



ALLIANCEBERNSTEIN®

Alpha, Beta and Inflation

An Outlook for
Asset Owners

Asset owners face strategic questions at the nexus of three distinct areas: the capital market outlook, changes in asset managers' offerings, and how the policy environment is changing the needs and benchmarks of asset owners. Growing constraints on real return generation, diversification challenges, and a shifting dividing line between alpha and beta point to a need to rethink strategic asset allocation. We'll explore these and other topics in this note.

JULY 2021

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This note addresses key strategic questions for asset owners at the nexus of three distinct areas: the capital market outlook, changes in asset managers' offerings, and how the policy environment is changing the needs and benchmarks of asset owners. Discussing these issues necessarily transcends a classic investment strategy outlook and raises questions about the evolving interaction between asset managers and asset owners, leading to broader questions on the direction of policy and the investing framework.

These topics, as well as how they lead to specific investment solutions, are the focus of AB's new Institutional Solutions team. In the following pages, we outline key strategic issues asset owners face and provide a sample of the types of topics that readers can expect in our upcoming research. Our research will convey our view on the policy path and what that path implies for capital-market and factor returns, focusing on applying those views in the context of asset owners' changing needs.

Several challenges point to a need to rethink strategic asset allocation: greater constraints on the ability to achieve a given level of real return, increased difficulty in achieving diversification and an industry-wide duration problem. At the same time, the dividing line between alpha and beta (which has long been a grey area) has definitively moved—we think that the true definition of alpha must now be idiosyncratic alpha (IA), not simply excess returns. IA is the excess performance of active managers that remains after adjusting for simple, investable and cheaply available factor exposures. IA includes factor-timing and stock-picking decisions, neither of which can be replicated with passive factor exposures. The IA perspective has distinct advantages for asset owners, enabling more efficient fee allocation and enhancing the ability to identify persistent alpha. In a world of lower cross-asset real returns, if some managers are able to generate persistent alpha, it will become a larger share of end-client returns.

This landscape suggests an evolution of the interaction between asset owners and asset managers, and a greater desire on the part of asset owners to engage with asset managers who think about partitioning returns in this way—and who have the tools to do so. It also prompts profound questions on the nature of strategic asset allocation, a topic we cover in a later section. We will address these topics in more detail in upcoming research.

Inflation: The Burning Question

The prognosis for inflation is probably the greatest macro issue facing investors today. Much of the commentary on this topic focuses on the tactical inflation outlook in the reopening trade, but also emerging is the first plausible narrative in at least a decade for higher long-term inflation. At its core is the idea that the policy environment may have changed: both the monetary policy response to signs of inflation and fiscal policy.

One reason that this shift will likely have a significant impact is that most investors have not had to run their portfolios in a period when inflation is generally rising rather than falling. The task is complicated by the need to navigate an environment in which near-term inflation numbers are very high and could move higher still, while the medium-term prognosis is not as high. We think that inflation will likely end up above the pre-pandemic level but will not become unanchored. The distinction between inflation that is only moderately above pre-pandemic levels and inflation that is sharply higher is key for the risk-asset outlook.

Our view rests on the notion that deflationary as well as inflationary forces are at work. We analyzed this topic in much more detail in our recent black book [Inflation and the Shape of Portfolios](#), so we won't revisit the argument in depth here. But we can summarize the key pillars of our view.

Once the reopening trade has run its course, we expect strong deflationary forces:

- Persistent slack in the labor market, implying that wages will not lead inflation higher
- The influence of technology and automation, which have been deflationary for years and remain so

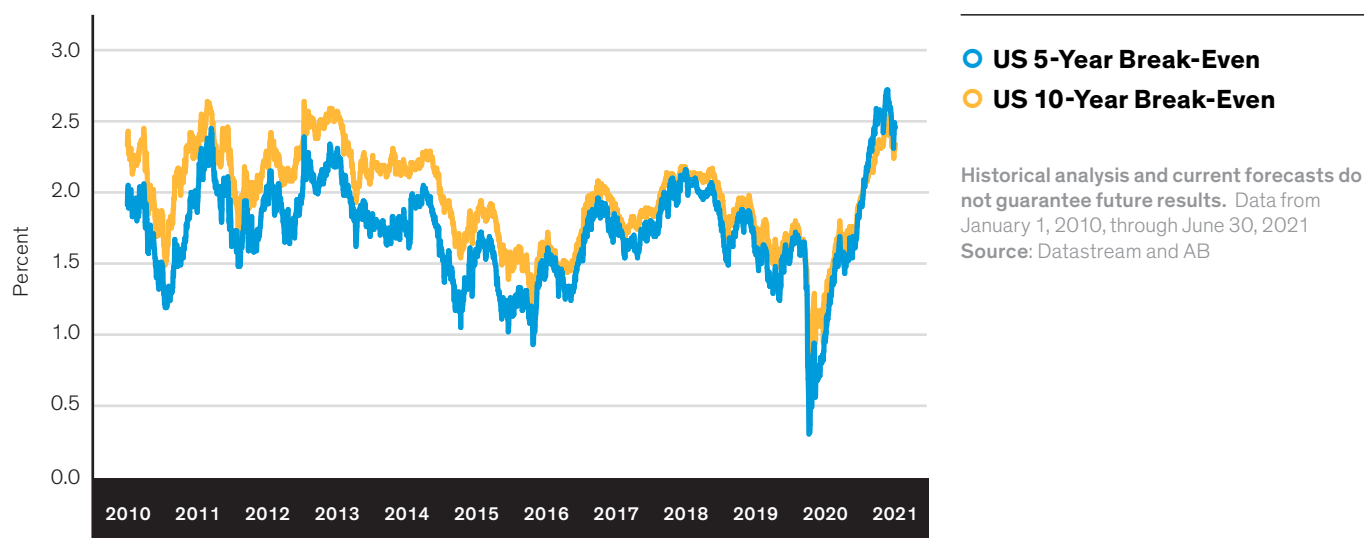
- The possible realization by consumers, once the reopening spending wave is over, that the nominal return on their savings is declining while inflation is rising, implying that they need to save more, which will lower the long-term velocity of money
- The risk of zombie companies in the wake of the pandemic, not least because it may be politically hard to let companies go bankrupt in large numbers

However, set against those deflationary forces are strong inflationary forces:

- With debt/GDP at its highest level since WWII, governments will prefer inflation in order to keep debt under control (we assume that it will be very hard to grow out of debt, and austerity does not seem politically feasible).
- Politicians are able to use fiscal policy proactively in a way that they could not pre-pandemic. This can take the form of fiscal spending plans (such as green infrastructure) but politicians may also resort to more cash handouts to individuals to counter future downturns or address the starkly wider inequality in society.
- A growing emphasis on environmental, social and governance (ESG) considerations may be inflationary, which can take a variety of forms: consumers being willing to pay more for "ESG-friendly" products; reduced investment in upstream extraction industries; or pushback against the gig economy, which could boost wages.
- The global supply of labor is shrinking, which hints at the possibility of wage inflation taking root "naturally," but we think that the policy backlash against the gig economy could happen more quickly.

DISPLAY 1: NEAR-TERM INFLATION MEASURES ARE HIGHER THAN LONGER-TERM MEASURES

Five- and 10-Year Forward Break-Even Inflation Rates



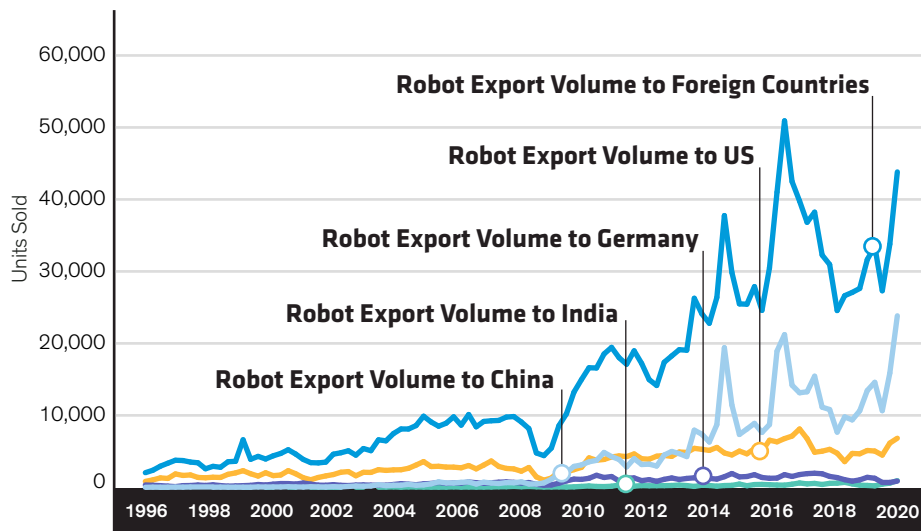
Taking all this together implies that inflation can rise but that policy might be needed to help sustain it proactively, not move to curtail it. Near-term inflation measures are higher than longer-term measures (*Display 1*), consistent with a transitory blip in inflation, while real yields remain low.

We detail the outlook for wages and the labor market, which are at the core of this strategic inflation outlook, in [Portfolio Strategy: Wages, Labour shortages and the outlook for inflation](#).

If declining inflation over the past 40 years was due to the confluence of Chinese and former Soviet workers joining the global labor force, baby boomers joining the labor force, and a growing participation rate among women, it's fair to say that the first three forces are reversing and the last has mostly happened. This hints at possible increases in labor bargaining power and wage inflation, which would imply a different outlook of rising inflation and a steepening yield curve in order to offset those forces.

DISPLAY 2: RISING ROBOT SALES SIGNAL THAT THE PANDEMIC HAS BROUGHT FORWARD AUTOMATION INVESTMENT

Volume of Robot Exports from Japan



Historical analysis and current forecasts do not guarantee future results.

Data from January 1, 1996, through June 30, 2021 | Source: Bloomberg, Ministry of Finance Japan and AB

However, set against these inflationary forces is the force of automation. We suspect that the social distancing requirements of the pandemic have accelerated job losses that would have occurred anyway over the next decade. It is hard to see this change directly in data yet, given the various wage-support schemes still in place, but there has been a material increase in robot sales (*Display 2*). Therefore, we do not yet see signs that recent increases in wages are anything other than narrow in scope and short in duration.



Global Equities: Inflation-Resistant, Though Valuations Are Stretched

Higher inflation poses a challenge for investors—a consistent theme in the topics covered here. We also think that nominal capital-market returns will be lower over the next decade than in the past 10 years, given the decades-long decline in yields.

As a result, investors on average will likely seek to increase real asset allocations, and public equities are the largest such pool. But there are several constraints on equity potential, creating a tension that informs our market outlook. The key to a rising allocation is the view that inflation will find an equilibrium that is moderately higher but not in an unanchored way, as it was in the 1970s.

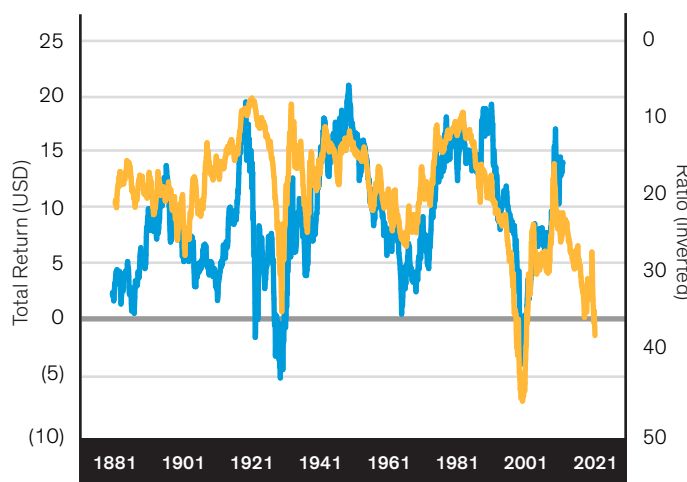
In our view, valuations are probably the key impediment for equities: valuations are at the top end of the 140-year range, as measured

by the Shiller price/earnings, ratio (*Display 3*). While this measure is no help in determining the year-forward outlook, it is one of the best indicators that we have over longer horizons (such as 10 years). Based on its past relationship with forward returns, the current P/E for US equities of 37× implies a zero real return over the next 10 years.

However, that is likely too harsh a view. As we outlined earlier, there is a case to be made that real yields may not rise as they have in previous cycles. This case has a material impact on the fair value of equities, especially in a moderately higher inflation regime. In *Display 4*, we show a measure of the equity risk premium (again, based on cyclically adjusted earnings), which implies mid single-digit returns.

DISPLAY 3: EQUITY VALUATIONS ARE EXTENDED

Shiller Price/Earnings Ratio and 10-Year Forward Returns



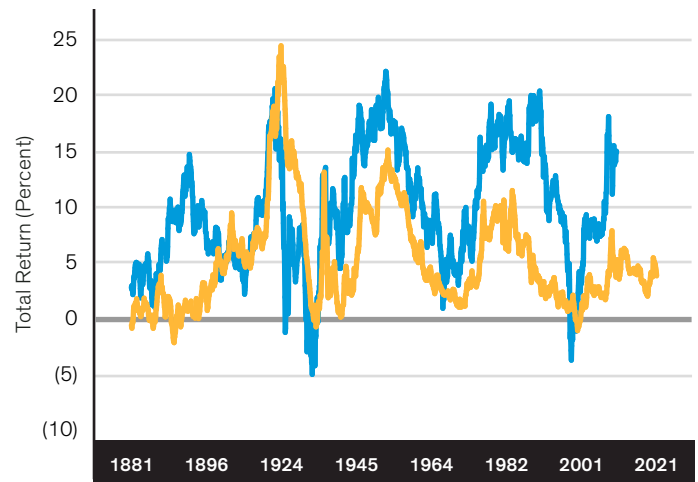
● 10-year forward equity total return (annualized) ● US Shiller CAPE* (RHS, inverted)

Historical analysis and current forecasts do not guarantee future results.

* Cyclically adjusted price-to-earnings. Shiller P/E defined as price divided by 10-year average inflation-adjusted earnings. Data from January 1, 1881, through June 30, 2021 | **Source:** Global Financial Data, Robert Shiller's database and AB

DISPLAY 4: EQUITY RISK PREMIUM SUGGESTS MODEST RETURNS

Cyclically Adjusted Equity Risk Premium and Forward Excess Returns



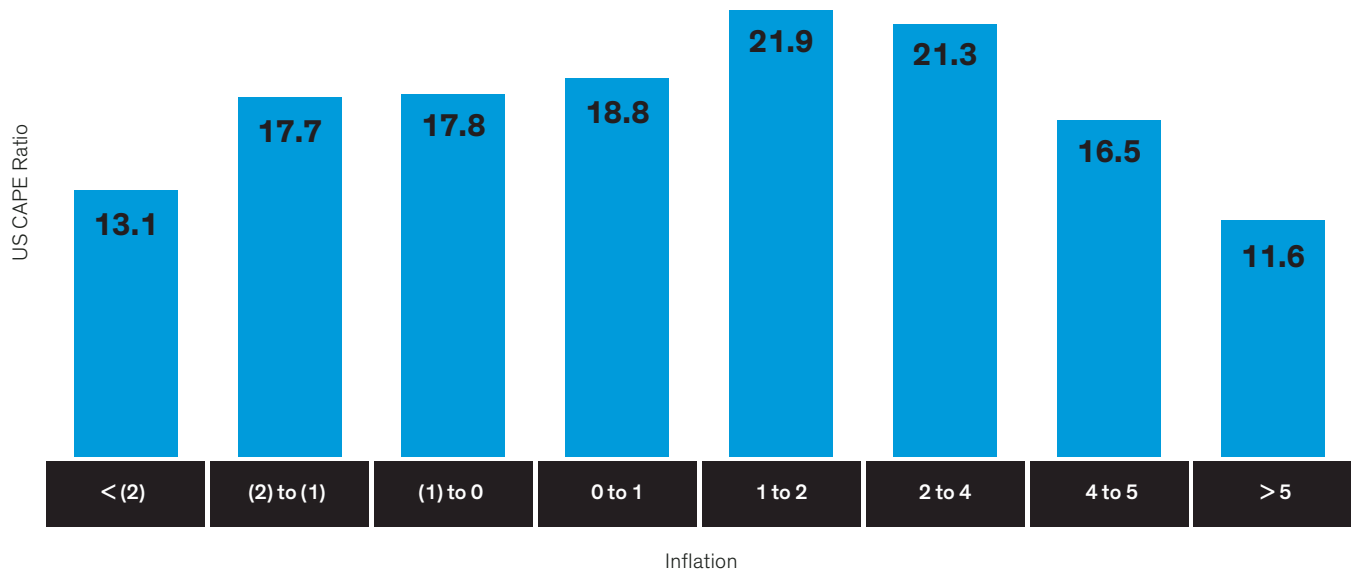
● 10-year forward equity total return (annualized) ● US Shiller Equity Risk Premium

Historical analysis and current forecasts do not guarantee future results.

Risk premium defined as cyclically adjusted (i.e., 10-year average inflation-adjusted) earnings yields minus real yields on government bonds. Data from January 1, 1881, through June 30, 2021 | **Source:** Global Financial Data, Robert Shiller's database and AB

DISPLAY 5: MODERATELY HIGH INFLATION HAS SUPPORTED EQUITY MULTIPLES

Cyclically Adjusted Price-Earnings Ratio of US Equities by Inflation Regime



Historical analysis and current forecasts do not guarantee future results.

As of February 28, 2021 | Source: Datastream, Global Financial Data, Robert Shiller's database and AB

The equilibrium level of inflation is key here, given the pronounced nonlinear relationship between valuation and inflation level. Deflation and very high levels of inflation are detrimental to equity valuations. Perhaps it is no surprise that the 2% inflation level traditionally targeted by central bankers is the level that has tended to maximize P/E multiples (*Display 5*). However, inflation outcomes in the 2%–4% range have also tended to be benign for multiples (as long as any inflation movement does not happen too quickly). In this context, the narrative of both deflationary and inflationary forces—but with a policy tendency to favor moderately high inflation—supports equity multiples.

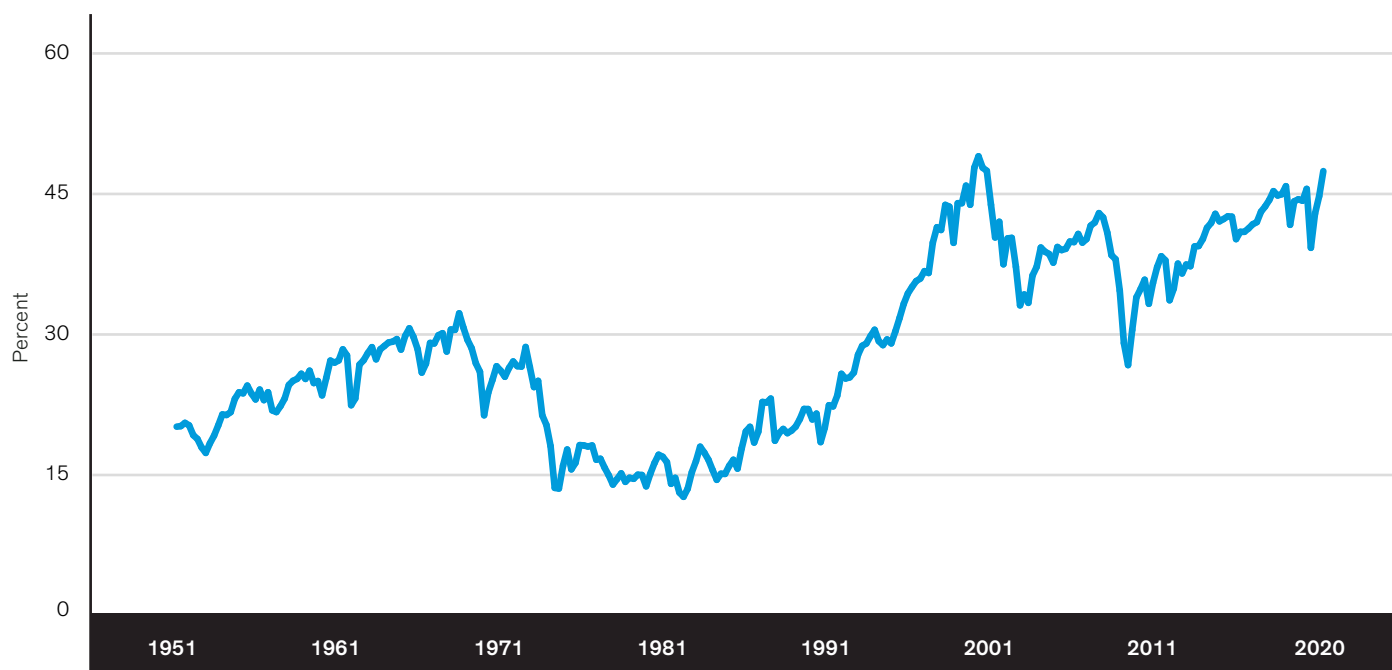
One argument that supports the equity outlook is that “there is no alternative” (TINA), an argument that should be met with caution. After all, it represents a statement of hope (or maybe desperation!) rather than a normative force.

US household equity allocations (including direct and indirect holdings via pensions) are at the top end of their 70-year range (*Display 6*). If we were in a normal mean-reverting environment, the juxtaposition of record-high multiples and equity allocations would imply a bearish outcome for the market, but now we are not so sure.

An outlook of moderately higher inflation and low real yields (in other words, slightly rising nominal yields) begs the question: Why aren't equity allocations even higher? In this context, we think that there's room for equity allocations to grow further and exceed their range of the past 70 years. Implicit in this view is the bigger concept: to avoid the risk of failing to preserve purchasing power, risk (in the volatility sense) might need to increase. We discuss this in more detail in our black book [Are We Human or Are We Dancer?](#)

DISPLAY 6: US EQUITY ALLOCATIONS ARE NEAR HISTORICAL HIGHS

US Household Total Equity Share of Total Financial Assets, Including Pension Assets



Historical analysis and current forecasts do not guarantee future results. Chart shows the portion of US household and nonprofit sector total financial assets allocated to equities. Equities is defined here as directly held corporate equities + mutual fund shares (includes exchange-traded funds) + the equity portion of public and private pension fund assets. The data are quarterly. The latest data point is 3Q:2020.

Data from January 1, 1951, through September 30, 2020 | Source: FRED and AB

Another way we can determine a strategic equity outlook is to decompose the various sources of return for shareholders:

$$\text{Real equity return} = \text{dividend yield} + \text{buyback yield} + \text{real GDP per capita} + \text{population growth} + \text{change in profit share of GDP} + \text{multiple expansion/contraction}$$

In this construct, we've folded margin expansion/contraction into the broader measure of GDP profit share. We see the pressures on both as related, as they are linked to the policy outlook.

Let's assume—for the purposes of argument—that the multiple and margin remain constant, which also depends on the prognosis for share buybacks. For the past 10 years, corporations have been by far the biggest buyers of equities, far outstripping investors, as the environment has encouraged levering up corporate balance sheets and issuing debt to buy back shares. We see limits to how long this can be maintained, given the growing chorus that buybacks lead to greater inequality and constitute a governance failure. The complaint is that corporate management teams are measured on too short a horizon, leading to lower capex and greater debt issuance to complete buybacks.

Again, in our base case, let's assume that the future is like the recent past in terms of buybacks. The key inputs are: the United Nations population growth projection for the US is 0.6% per year; achieved real GDP per capita average growth over the last 30 years has been 1.5% annualized (long-run consensus forecasts have tended to be in a similar range); the US dividend yield is 1.5%; and the 10-year average net buyback yield (buybacks minus issuance as a percentage of market capitalization) has been 1.5%, although only 0.3% in the last 12 months of pandemic-influenced markets.

With no change in the multiple or profit share, the decomposition of returns simplifies to:

$$\text{Real equity return} = \text{dividend yield} + \text{buyback yield} + \text{real GDP growth per capita} + \text{population growth}$$

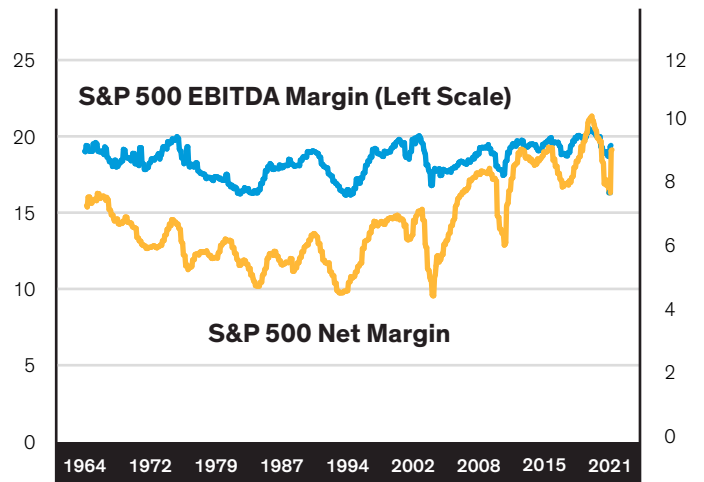
So, what does this imply in terms of real return? Plugging numbers into the above equation, we get: $\text{real return} = 1.8\% + 1.5\% + 1.5\% + 0.6\% = 5.4\%$. Adding back 2% annualized inflation over the forecasting horizon leaves us with a 7.4% annualized nominal return.



In a less benign aspect of the policy environment, we expect corporate margins to decline for several reasons. For one thing, a swing of the pendulum toward labor and away from shareholders seems highly likely in the wake of the pandemic. Put another way, a macro interpretation of ESG implies more labor bargaining power. On top of this driver, one of our highest-conviction forecasts is that taxes will rise globally, implying that pre- and post-tax corporate margins (*Display 7*) will decline from their highs of recent years.

DISPLAY 7: WE EXPECT MARGINS TO FALL FROM RECENT HEIGHTS

US Pre- and Post-Tax Corporate Margins (Percent)



Historical analysis and current forecasts do not guarantee future results.

Data from January 1, 1964, through June 30, 2021 | Source: FactSet, S&P and AB

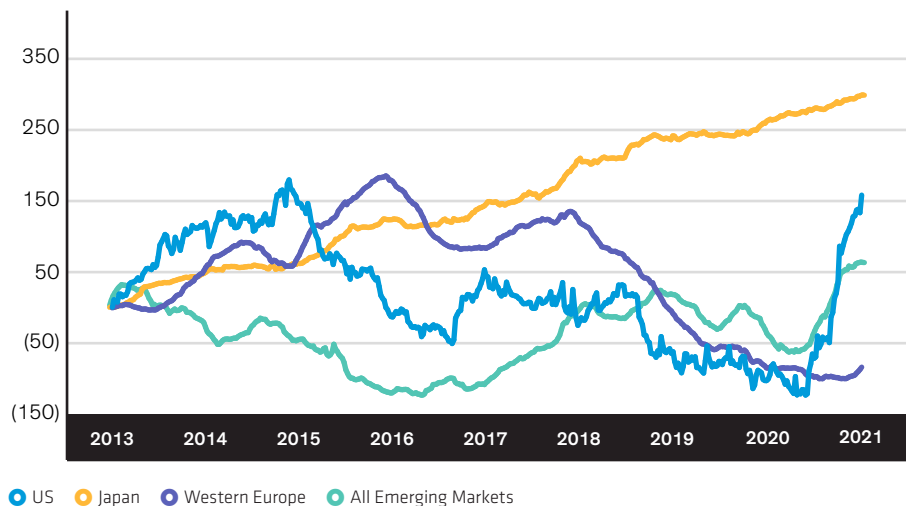
So, after a strong run of equity returns in favor of the US, should investors consider rebalancing across regions?

Tactically, perhaps, but not over a strategic horizon. The most striking difference among recent regional equity flows has been the record recovery of US-bound flows and the stark lack of interest in Europe (*Display 8*). Does this suggest that investors should be contrarian and start to overweight non-US equities? That may be a possibility for those who wish to be very tactical; but over any strategic horizon, we don't think that it makes sense.

In *Display 9*, we show that large shifts in relative equity returns of the US and Europe are determined by relative growth—not valuation multiples. And an environment in which the US seems willing and able to continue offering fiscal and monetary support is a key in suggesting that US leadership can continue. Moreover, small to midsize enterprises make up 10 percentage points more of the European economy than the US economy, and these businesses will presumably have taken a heavy blow during the pandemic, the extent of which is still unknown.

DISPLAY 8: THE RECENT DISCONNECT IN FLOWS BETWEEN THE US AND EUROPE HAS BEEN STARK

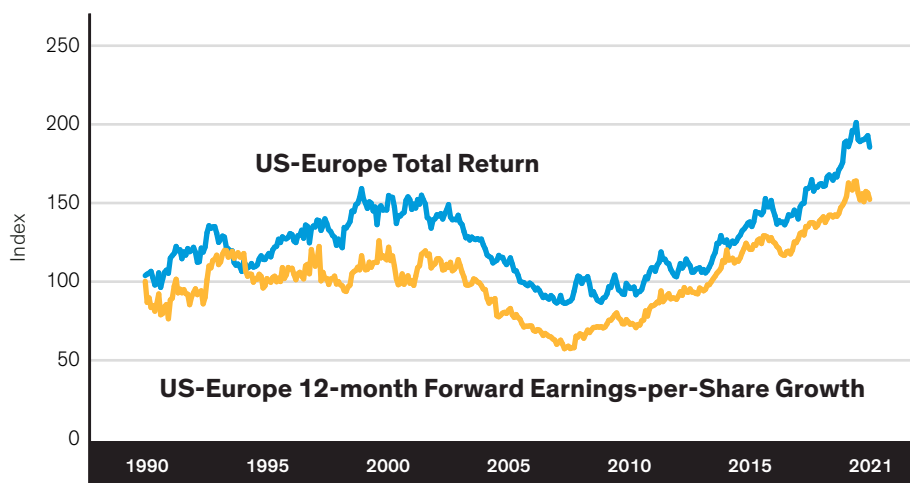
Cumulative Regional Equity Fund Flows



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 2013, through June 30, 2021 | Source: Emerging Portfolio Fund Research Global and AB

DISPLAY 9: FOR EUROPEAN EQUITIES TO OUTPERFORM REQUIRES EUROPEAN CORPORATES TO GROW EARNINGS FASTER THAN US CORPORATES

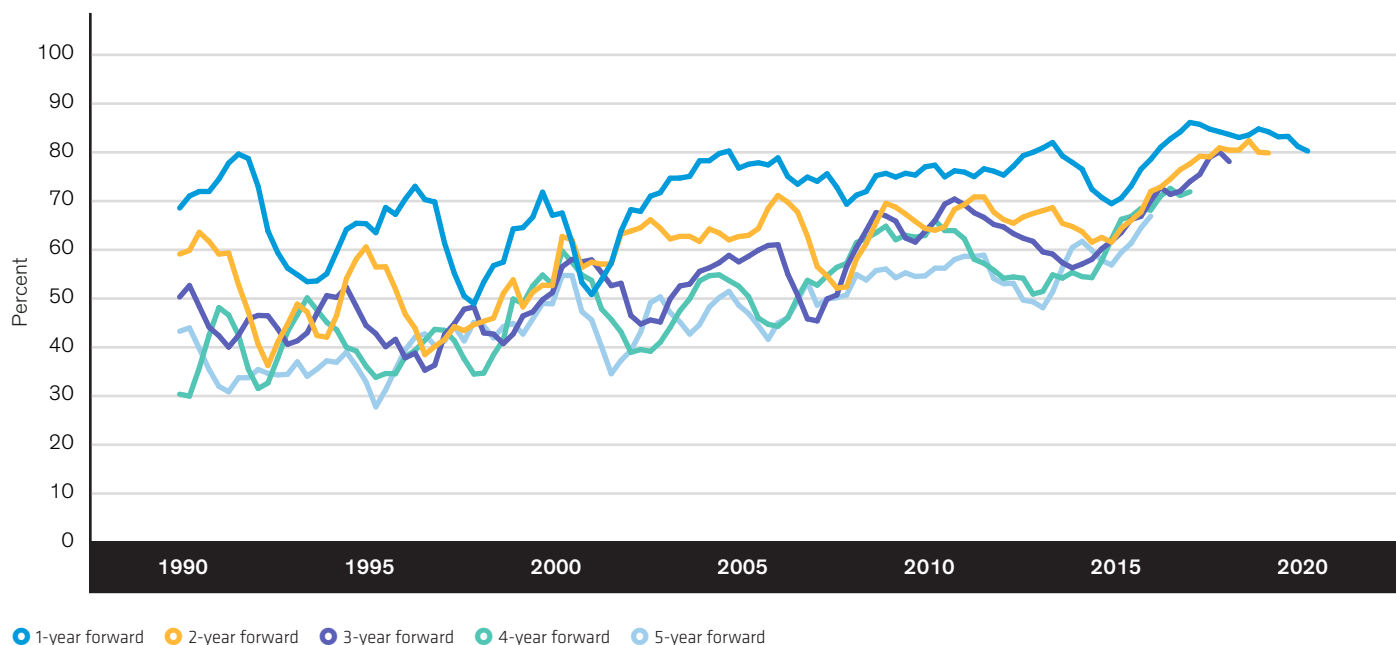
US and European Relative Total Returns and Earnings-per-Share Growth



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 1990, through March 31, 2021 | Source: Datastream, S&P and AB

DISPLAY 10: HIGH-PROFITABILITY US COMPANIES ARE STAYING THAT WAY FOR LONGER

Percentage of High-Return-on-Equity Decile US Stocks That Remain in the Top Two Deciles 1–5 Years Later



Historical analysis and current forecasts do not guarantee future results. In each quarter since 1990, we split the stocks in the MSCI USA Index into groups by ROE deciles (within sectors) and calculated the percentage of stocks in the high ROE decile at a specific point in time in the highest two deciles over the next 1–5 years. A four-quarter smoothing is applied to the quarterly percentages.

Data from January 1, 1990, through March 31, 2021 | Source: FactSet, MSCI and AB

Should a positive prognosis on the value factor (which we'll detail in the next section) indicate an overweight position in Europe? We think not, and our view is that the factor call can be separated from the regional call. Also, an environment of low real yields in tandem with the observation that high-profitability US companies have maintained their superior growth for longer (*Display 10*) implies that elevated multiples on some high-growth US companies can be justified.

We provide more detail on our global equity market outlook in [Portfolio Strategy: S&P 4000 or S&P 8000?](#) [Our strategists disagree](#) and [Portfolio Strategy: Oops—I hit my 10-year price target with 8½ years to go... what do I do now?](#), as well as [A Cross-Asset View of Equities](#).

The Great Debate over the Value Factor

As we see it, factors will play a permanently larger role in strategic asset allocation. Yes, there is a huge debate about risk premiums: Can they persist, or are they necessarily transitory? What is their capacity? Should factors be long-only or long/short? We will address these questions in future research. Here, we will focus on the one factor that is probably spurring the most debate right now: value. There is a massive tactical debate about whether the value rally of early 2021 can last. We think that it can, but the question we tackle in this note is a strategic one, and we see a strategic case to hold value exposure in the medium term.

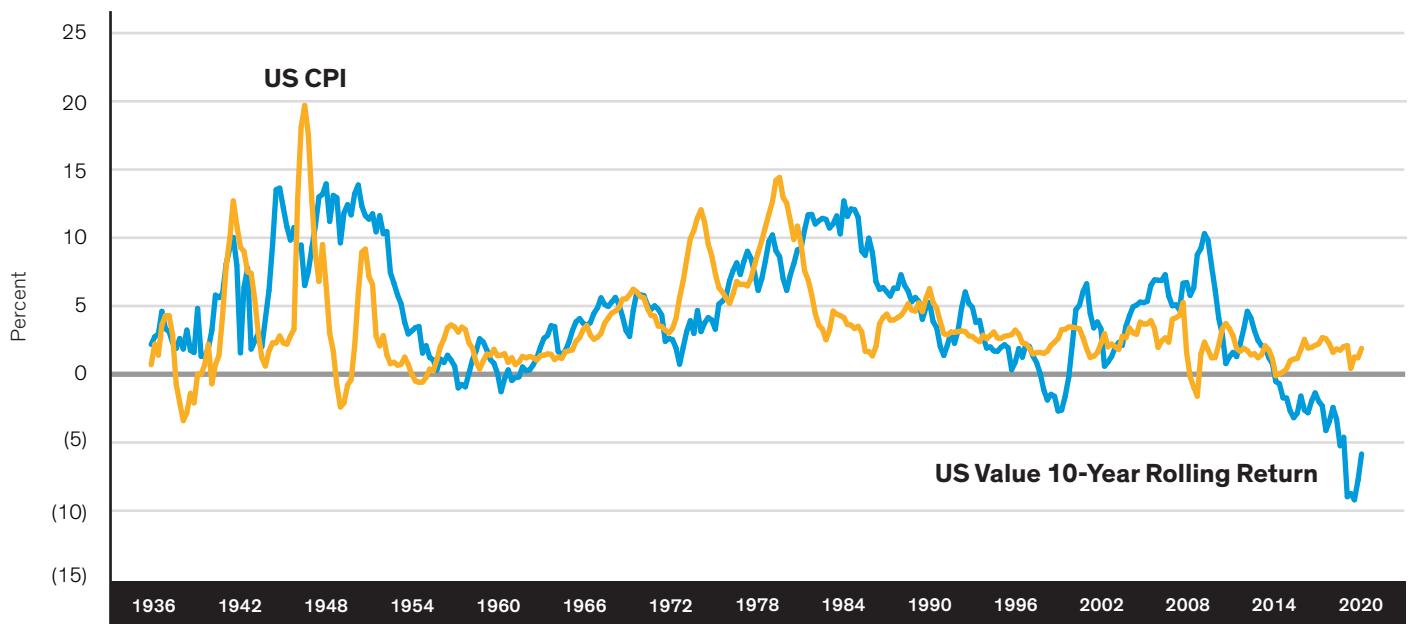
Value has been hindered during the past decade by structural challenges: Progressively lower yields benefited long-duration

assets and those with growing cash flows forecast far into the future, whereas value is a short-duration asset. Technology destroyed moats around some industries, which impeded mean reversion. The higher proportion of intangible assets in value has raised questions about the appropriate metrics. And the rotation continues into passive funds, which have been inherently pro-momentum.

These challenges have not gone away, but we think that if we enter a longer-run regime of higher inflation, a key impediment to value success is removed and the trade can persist. There is an established and strong long-run positive link between inflation and value performance (*Display 11*), so structurally higher inflation could provide a crucial long-term support pillar for the value factor.

DISPLAY 11: 90 YEARS OF INFLATION AND VALUE—IS INFLATION ALL THAT WAS MISSING?

US Consumer Price Inflation and US Value Returns



Historical analysis and current forecasts do not guarantee future results. 10-year regression of year-on-year (YoY) banks, relative performance on YoY CPI change and YoY yield-curve change (monthly frequency data).

Data from January 1, 1936, through June 30, 2020 | Source: Datastream, Ken French Data Library and AB

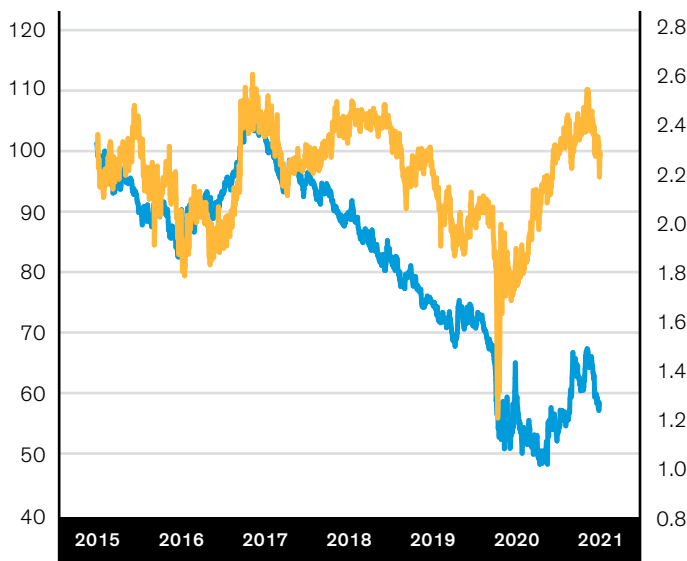
Highlighting another important connection, *Displays 12 and 13* show a close link between inflation expectations and value performance using daily data over the past five years. The link has been exceptionally close in Europe. In the US, where the dominance of growth stocks has been more pronounced, the fit has likewise been less pronounced but still significant at turning points.

Valuations are another possible strategic support for the value factor. From an asset-owner perspective and from a strictly cross-asset view, a major challenge is that nearly all assets are expensive compared with history: equities, sovereign bonds, credit and private equity. At the same time, valuation spreads across the market are, by some measures, at extremes. If asset classes and factors are, in a

sense, interchangeable as long-term return sources, value looks like one of the very few cheap “assets” that investors can buy.

The challenge for investors in making a strategic allocation to value will be unstitching the direct impact of inflation, as opposed to the indirect impact via the usual policy response to inflation. Evidence suggests that the core of the value factor in nonfinancial sectors, such as commodity and industrial equities, has a direct link to inflation. However, banks tend to be relatively more responsive to a steepening yield curve. So, if there is less curve steepening in this cycle, it would suggest a more prudent strategic allocation to the value factor. We discuss this topic in more detail in [Portfolio Strategy: Strategic outlook for factors, and why they are needed in portfolios](#).

DISPLAY 12: VALUE AND US INFLATION EXPECTATIONS

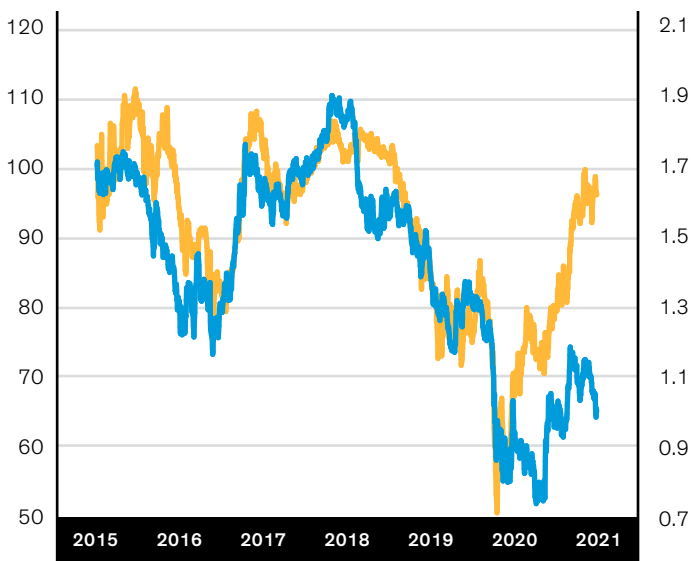


● US LS Value (Left Scale) ● US 5y5y

Historical analysis and current forecasts do not guarantee future results. Chart shows the daily performance of cheap price-to-book stocks relative to expensive price-to-book stocks vs. the regional 5y5y inflation swap.

Data from January 1, 2015, through July 13, 2021 | Source: Bloomberg, MSCI and AB

DISPLAY 13: VALUE AND EUROPEAN INFLATION EXPECTATIONS



● Europe LS Value (Left Scale) ● Europe 5y5y

Historical analysis and current forecasts do not guarantee future results. Chart shows the daily performance of cheap price-to-book stocks relative to expensive price-to-book stocks vs. the regional 5y5y inflation swap.

Data from January 1, 2015, through July 13, 2021 | Source: Bloomberg, MSCI and AB



Isolating Idiosyncratic Alpha

Our Alphalytics platform and database center distinguishes idiosyncratic data, helping asset owners to identify managers and active strategies that add true value over passive, therefore justifying an active management fee (please see [Alphalytics: Tearing up the rules on active management](#) and [Alphalytics: Is there “true” alpha in fixed income?](#)).

IA is the alpha that is left over after adjusting for simple, investable and cheaply available factor exposures. We estimate IA via a two-stage linear regression of active fund returns against appropriate factors. As an extension of this approach, we also use quadratic factors to separate timing-derived IA from stock-picking IA—two separate and important sources of manager skill, both of which deserve to be rewarded because they can't be replicated by holding a static combination of passive-factor exchange-traded funds.

Our research has shown that IA is considerably more persistent over time than past performance and is more predictive of a strategy's

future excess return. Crucially, maximizing IA and IA diversification at the overall portfolio-of-funds level also results in higher expected excess return, so IA should be a key area of focus in manager selection and portfolio construction.

Our Alphalytics platform's interactive, web-based interface enables asset owners to quickly and easily access IA data and rankings for thousands of equity and fixed-income products globally, identifying the most highly skilled managers who best suit their needs, monitoring their existing holdings (and analyzing any custom return stream in complete confidence), performing factor-based return attribution, and building effective portfolios of strategies.

We are constantly refining Alphalytics, and we look forward to sharing the tool with more clients and working with them on manager research and selection, portfolio construction, and creating tailored investment solutions.

Who Is Really Generating Alpha?

With the sizable database of active strategies that we have created as part of the Alphalytics effort, we can track the performance and IA of different managers over time, see what is working, and explore relationships between alpha generation and characteristics such as manager/portfolio attributes and aspects of market structure and environment.

This analysis generates insights into which managers/strategies are most likely to deliver value that can't be replicated, as well as which environments may be more or less favorable for alpha generation—and thus for allocating capital to active managers. We're exploring many topics using Alphalytics, including the age-old active/passive debate and the impact of attributes such as styles, investment approaches, fund size and concentration.

In the following sections, we focus on a few topics, and we will explore more of them in future research.

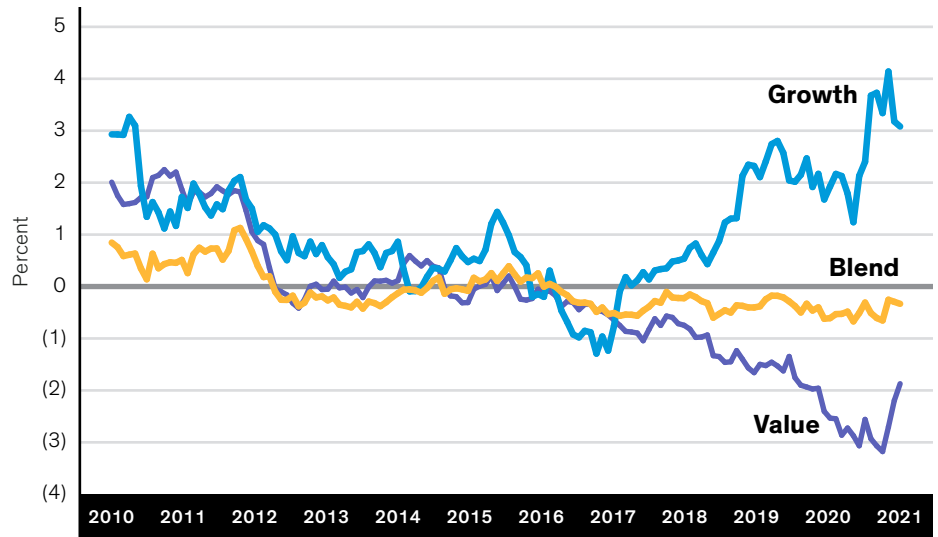
Changing Fortunes for Value and Quant?

Our data suggest that active, as a whole, has posted a very strong 12 months, at least in the US. In fact, we have seen the highest outperformance from active in at least a decade, with active beating passive and smart-beta products by 2% so far in 2021. The outperformance versus benchmarks would generally be even higher, given that we are comparing active with passive *and* smart-beta products. In other words, we're including products that provide exposures to factor premiums, not just the equity market, thus creating a higher hurdle.

Within active, we are seeing important changes in entrenched trends. One trend that may be reversing is the alpha generation dichotomy between growth and value managers. This dichotomy has been extreme since around 2016, with value managers suffering and growth managers outperforming in terms of both excess and idiosyncratic returns. The dichotomy has been present, if less starkly, for the past decade (*Displays 14 and 15*).

DISPLAY 14: THE GROWTH/VALUE DIVIDE

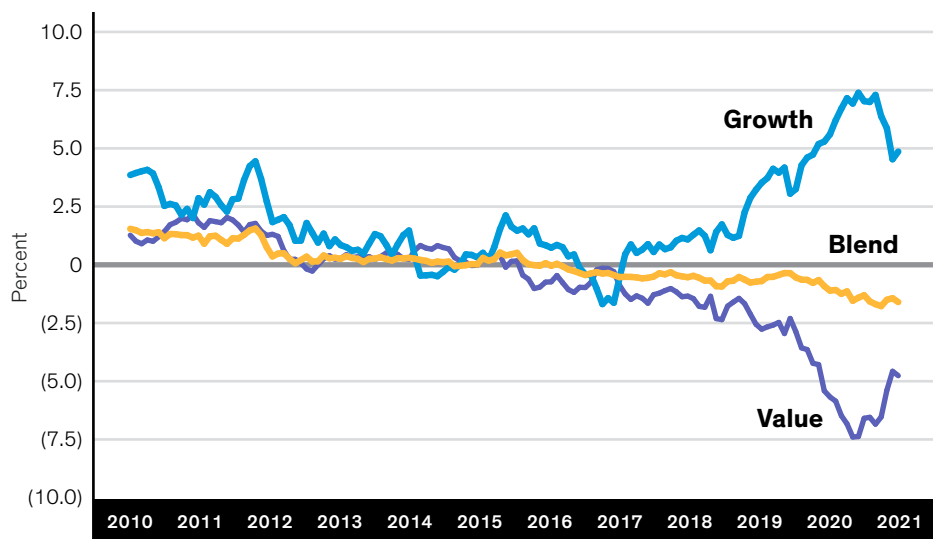
Idiosyncratic Alpha by US Manager Style Tilt: Three-Year Rolling Total



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 2010, through April 30, 2021 | Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 15: THE GROWTH/VALUE DIVIDE

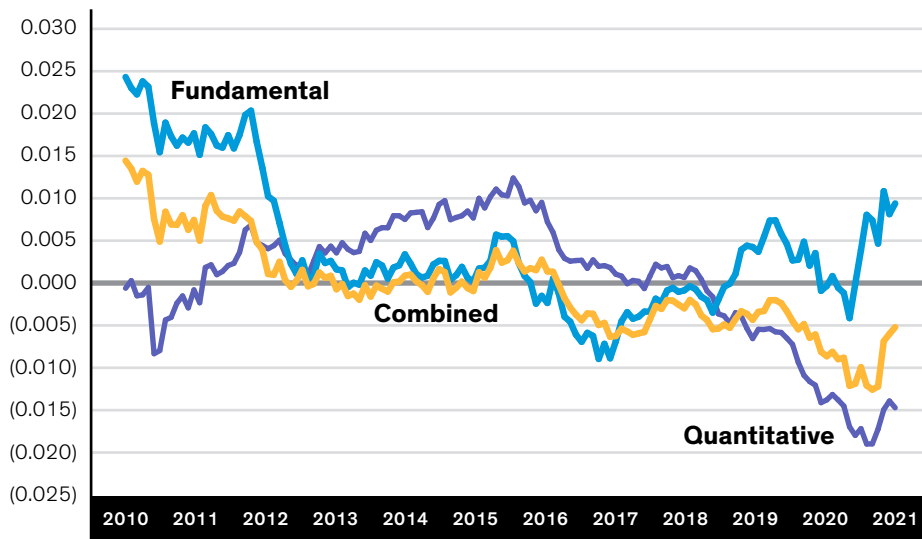
Idiosyncratic Alpha by US Manager Style Tilt: Three-Year Rolling Excess Return



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 2010, through April 30, 2021 | Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 16: BETTER TIMES AHEAD FOR QUANT MANAGERS?

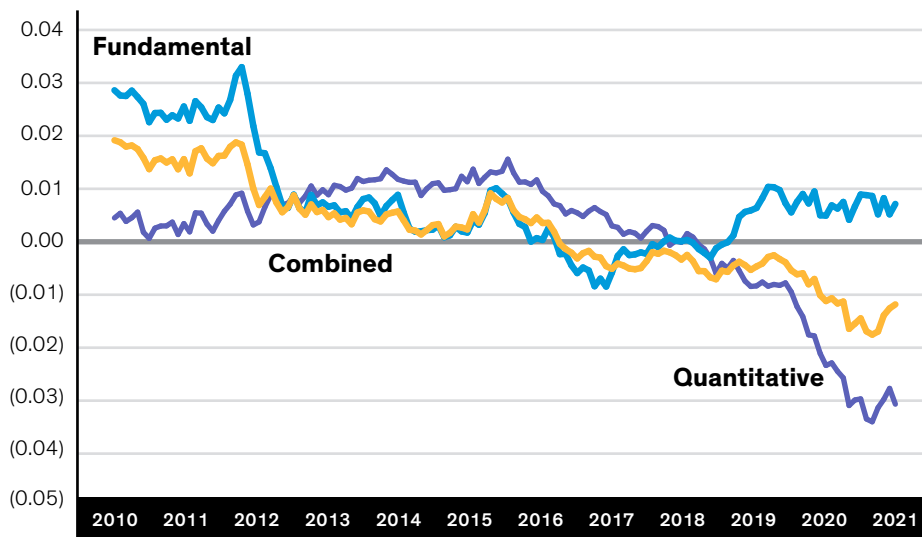
Three-Year Rolling Idiosyncratic Alpha by Investment Process (US Sample): Total



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 2010, through April 30, 2021 | Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 17: BETTER TIMES AHEAD FOR QUANT MANAGERS?

Three-Year Rolling Idiosyncratic Alpha by Investment Process (US Sample): Excess Return



Historical analysis and current forecasts do not guarantee future results. Data from January 1, 2010, through April 30, 2021 | Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

With the value factor outperforming considerably this year (in the US, at least) and with growth underperforming, growth strategies' long winning streak may be ending. Value managers have beaten their benchmarks by 7% year to date in the US and by 4.2% globally; growth managers are down nearly 5% in the US and 2.4% globally (All numbers through April 30, 2021). In terms of "true" alpha, or IA, we are also seeing a tentative turn. Of course, as we discussed in the value factor section, the value rebound is related to the environment of a cyclical recovery and rising inflation expectations, and we think that the value trade can sustain support over both tactical and strategic horizons. This suggests, at long last, better prospects for value managers.

Related to value's changing prospects is a tentative upturn in the fortunes of quantitative/systematic strategies, which have also struggled in recent years (*Displays 16 and 17*). US and global quant managers are ahead of their benchmarks by 2.7% and 1%, respectively, compared with a more modest 0.5% and 0.4% outperformance for fundamental managers (All numbers through April 30, 2021). The environment of lower stock correlations, the declining skew of returns toward growth mega-caps and the recovery in the value factor have also helped these investment processes, which have traditionally relied on diversification across both positions and styles in their alpha-generation processes.

While the trends are tentative, we do think that the current market structure may indicate better prospects for value and quant products than we have seen in a while and it gives us reasons to be optimistic about the prospects for active managers more generally.

Is there Alpha in ESG?

Another area we've explored with the Alphalytcs dataset is whether alpha is present in ESG. The ESG banner encompasses a huge variety of approaches, including funds where ESG is the core ethos and funds where ESG is merely considered alongside other factors. The banner also includes funds that use ESG metrics to screen and those that actually integrate ESG and engage with underlying companies.

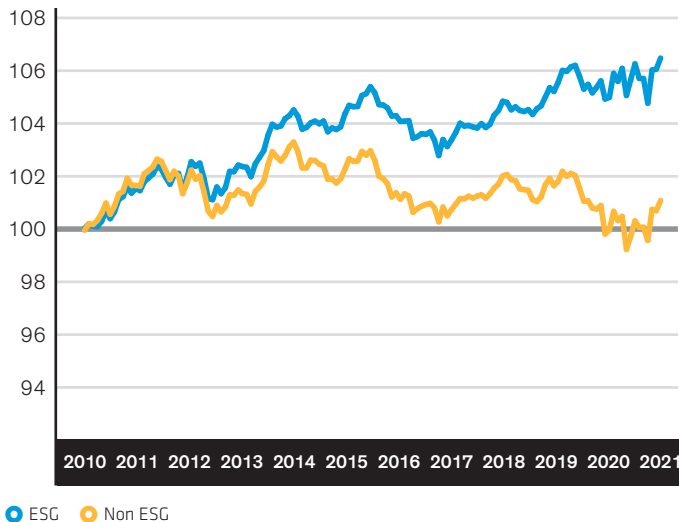
Using large samples of strategies from both eVestment and Morningstar, our research indicates that products with a positive ESG tag have outperformed "non-ESG" peers over the past 10 years, within our US manager samples, by 5.47% (versus benchmarks). We've also found that the alpha "survives" after we adjust it for differences in factor exposures—and that our sample of US ESG strategies has generated higher IA since 2010 (*Displays 18 and 19*).

The question of ESG as a source of alpha remains hotly debated, with a huge number of studies both supporting and refuting ESG as an alpha source. The divergences between the ESG criteria used and their measurement is still a key problem, which may mean that reaching definitive conclusions will likely remain difficult. Still, these results suggest some robustness (to key factor betas) to ESG outperformance, which we will explore further in future research.

In the meantime, flows into ESG products continue at an astonishing pace, and the spread between ESG and non-ESG in terms of performance has recently hit an all-time high. The three-year active return spread between ESG and non-ESG strategies widened to 1.23% annualized in 1Q 2021—the widest spread in a decade. We also see that ESG stocks have become expensive in the European Union and that a valuation premium has started to emerge in the US.

DISPLAY 18: IS THERE ALPHA IN ESG?

Monthly Excess Return Indexed: ESG vs. Non-ESG Portfolios (US)



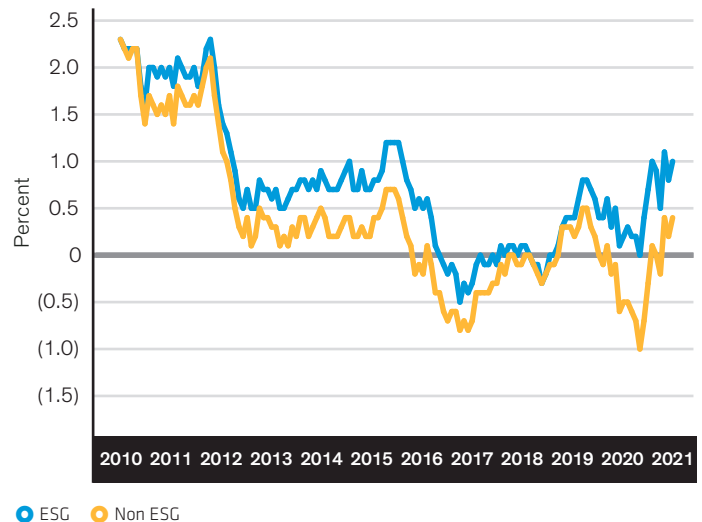
● ESG ● Non ESG

Historical analysis and current forecasts do not guarantee future results.

Data from January 1, 2010, through April 30, 2021 | Source: eVestment, Factset, Morningstar, MSCI, S&P and AB

DISPLAY 19: IS THERE ALPHA IN ESG?

Three-Year Rolling Total IA: ESG vs. Non-ESG Portfolios (US)



● ESG ● Non ESG

Historical analysis and current forecasts do not guarantee future results.

Data from January 1, 2010, through April 30, 2021 | Source: eVestment, Factset, Morningstar, MSCI, S&P and AB

DISPLAY 20: WORST-SCORING ESG STOCKS HAVE DERATED VS. THE MARKET; BEST-SCORING HAVE RERATED

Valuation of Best and Worst ESG Quintiles (z score)

				Europe			
z score of relative 12m fwd P/E	Environment score	Environment improvers	ESG score	z score of relative P/B	Environment score	Environment improvers	ESG score
Best quintile	1.38	0.32	(0.87)	Best quintile	1.84	0.25	1.73
Worst quintile	(1.61)	(1.70)	(1.24)	Worst quintile	(2.53)	(2.35)	(3.11)

				US			
z score of relative 12m fwd P/E	Environment score	Environment improvers	ESG score	z score of relative P/B	Environment score	Environment improvers	ESG score
Best quintile	0.99	1.17	0.58	Best quintile	0.21	0.28	0.50
Worst quintile	0.36	0.64	1.41	Worst quintile	(1.04)	(1.43)	(1.11)

Historical analysis and current forecasts do not guarantee future results. Table shows the z score of the median multiple relative to the benchmark median, using data since 2015. Best quintile is the top 20% of stocks based on the ESG scores from Sustainalytics. Universe is stocks that have Sustainalytics scores within the MSCI Europe and US. Sustainalytics scores are relative to industry peers. Data as of April 30, 2021. | **Source:** Factset, MSCI, Sustainalytics and AB

In *Display 20*, we show the spread of valuations, conditioned on ESG score, on both a P/E and P/B basis. In Europe, there is a significant valuation spread between best- and worst-rated companies (in this case, using Sustainalytics scores) and between best and worst ESG improvers. That valuation spread is now starting to show up in the US as well.

What is driving these extremes? Arguably, they are flow driven, and the flows seem unlikely to reverse in the near future. A complicating consideration is that ESG stocks tend to be long-duration assets (such as tech), while bad ESG stocks tend to be short duration (like energy), and as part of the value/short-duration rally, we have been seeing some pickup in the performance of stocks that score poorly on ESG. Whether this effect will be powerful enough to counteract the flows into ESG strategies is a moot point and a subject for further research.

China: Nirvana for Active Management?

When looking at regional trends in excess return and IA generation by active equity managers, Asia is particularly interesting. In Asia, managers have been outperforming their US and European counterparts recently, with China a true standout.

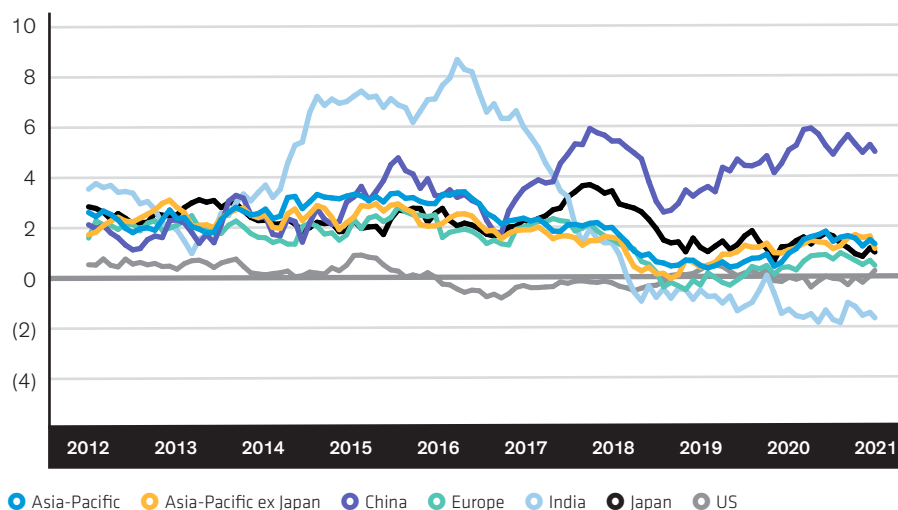
Our China sample includes 150 managers benchmarked to indices such as MSCI China, MSCI Golden Dragon and MSCI China A. In other words, they invest across the range of A, H and other main share types. These managers have been generating a gross annualized active return of 4.95% over the past three years, compared with 1.09% by managers in the broader Asia ex Japan region (*Display 21*) and 0.21% by US-benchmarked managers. Over the longer term, their performance has also been superior to managers in other regions.

China is also a standout in idiosyncratic terms (*Display 22*). Managers in China have generated an IA of more than 4% annualized over the past three years versus 61 basis points by managers in Japan and negative IA from managers in Asia ex Japan and the US.

Of course, the onshore China market has very different characteristics. It is more “managed” and controlled, much more closed to foreign participation (despite continuing progress in opening it up), and is highly dominated by retail investors, affecting both how the market responds to external shocks and how active managers are selected. There are almost certainly other factors at play, such as differences in market composition and manager positioning, but this does suggest a less efficient market with greater opportunities for alpha generation that should be explored.

DISPLAY 21: THREE-YEAR ROLLING ACTIVE EXCESS RETURN VS. BENCHMARK: ASIA

Percent

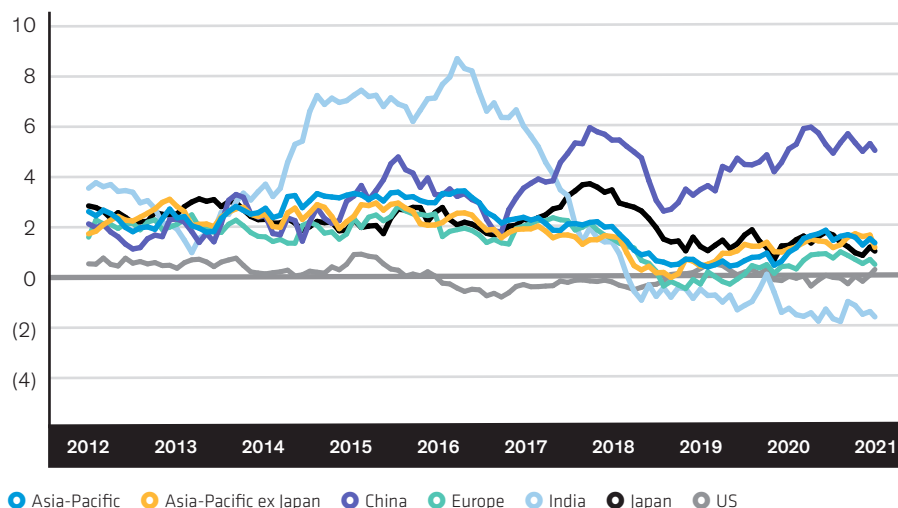


● Asia-Pacific ● Asia-Pacific ex Japan ● China ● Europe ● India ● Japan ● US

Historical analysis and current forecasts do not guarantee future results. Data from June 1, 2012, through May 31, 2021 | Source: eVestment, Factset, Morningstar, MSCI, S&P and AB

DISPLAY 22: THREE-YEAR ROLLING TOTAL IDIOSYNCRATIC ALPHA: ASIA

Percent



● Asia-Pacific ● Asia-Pacific ex Japan ● China ● Europe ● India ● Japan ● US

Historical analysis and current forecasts do not guarantee future results. Data from June 1, 2012, through May 31, 2021 | Source: eVestment, Factset, Morningstar, MSCI, S&P and AB

Implications for Strategic Asset Allocation and Roles of Alpha and Beta

This note has covered some seemingly very different strands in investing, from the policy and inflation environment to the outlook for markets and the measurement of alpha.

This final section seeks to bring these strands together under a common narrative by way of their impact on asset owners. It is important to acknowledge clear differences between particular asset owners based on liabilities, time horizons, risk tolerance and other factors. However, we think the implication of generally lower returns and the likelihood of diversification being harder to come by is that most asset owners need to increase risk.

In *Display 23*, we show realized returns over the past 10 years for a range of major assets and how we expect them to evolve in the future. Aside from the likelihood of a rising risk level, this analysis also points to factors becoming a larger part of the mix in response to the changing outlook.

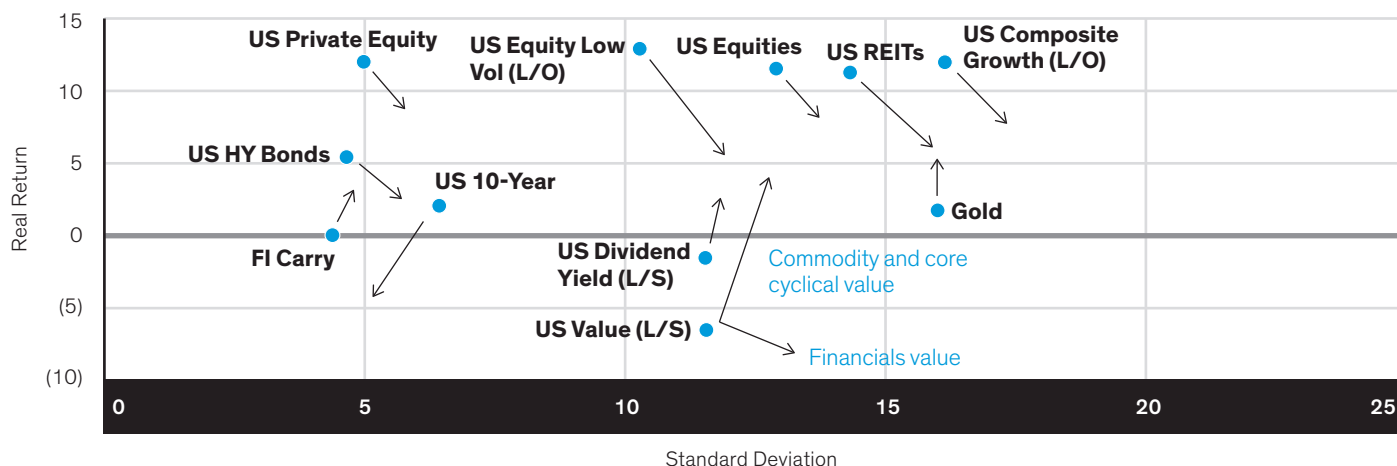
More fundamentally, our outlook for markets and alpha point to the need to reconsider the building blocks of strategic asset allocation.

We made the case in our recent black book [Are We Human or Are We Dancer?](#) that the pandemic will not only drive a repositioning of portfolios but also a rethinking of the methodology of investing, and the nature of strategic asset allocation is one such area.

Rather than thinking of strategic asset allocation as allocating to equities, credit, duration and other components, an even more fundamental distinction is the one between idiosyncratic alpha and beta. Thinking about portfolios in these terms can more efficiently allocate where asset owners pay fees—in other words, they should save fee budgets for idiosyncratic alpha rather than cheap betas.

This approach also allows the choice of betas (encompassing asset classes, factors and other easily obtainable return streams) to adapt over time to eke out whatever diversification opportunities may be available. Moreover, we can show that idiosyncratic alpha is more persistent than traditional alpha. In a world where the real return from betas might be lower, investors' portfolio construction should be designed to tap a greater share of total returns from these more persistent alpha sources.

DISPLAY 23: INVESTORS MUST ADD RISK; PENSION PLANS MAY NEED TO ADD FACTORS



Historical analysis and current forecasts do not guarantee future results. The dots represent the last 10 years of real returns and volatility for the major return streams that investors can buy. The arrows represent the AB Institutional Solutions team's forecasts for the next 5–10 years. | **Note:** The US Private Equity data are compiled from 1,562 funds, including fully liquidated partnerships, formed between 1986 and 2019. All returns are net of fees, expenses, and carried interest. Data are provided at no cost to managers. Data provided as of March 31, 2020. | **Source:** Cambridge Associates, Datastream, Factset, FRED, Ken French Data Library and AB



Recommendations

This note eschews specific portfolio recommendations, because asset owners have varying risk constraints, benchmarks and time horizons. We will recommend approaches for specific investor groups in forthcoming research, but we suggest that many investors need to consider key dimensions (some of which will be detailed in coming publications) when forming a strategic allocation today.

- We see a strong case to hold overweight exposure to equity beta. Despite high valuations, the prospect of declining margins and already-high US household equity allocations, we think this will be the major source of positive real returns in a moderate inflation scenario.
- In our view, there's a positive case for exposure to the value factor. Yes, there are headwinds (technology destroying defensive moats around industries), but the combination of inflation and wide valuation spreads makes this the most compelling strategic case for value in many years. The question, really, is how exactly to define that value.
- In our view, it makes sense to underweight duration. We think investors have a duration problem, not just with respect to high-grade fixed-income holdings but also the prospect of higher-duration risk in simple cross-asset portfolios such as 60/40 if bonds are less effective at diversifying equity risk as inflation rises.
- Greater exposure to "alternative" return streams, such as long-short, infrastructure, real estate and other physical assets seems sensible—possibly even tokenized real assets in future years. These return streams are likely to be key both in the generation of positive real returns and also as diversification becomes more scarce. However, we are more negative on private equity, given the buildup of dry powder and the prospect of nominal yields rising.
- The other key dimension to consider is the role of alpha, once it is properly defined as idiosyncratic alpha, in the context of declining real returns and greater risk levels in traditional beta sources.

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IMA-202472-2021-07-19 | IC2021880
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