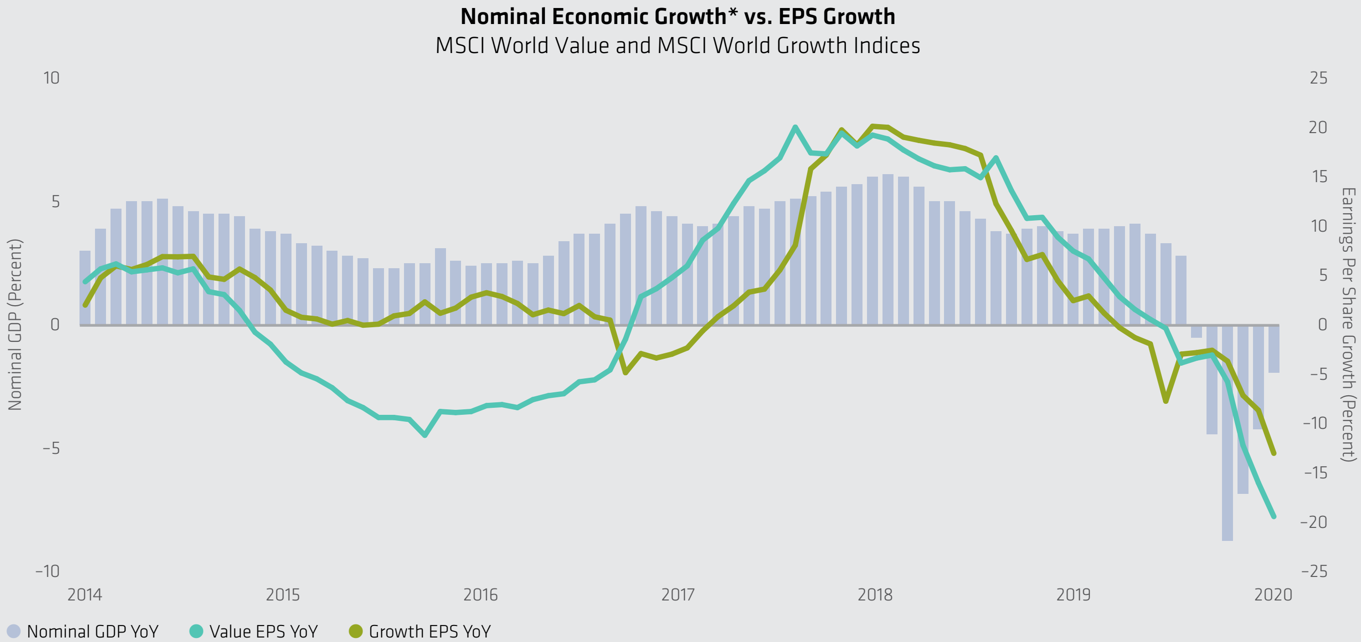
* Based on the MSCI World Value Index and MSCI World Growth Index returns from January 2015 to December 2020. All index returns shown in US-dollar terms. Numbers may not sum due to rounding.

As of December 31, 2020

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

DISPLAY 5: WHY HAVE VALUE EARNINGS LAGGED?

Value Is More Cyclically Sensitive and Economic Growth Has Been Weak



Past performance does not guarantee future results.

***** Nominal US GDP growth

Through June 30, 2020

Source: FactSet, MSCI and AB

The relatively small return gap owing to dividends and earnings growth tells an important story. Many investors believe that growth's dominance has been propelled by dramatic changes in business trends that have favored growth-oriented companies in recent years. Yet the 10% difference in earnings and dividend performance—about 1.5% per year—suggests that these seemingly seismic business shifts haven't made a huge difference to profits and cash flows, which ultimately determine a stock's value.

Instead, investors have simply chosen to reprice the growth cohort. Even before the pandemic, investors pushed up share prices of growth stocks, while pushing down value stocks disproportionately to the actual disparity in profitability.

WHY HAVE VALUE EARNINGS LAGGED?

To be sure, value companies' earnings have lagged those of their growth peers. That's largely because value companies are generally more sensitive to changes in the macroeconomic cycle than are growth companies. And global GDP growth has been rather tepid in recent years, even before COVID-19.

So in 2020, when the pandemic triggered economic shutdowns and GDP crashed, earnings of value companies took a bigger hit than that of growth companies (*Display 5*). In a socially distanced, work-from-home world, some growth companies—particularly those offering digital services in the technology and consumer sectors—benefited from an acceleration of shifts in demand that were already under way.

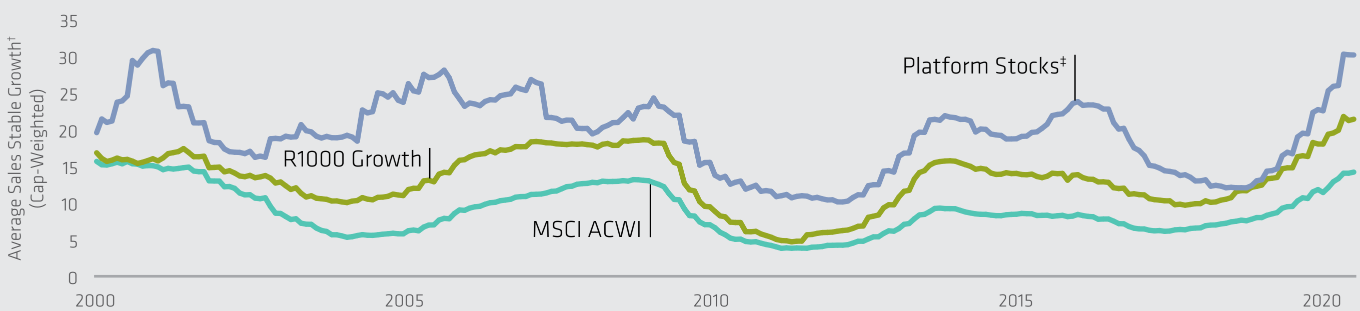
Widespread disruption across industries, which had begun before the pandemic, also helps explain the divergence of value and growth earnings. Disruption has often been the result of powerful network effects—business models and platforms that generate outsize demand in the internet economy, from social media companies such as Facebook to consumer giants such as Amazon. As a result, platform companies that benefit from network effects have posted much faster sales growth than have the broad global market and US growth stocks (*Display 6*). These companies have created a moat around their businesses with revenues and profits that are less vulnerable to competition.

DISPLAY 6: TECHNOLOGICAL PROGRESS DRIVES GROWTH SALES

Technology enables an important shift in the source of scale economies…

> "The engine of the **industrial economy** was, and remains, supply-side economies of scale…The driving force behind the **internet economy**, conversely, is demand-side economies of scale, also known as network effects."
>
> —*Marshall W. Van Alstyne, Geoffrey G. Parker and Sangeet Paul Choudary**

…which drives superior sales growth



Past performance does not guarantee future results.

***** "Pipelines, Platforms, and the New Rules of Strategy" *Harvard Business Review*, (April 2016).

† Sales stable growth factors in both magnitude and stability of sales growth from January 2000 to July 2020.

‡ Platform stocks are global companies that have both an inverted firm structure (participants, rather than the business, own the means of production) and network effect (growing participant connections that exponentially add value).

Through July 31, 2020

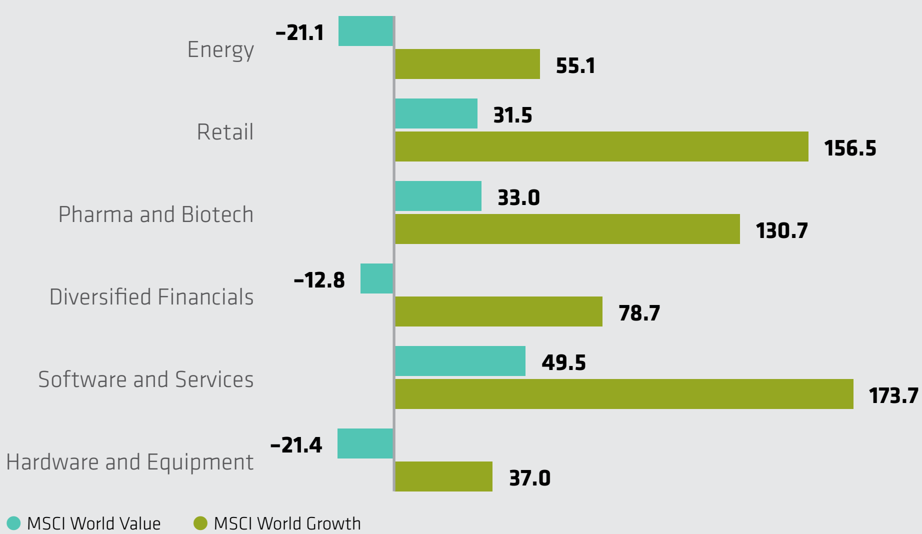
Source: FTSE Russell, MSCI and AB

This trend helps explain why the revenue growth of growth companies has outpaced that of value peers. In several industries, technological disruptors are shaking up traditional business models and grabbing a larger share of business. Companies such as Amazon, in retail, and Salesforce.com, in software, are making life much more difficult for rivals such as Target and Oracle (*Display 7*). In many cases, we believe share prices have been rewarded for outstanding revenue growth, even if it hasn't always translated into superior fundamental performance for profits or margins.

Then perhaps the fundamentals of value companies have deteriorated dramatically? Value fundamentals, in fact, aren't

DISPLAY 7: VALUE EARNINGS LAG AS DISRUPTION DRIVES GROWTH REVENUES
Technological Disruption Across Industries

Cumulative Revenue Growth from January 1, 2010, to December 31, 2020 (Percent)



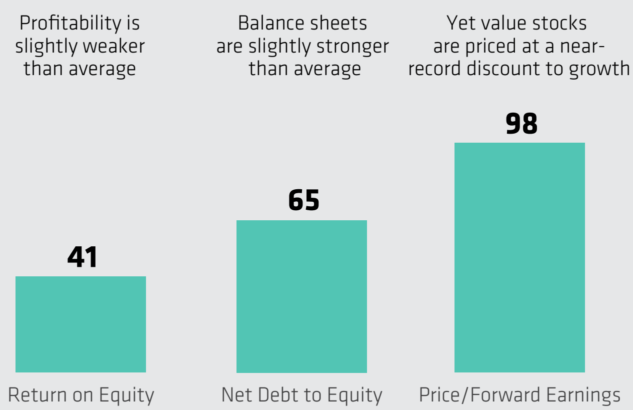
Key Competitors

Value	Growth
Exxon Mobil	Neste Oyj
Target	Amazon
GlaxoSmithKline	Vertex Pharmaceuticals
Deutsche Bank	The Intercontinental Exchange
Oracle	Salesforce
Cisco Systems	Apple

Past performance does not guarantee future results.
As of December 31, 2020
Source: MSCI and AB

DISPLAY 8: RESILIENT FUNDAMENTALS DEFY HISTORIC VALUATION DISCOUNT

Current Value vs. Growth Spread Percentiles (1997–2020)*



Analysis provided for illustrative purposes only and is subject to revision.

* Discount percentile based on the price/forward earnings ratio, return on equity and net debt to equity of the MSCI World Value Index, relative to the MSCI World Growth Index, from January 1, 1997, through December 31, 2020.

As of December 31, 2020

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

nearly as bad as today's valuations suggest. The profitability of value companies as compared to growth companies, measured by return on equity, is only slightly below average. And value balance sheets (net debt to equity) are stronger than usual, relative to growth companies, based on data from 1997 (*Display 8*). So the huge discount of value stocks clearly doesn't stem from any major degradation in fundamentals overall, in our view.

WHY HAVE MULTIPLES DIVERGED?

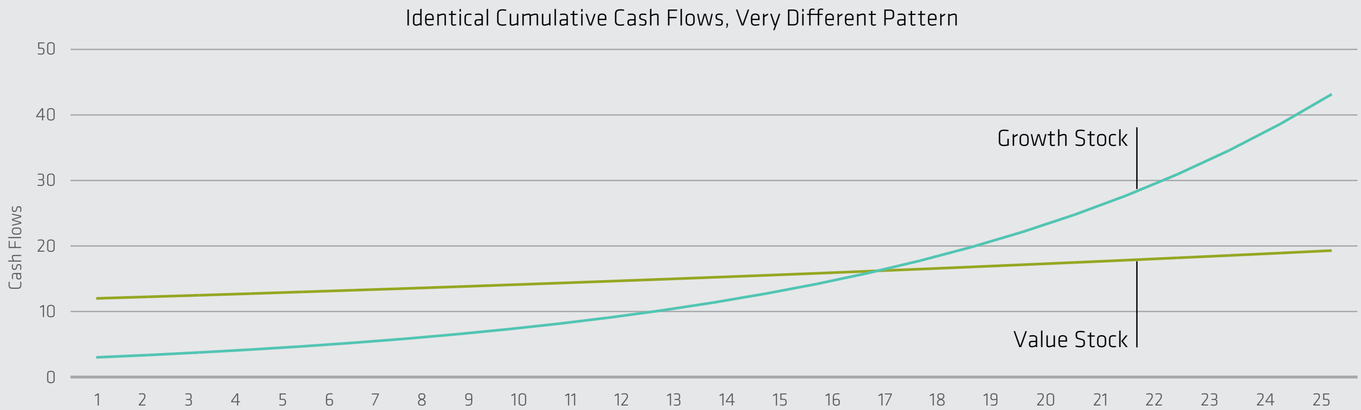
So, why has the value discount continued widening to historic proportions? We see three primary reasons: (1) the fall in interest rates; (2) an increase in the premium paid for revenue growth and (3) a divergence in risk premiums amid weak economic growth, the pandemic-induced recession and a more uncertain future.

Interest rates are always an important influence on stock performance, but even more so today. Major central banks have pledged throughout the COVID-19 crisis to keep rates at historically low levels for an extended period. And falling interest rates disproportionately benefit growth stocks (*Display 9, page 11*).

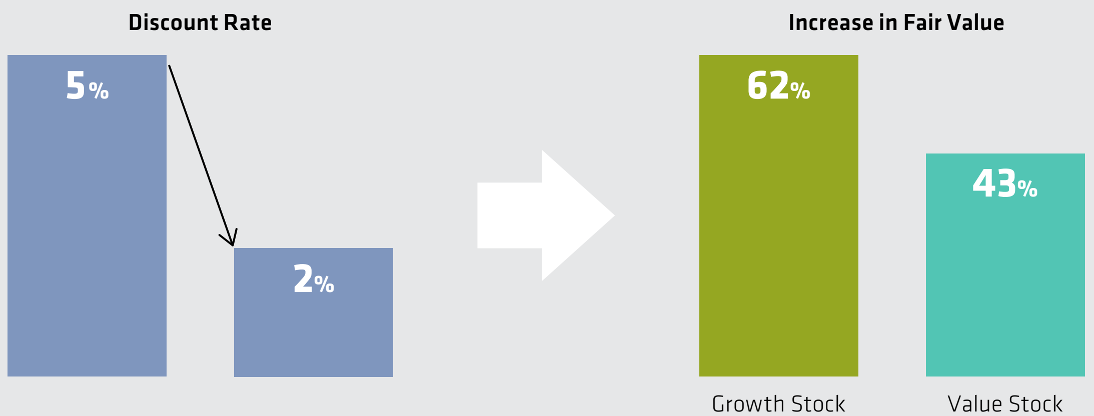
Low rates flatter growth because a stock's value is determined by the present value of its future cash flows. Since cash flows of growth companies are typically generated much further in the future than those of value companies, a decline in the discount rate used to calculate the present value disproportionately benefits growth stocks. Display 9 shows an illustrative example of two stocks that generate identical cumulative cash flows over a 25-year period. But because the timing of when these cash flows are generated differs, a decline from 5% to 2% in the discount rate applied to these cash flows would fuel a 62% increase in the fair value of a growth stock but only a 43% rise for the value stock (*see page 10, How do Interest Rates Affect Stock Valuations?*).

DISPLAY 9: FALLING RATES DISPROPORTIONATELY BENEFIT GROWTH MULTIPLES

Growth cash flows are generated further in the future



Long-duration growth stocks benefit disproportionally as interest rates fall



Past performance and current analysis do not guarantee future results.

Based on the MSCI World universe. Value stock cash flow per share is assumed to be $12 in year one and grow 2% annually thereafter. Growth stock cash flow per share is assumed to be $3 in year one and grow 11.75% annually thereafter.

Source: MSCI and AB

HOW DO INTEREST RATES AFFECT STOCK VALUATIONS?

Monetary policy and the interest-rate environment can have a profound effect on equity valuations. Low interest rates push up multiples of all types of equities but benefit growth stocks disproportionately.

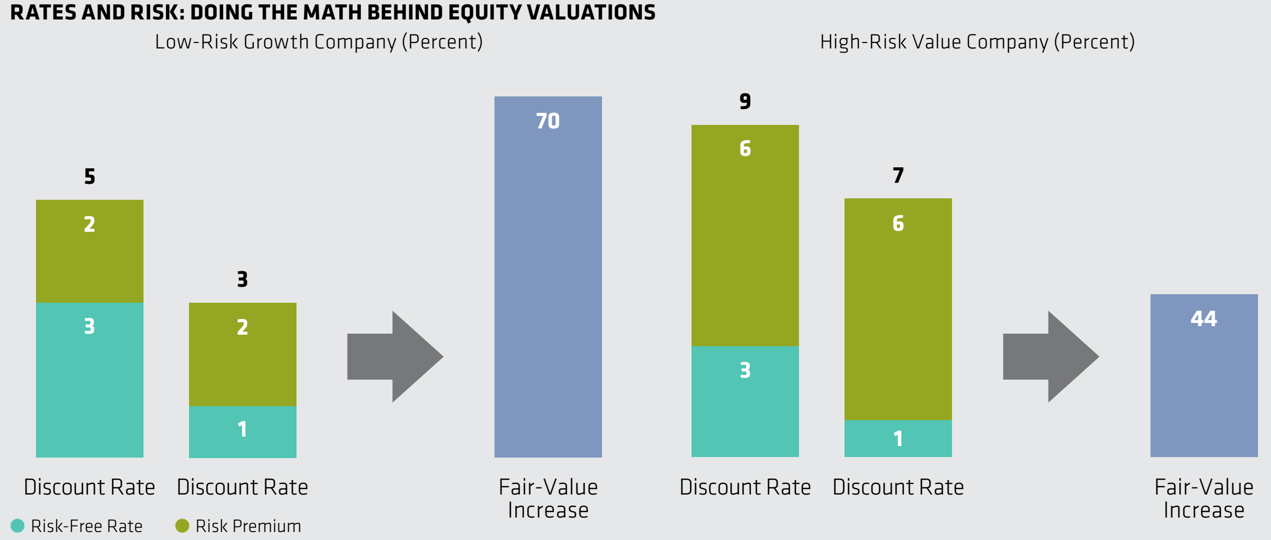
How does this happen? It's really just mathematics applied to the discount rate that investors use to value companies. The discount rate is the required rate of return that investors believe is necessary to justify an investment. This discount rate is composed of a risk-free rate, usually the 10-year government bond yield; an equity risk premium, which is the excess return required by equity investors to justify the increased risk of owning a stock over a bond; and finally, a stock-specific risk to reflect the differing nature of companies and their earnings.

In the illustrative example below, we show how a decline in the risk-free interest rate from 3% to 1% would affect two different types of stocks that both generate earnings of $3 per share and earnings growth of 5% a year. On the left, we show a lower-risk company, for which investors only require a 2% risk premium to own it. In other words, investors require an annual return that would be 2% greater than holding cash at the risk-free interest rate. As the risk-free rate falls from 3% to 1%, the discount rate drops from 5% to 3%. All else being equal, that results in a 70% increase in the fair value of the stock.

On the right, we look at the impact of falling rates on a riskier company that commands a higher risk premium of 6%. In this case, the same 2% drop in the discount rate, from 9% to 7%, generates a 44% gain in the share price. So when the risk-free rate falls, companies with low risk premiums experience a larger relative change in their discount rate, which generates a bigger increase in their stock price.

Of course, not every high-risk company is a value company, and not every low-risk company is a growth company. But overall, the value cohort contains more stocks that are perceived to be riskier than the growth universe. This example doesn't tell us how much of the value-growth spread widening that we've seen in recent years was caused by interest rates. But it does suggest that in a falling-rate environment—as we've seen to an extreme degree in recent years—the benefit to value stocks is depressed by the effects of higher risk premia. And it can also help us consider what might happen if interest rates rise over time—even modestly—adding a mathematical impetus for a revaluation of downtrodden value stocks relative to growth.

RATES AND RISK: DOING THE MATH BEHIND EQUITY VALUATIONS



- For any drop in the risk-free rate, companies with low risk premiums experience a larger relative change in their discount rate
- This results in a greater valuation benefit from falling rates for low-risk companies

Past performance and current analysis do not guarantee future results.
For both the low-risk growth and high-risk value data, each company earns $3 as EPS, with earnings growth of 5%.
Source: MSCI and AB

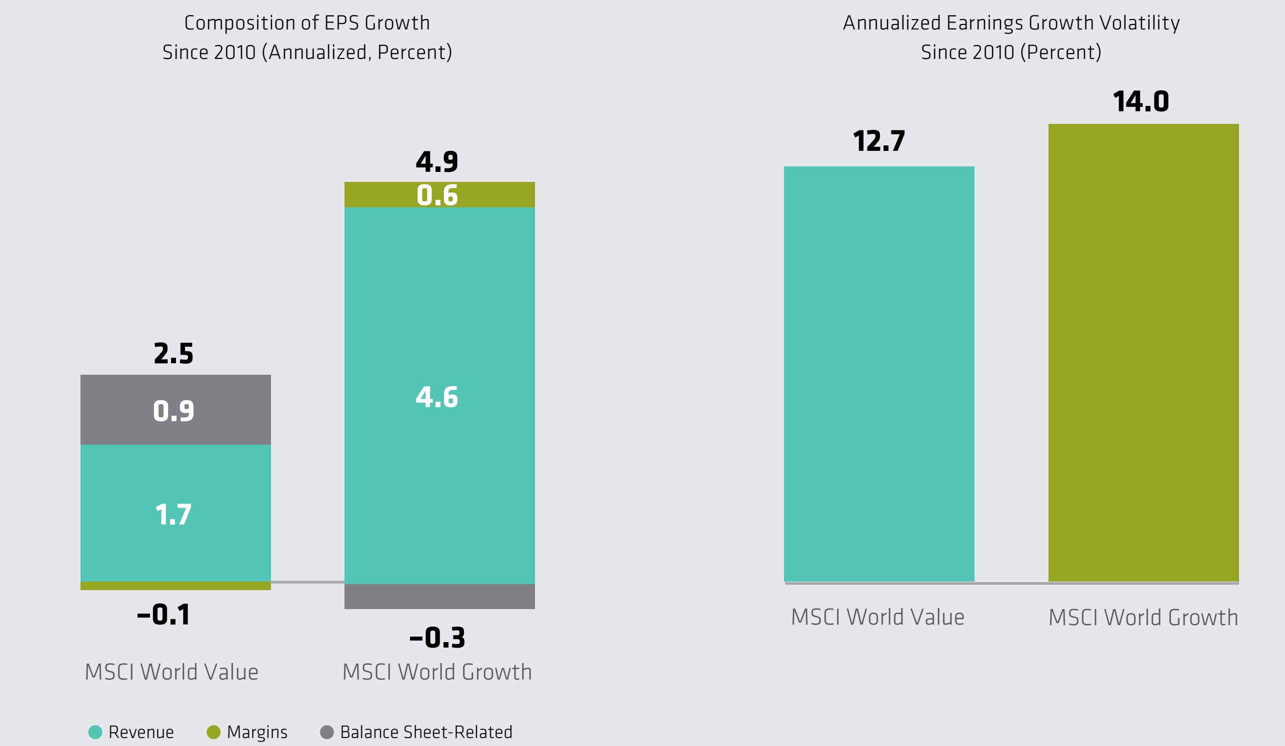
INVESTORS ARE OVERPAYING FOR REVENUE GROWTH

Beyond the effects of interest rates, the macroeconomic environment has influenced equity investors in many ways. For example, in a world of low and uncertain growth, investors have prized revenue growth.

Over the last 10 years, global growth companies—as expected—posted stronger earnings growth than did value counterparts. In addition, almost all the earnings growth came from increased revenues (*Display 10, left*). And investors have rewarded growth companies, even though their earnings growth has been more volatile than that of value companies (*Display 10, right*).

In a world of scarce growth, it's easy to understand why investors prize tangible revenues. However, the question is whether that revenue gap really justifies the 82% difference in multiple expansion between value and growth stocks that we saw on page 4.

DISPLAY 10: GROWTH EARNINGS ARE SEEN AS HIGHER QUALITY, DESPITE VOLATILITY



Past performance does not guarantee future results.
As of December 31, 2020
Source: MSCI, S&P Compustat, Worldscope and AB

CAN VALUE STOCKS RECOVER WITHOUT HELP FROM FINANCIALS?

Financial stocks have continued to struggle through the pandemic. During 2020, financial stocks, which comprise about one-fifth of the global value benchmark, fell 5.5% in local-currency terms. Banks have been hit by low interest rates, which compress net interest margins, as well as falling loan volumes and rising bad debts.

In this environment, banks will struggle to outperform. Yet our research suggests that value stocks can do well without relying on banks as the engine for recovery.

JAPAN'S NO-BANK VALUE MARKET

Japan provides a good case study. In the Japanese market, financials have underperformed the broader market since 1998. Yet over the same period, value stocks outperformed. That's counterintuitive to many investors. In Japan's ultralow-rate environment, banks were indeed handicapped. Since 1998, Japanese banks underperformed sharply, while Japanese insurance companies did well and performed in line with the broader market. With banks around the world facing similar challenges today, we think the Japanese experience could be more relevant for global value investors than it was in the past, when the country was widely seen as a macroeconomic outlier.

GLOBAL VALUE: MORE THAN JUST FINANCIALS

For equity investors, the association between value stocks and financials is hard to break. Yet the weight of financials in the MSCI World Value Index has been falling, from 34% in September 2009 to about 21% at the end of 2020.

It's true that financials have been standout performers when value has done well. Our research shows that the financial sector outperformed the broader market in nine out of 11 years of global value outperformance since 2004 (*Display, left*). Yet in those periods, excess returns of global financials were relatively modest, at 2.6% on average. Other sectors such as energy, materials and real estate did even better on average. The same pattern holds true when excluding the US, as in the MSCI EAFE benchmark, where value outperformed in 13 years (*Display, right*). In our view, these past trends show that strong returns in nonfinancial sectors have been an engine for value outperformance.

Companies with attractively valued cash flows and resilient businesses can be found today across many industries, sectors and countries. This provides investors with a wide opportunity set to position in higher-quality companies with unrecognized potential to drive a recovery, without taking riskier positions in the banking sector.

WHICH SECTORS HAVE DRIVEN STRONG VALUE EQUITY MARKETS?

Periods of Sector Outperformance When Value Outperforms (1995–2020)

MSCI World
Number of Years of Outperformance

Sector	MSCI World Value Outperforms 11	Average Outperformance (Percent)
Energy	9	**9.1**
Financials	9	2.6
Materials	8	**3.7**
Real Estate	8	**7.1**
Industrials	6	1.3
Consumer Staples	6	**4.8**
Healthcare	6	**4.7**
Utilities	6	**5.7**
Consumer Discretionary	5	–2.1
Technology	4	–4.1
Communication Services	4	–5.6

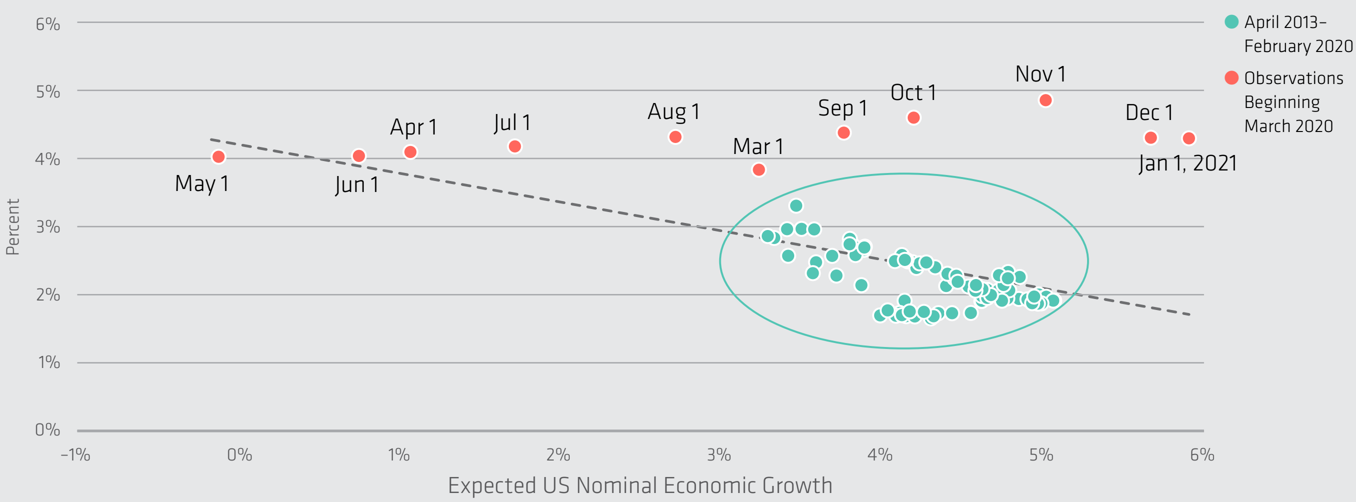
MSCI EAFE
Number of Years of Outperformance

Sector	MSCI EAFE Value Outperforms 13	Average Outperformance (Percent)
Financials	10	3.3
Real Estate	10	**8.7**
Materials	9	**5.6**
Industrials	9	2.0
Energy	8	3.2
Consumer Discretionary	6	2.4
Consumer Staples	6	1.5
Healthcare	6	1.8
Utilities	6	1.0
Technology	4	–5.2
Communication Services	4	–7.2

Past performance and current analysis do not guarantee future results.
As of June 30, 2020
Bar chart shows the number of years that each sector outperformed when MSCI World Value outperforms MSCI World. Average outperformance shows the average annual outperformance of the sector when MSCI World Value outperforms MSCI World.
Shaded boxes refer to sectors that delivered stronger returns than financials on average in years when value stocks outperformed the market.
Source: FactSet, MSCI and AB

DISPLAY 11: WEAK ECONOMIC OUTLOOK RAISES THE PERCEIVED RISK OF VALUE STOCKS

Risk Premium: Value–Growth*



- A weak economic growth outlook increases the risk premiums assigned to value companies
- A strong economic growth outlook reduces the insurance premium assigned to growth companies

Past performance does not guarantee future results.

* Equity risk premiums based on cyclically adjusted price/earnings for the MSCI World Value Index, relative to the MSCI World Growth Index, from April 30, 2013, to December 31, 2020.

As of December 31, 2020. Source: FactSet, MSCI and AB

RISK PREMIUMS DIVERGE AMID EXTREME UNCERTAINTY

If the fundamentals of value stocks have been relatively resilient, why are investors so pessimistic? On one hand, we think the extremely uncertain outlook for the economy and disrupted industries has played a big role in pumping up the perception of value stocks as being overly risky. On the other hand, many growth stocks are viewed as relatively safe and insulated from the economic environment.

As discussed earlier, value stocks are indeed generally more sensitive to the macroeconomic cycle. However, we're taken aback by the extent to which the discount rate used for value stocks versus growth stocks has been recently disconnected from historical norms.

Our analysis shows that the perceived risk of value stocks, relative to growth stocks, jumped as the pandemic spread throughout 2020. In *Display 11*, the dots represent the excess risk premium that investors have assigned to value stocks versus growth stocks amid different economic growth expectations. The teal dots represent monthly observations between 2013 and February 2020, when the risk premium that investors demanded for value stocks was clustered closely to the regression line, peaking at just over 3%.

In 2020, this tight relationship was torn apart by economic uncertainty. With the pandemic raging, expected economic growth collapsed. As this happened, the risk premium that investors demanded for value stocks jumped to between 4% and 5%—well beyond the typical range since 2013. Surprisingly, value's excess risk premium remained at these historically elevated levels, even as expected nominal growth recovered to 6% by the beginning of 2021.

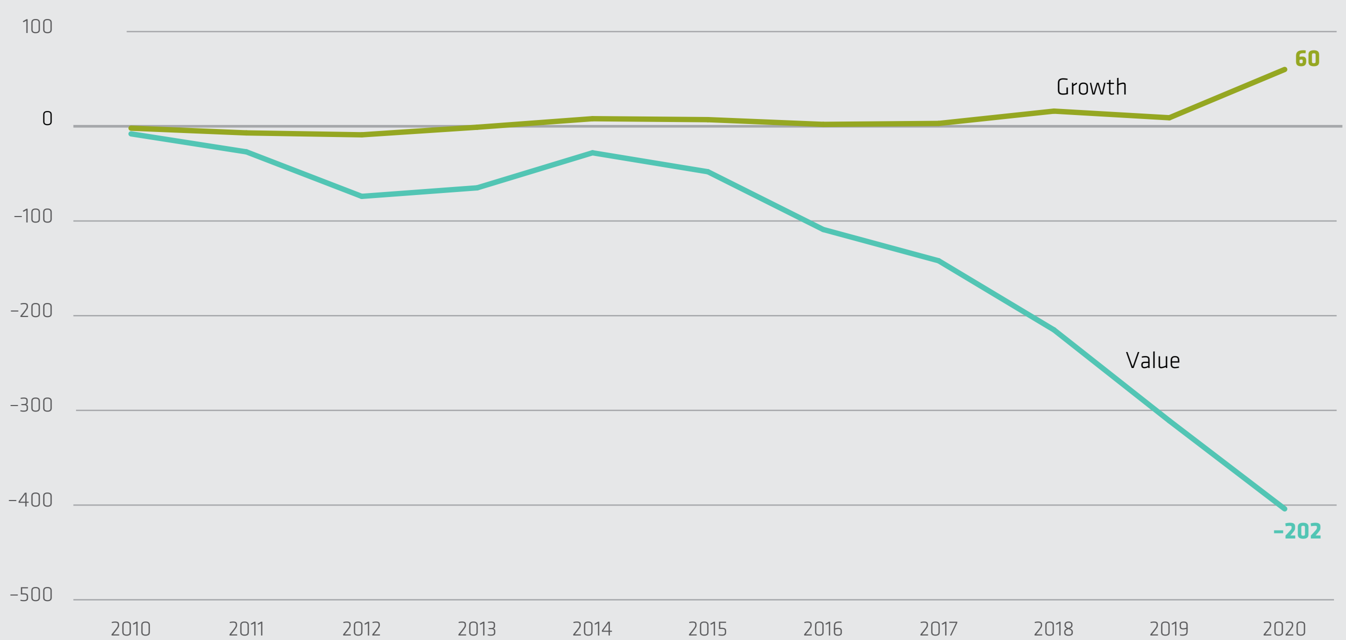
This phenomenon can be explained partly by the continuation of historically low interest rates. But we believe that the extraordinary risk premiums reflect the impact of extraordinary uncertainty and, with it, an unusually wide range of expected outcomes for economies and companies. As a result, stock multiples became disconnected from any semblance of historical norms.

Negative sentiment is often a self-fulfilling prophecy. As investors became increasingly disillusioned with value stocks and performance weakened, they pulled more and more money out of value equity strategies.

Since 2010, investors have withdrawn $404 billion from active global value equity strategies, while adding $60 billion to global growth strategies (*Display 12*). These outflows added selling pressure to value stocks, which likely intensified some of the extreme valuation divergence.

DISPLAY 12: FUND OUTFLOWS PUT SELLING PRESSURE ON VALUE STOCKS

Cumulative Net Flows in Global Equities*
Value vs. Growth (USD Billions)



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***** Net flows in the eVestment ACWI ex-US All Cap Equity, ACWI ex-US Large Cap Equity, EAFE All Cap Equity, EAFE Large Cap Equity, Global All Cap Equity and Global Large Cap Equity categories.

Through December 31, 2020

Source: eVestment and AB

HIDDEN VALUE IN SMALLER STOCKS

Both small-cap stocks and value stocks have underperformed in recent years. From 2017 to September 2020, the Russell 2000 Value Index of small-cap stocks trailed the Russell 2000 Growth Index by 58% and underperformed large-cap growth stocks by more than double that (*Display, left*). But from October 2020 through mid-March 2021, US small-cap value stocks surged by 71.7%, outperforming growth stocks and the broader market (*Display, right*).

IS THE RALLY OVER?

After such a sharp recovery, have investors missed the opportunity? We don't think so. Since the small-cap slump of recent years was so dramatic, the late-2020 rebound has recovered only a small amount of the underperformance. And there are good reasons to expect smaller, attractively valued companies to do well as the macroeconomic recovery progresses.

Earlier in 2020, investors shunned smaller stocks amid fears that they were more vulnerable to the pandemic's consequences. In fact, sales and earnings in many of these companies recovered more quickly than expected after the initial pandemic-shutdown panic abated.

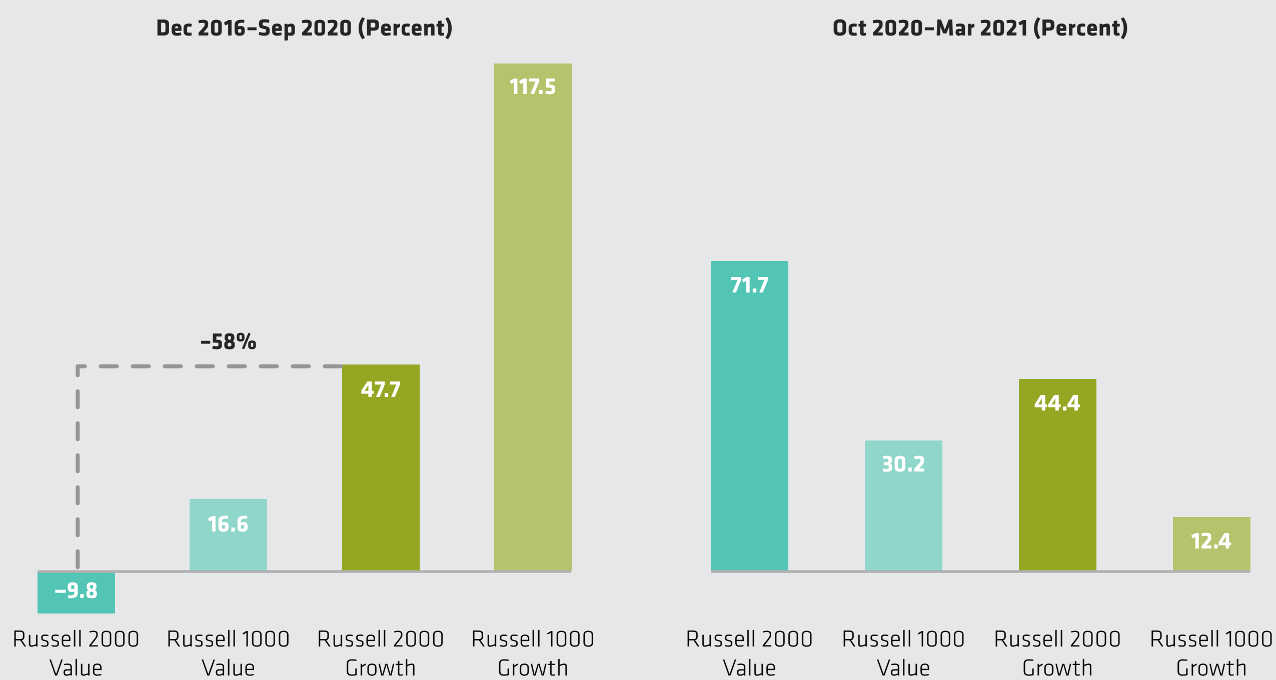
SMALLER BUSINESSES ADAPTED WELL TO COVID-19

For example, when economic shutdowns began, it was feared that small-cap banks' provisions for bad debts would overwhelm their earnings and perhaps even force them to raise equity. Yet six months later, many of those banks beat quarterly earnings expectations on lower-than-expected loan losses.

Small value companies have also been more flexible than expected. Of course, some industries such as restaurants and airlines have faced intense pressure. But, in general, revenues and profits for consumer cyclicals and industrials, among others, bounced back better than expected, even though investors gave them no credit for potential resilience during the downturn. And even after recent gains, small value stocks still trade at a near-historic discount to small-cap growth stocks.

For more than 25 years, through 2016, smaller-cap stocks with attractive price-to-free-cash-flow multiples in the top quartile outperformed the rest of the small-cap market by more than 10% per year. But in the last four years, stock prices haven't followed cash flows, and multiples have contracted for smaller-cap stocks. We believe this is an irrational market reaction that will eventually correct, especially since company fundamentals have continued to improve during this period of underperformance.

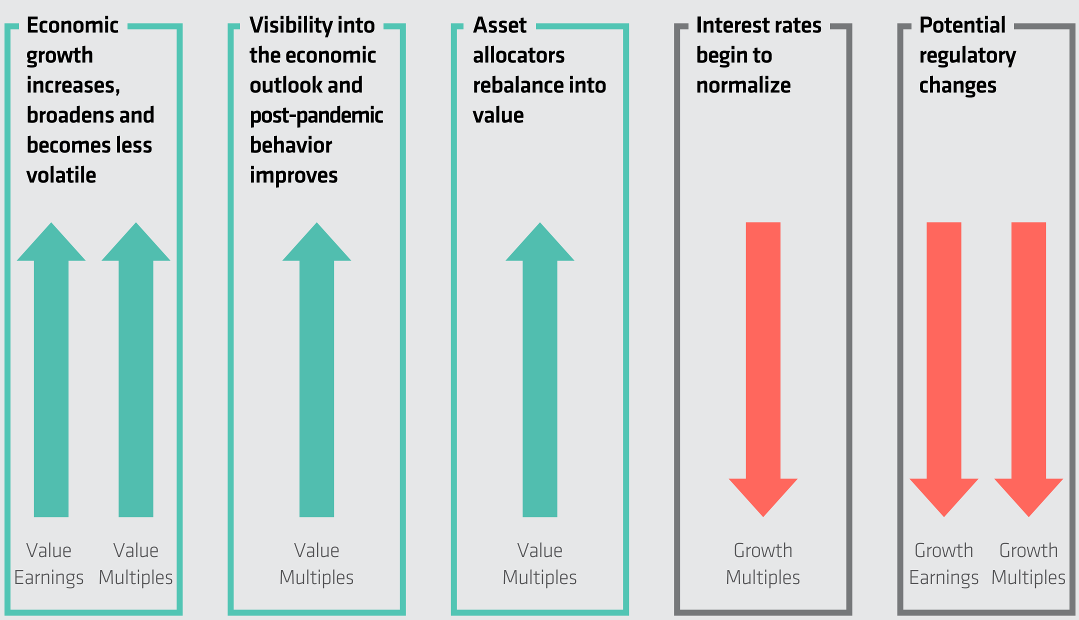
AFTER FOUR-YEAR SLUMP, SMALL-CAP AND VALUE STOCKS SHOW SIGNS OF RECOVERY



Past performance does not guarantee future results.
As of March 15, 2021
Source: FTSE Russell and AB

DISPLAY 13: HOW MIGHT VALUE WIN?

Recovery from the Pandemic—Moving Toward Normal



Past performance and current analysis do not guarantee future results.

Source: AB

TURNING THE TIDE: FIVE POTENTIAL RECOVERY DRIVERS

So what would it take to turn the tide? Value investors have been asking this question repeatedly over the last decade. Yet today, the dramatic effects of the pandemic may be a catalyst for change. In our view, five key developments could foster an unwinding of the extreme divergence of value and growth stock valuations in the coming years (*Display 13*).

1. **Economic Recovery Accelerates and Broadens**

   The COVID-19 pandemic triggered the worst global macroeconomic crisis in decades. As entire industries shut down, unemployment surged, growth collapsed and uncertainty mounted. However, the historic collapse may also map the contours of a historic recovery.

At the beginning of 2021, consensus estimates projected nominal US GDP growth of 6.3% in 2021. While the path to recovery will face obstacles, over time, as the world begins to return to normal, we believe growth will accelerate and broaden, generating a tangible rebound in business activity overall and across more industries. And growth will likely become less volatile as its sources diversify. These trends should make a visible impact on the earnings of value companies, which would in turn provide an impetus for pushing up the multiples of value stocks.

2. **Visibility into the Outlook as Post-Pandemic Behavior Improves**

   Multiples of value stocks are also affected by confidence in the future. Since value stocks are typically seen as riskier investments than their growth peers, a lack of confidence in the outlook makes investors demand much higher risk premiums for owning these stocks (as shown on page 13), which in turn suppresses their multiples.

   As COVID-19 vaccinations are increasingly rolled out and countries make progress in combating the pandemic, we believe investors will gain confidence in the trajectory of the nascent economic recovery. When this happens, the risk premia for owning value stocks should decline, which would help support a recovery of value multiples, in our view.

   Today's uncertainty isn't limited only to the economic outlook. Uncertainty about how consumer and business behavior will change after the pandemic has made it very difficult for investors to forecast long-term cash flows in many industries.

   But this won't last forever. As economies start to reopen, we expect to see a rise in consumer and business spending, particularly in hard-hit industries such as travel, entertainment and retail. It's hard to say today what the recovery trajectory will look like for industries that were severely impaired during the crisis. That's why the range of expected outcomes for many companies is extremely wide. However, as life begins to return to normal and investors gain clarity on post-pandemic behavior, we expect that range of outcomes to narrow. Even if demand in industries such as business travel will be reset at much lower levels than in the past, the reduction in uncertainty itself will help lower the risk premium for value stocks.

3. **Asset Allocators Rebalance into Value**

   Growing confidence could start to pull flows back toward value portfolios. As asset allocators reassess the environment—and their exposures—we expect more fund flows to shift toward value, which should add support for value stocks.

4. **Interest Rates Begin to Normalize**

   As the global economy struggles to regain its footing, central banks are committed to keeping interest rates low. But in late 2020, US Treasury yields began to rise amid hopes that COVID-19 vaccines could support a broader economic recovery.

   Massive fiscal stimulus programs around the world may ultimately fuel higher inflation. And at some point, central banks would be compelled to raise rates in response. An incremental rise in rates would add an important element to the normalization of the value-growth valuation gap by pushing down multiples of growth stocks relative to value stocks.

5. **Potential Regulatory Changes**

   In recent years, the best-performing growth stocks were dominated by the US FAANGs—Facebook, Amazon, Apple, Netflix and Google. Investors have been captivated as the growing dominance of these companies has fueled strong, long-term growth potential, and by the boost they received from increasing digitalization of work, leisure and commerce during COVID-19.

   At the same time, increasing concern about the FAANGs' unchecked power in multiple industries has raised concerns among lawmakers and regulators. In December 2020, the US Federal Trade Commission launched a landmark antitrust lawsuit against Facebook. European Commission regulators are also pressing ahead with efforts to curb Facebook's power, alongside probes of business practices at Amazon and Apple. While it's too soon to say how these or other regulatory moves will conclude, increased regulatory scrutiny in the coming years may have an impact on big tech's business models and earnings potential. If regulators step up these campaigns, earnings and multiples of mega-cap growth stocks could be constrained, and investor sentiment might sour.

WHAT ARE THE RISKS TO RECOVERY?

There are many risks to this five-pronged value-recovery scenario. First, the global economic recovery from the pandemic won't progress in a straight line. Since every country will have a different experience in combatting COVID-19, exit trajectories from the economic crisis will differ accordingly. Variable outcomes will also affect confidence in the long-term outlook.

Second, since the world hasn't experienced a global pandemic of this magnitude for more than a century, it's still difficult to predict how business and consumer behavior will change over the long term. Meanwhile, some sectors, such as energy—which is heavily represented in the value universe—may face structural challenges to recovery that could impede a value renaissance.

Third, interest rates are a wild card. While there are good reasons to believe that interest rates will eventually rise—particularly if inflation surfaces—major central banks are still committed to keeping rates at historical lows for an extended period.

Fourth, regulatory action is always hard to predict. So although a crackdown on growth mega-caps looks inevitable, it's hard to determine how tighter scrutiny might unfold, how long it will take and how investors will react to the new risks.

QUANTIFYING THE PAYOFF POTENTIAL

Nobody can say exactly how these trends will unfold. That said, since the value-recovery scenario we've outlined has five components, there is some room to maneuver—disappointment on one front could be offset by upside surprises on another.

If we assume a return to nominal economic growth of between 3.5% and 4.5% in 2023, the discount of value stocks versus growth stocks can be expected to narrow to between 35% and 28% (*Display 14, page 19*). This calculation is based on our analysis of the value-growth risk-premium gap versus economic growth scenarios as shown on page 13.

Based on consensus forecasts for 2021 and 2022, dividend yield would add 4.8% to the relative performance of value stocks versus growth stocks, although earnings growth would offset most of that benefit. Yet the cumulative impact of the change in multiples as the value discount to growth narrows would power value outperformance of about 45% over the two-year period in the 4% nominal growth scenario (*Display 15, page 19*). Even in a more moderate growth scenario of 3.5%, our research suggests value outperformance could exceed 38%. And if economic growth exceeds expectations and reaches 4.5% a year, value could potentially outperform by more than 52% over the two-year period. Active managers can add benefits for investors by targeting the most promising value-recovery opportunities, while incorporating risk controls to manage volatility through a potentially uneven recovery.

After 10 tough years for value, investors might scoff at such a forecast. But for value investors, the darkest moments for out-of-favor companies often create the most promising opportunities, when share prices are thrown wildly out of sync with unappreciated recovery potential. Today, we believe the uncommon market and macroeconomic conditions created by COVID-19 have given new hope for value stocks to defy the skeptics, deliver results, and reward investors who have higher risk appetites and aren't afraid to think differently.

DISPLAY 14: WHAT'S A REASONABLE EXPECTATION FOR THE PAYOFF?

MSCI World Value vs. MSCI World Growth. Price-to-Forward Earnings Discount* (Percent)

Past performance and current analysis do not guarantee future results. Component forecasts are provided for illustrative purposes only, involve a number of assumptions that may not prove valid and are subject to change without notice. These component forecasts are not intended to estimate the overall performance of any AB-managed portfolio.

* Price to forward earnings spread over the next 12 months (annual).

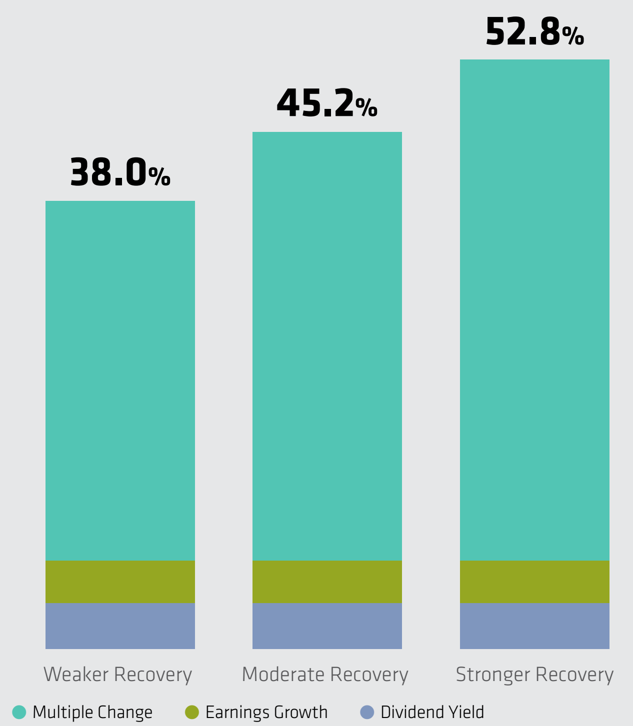
† Valuation discounts at December 31, 2022, are based on the historical relationship between the MSCI World Value and MSCI World Growth price-to-forward earnings multiples and expected 2023 nominal US GDP growth of 3.5%, 4.0% and 4.5%.

As of December 31, 2020

Source: FactSet, MSCI, Thomson Reuters I/B/E/S and AB

DISPLAY 15: WHAT'S A REASONABLE EXPECTATION FOR THE PAYOFF?

Cumulative Total Return Potential in Different Recovery Scenarios: 2021–2022 (Estimated)



Component forecasts are provided for illustrative purposes only, involve a number of assumptions that may not prove valid and are subject to change without notice. These component forecasts are not intended to estimate the overall performance of any AB-managed portfolio.

Dividend yield and earnings growth based on consensus forecast for 2021 and 2022 from FactSet for the MSCI World Value Index vs. the MSCI World Growth Index. Multiple change based on three recovery scenarios, as shown in Display 14.

As of December 31, 2020

Source: FactSet, MSCI and AB

A WORD ABOUT RISK

The value of your investment may go down as well as up, and investors may not get back the full amount they invested.

Market Risk: The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value.

Focused Portfolio Risk: Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since gains or losses from each security will have a greater impact on the portfolio's overall value.

Foreign (Non-US) Risk: Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets.

Derivatives Risk: Investing in 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. Capitalization Size Risk (Small/Mid): Small- and mid-cap stocks are often more volatile than large-cap stocks—smaller companies generally face higher risks due to their limited product lines, markets and financial resources. ESG Risk: Applying ESG and sustainability criteria to the investment process may exclude securities of certain issuers for nonfinancial reasons and, therefore, the Fund may forgo some market opportunities available to funds that do not use ESG or sustainability criteria.

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