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Balancing Responsibility, Risk and Return

Harvard Business School Social Enterprise Initiative

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Summary and Conclusions

- + Responsible investing is growing globally, across asset classes.
- + Growth is likely to continue, driven by demand from institutional asset owners and high net worth individuals
- + Responsible investing can be implemented in a variety of ways, from screening to impact investing, based on investor's objectives and preferences for responsibility, risk and return.
- + Responsible investing is inherently more complex than traditional investing because it requires attention to three dimensions rather than two.
- + A combination of strategies is often required to accomplish an investor's goals within a particular asset class or sub-asset class.

Balancing Responsibility, Risk and Return

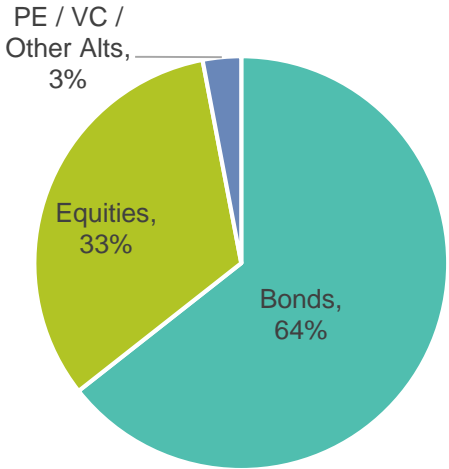
Agenda and Overview

- + Responsible Investing: Definition and Market Dynamics
- + Strategies for Implementing Responsible Investing
- + Role of Active Management in Balancing Responsibility, Risk and Return
- + Unintended Consequences of Restrictions and Exclusions
- + Relationship between ESG Ratings and Risk
- + Value of Fundamental Investment Research
- + Product Example
- + Q&A

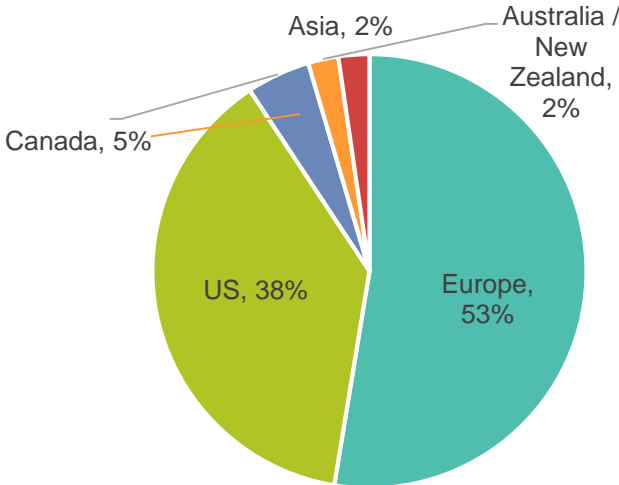
Responsible Investing is Global and Encompasses All Asset Classes

Sustainable, responsible and impact investing (SRI) is an investment discipline that considers environmental, social and corporate governance (ESG) criteria to generate long-term competitive financial returns and positive societal/environmental impact.

100% = \$23 trillion
~26% of Managed Assets



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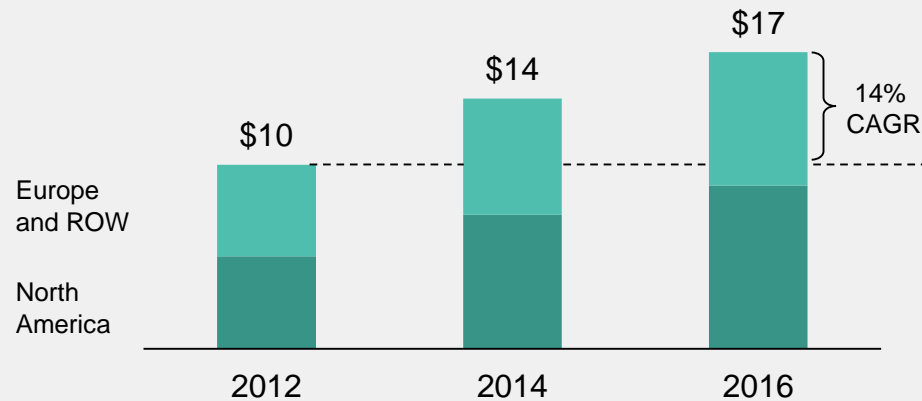
Source: Forum for Sustainable and Responsible Investment (US SIF); Global Sustainable Investment Alliance 2016 Global Sustainable Investment Review

Note: Data on AUM by asset class is estimated based on data reported by Canada and Europe. The US and other markets have not reported data on asset allocation for SRI investing.

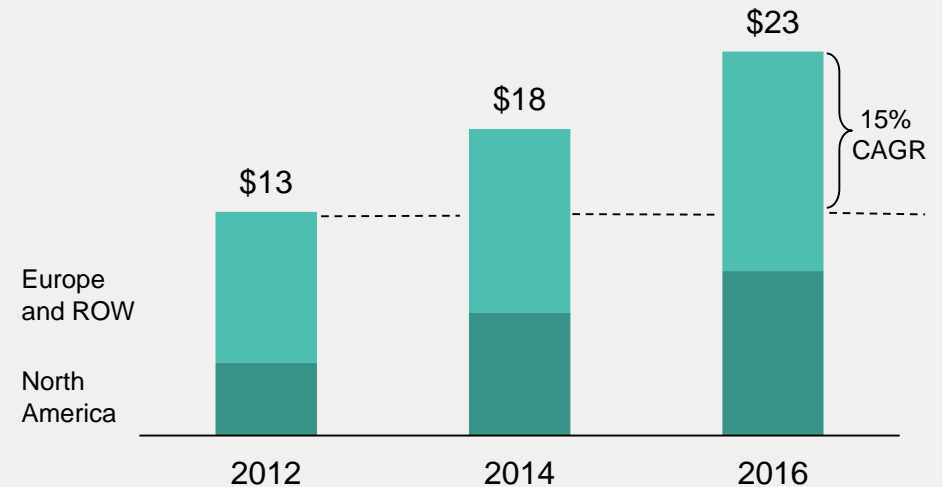


Responsible Investing is Growing Rapidly and is Larger than Passive Investing

Passively Managed Investments
Assets Under Management, \$US trillions



Global Socially Responsible Investments
Assets Under Management, \$US trillions



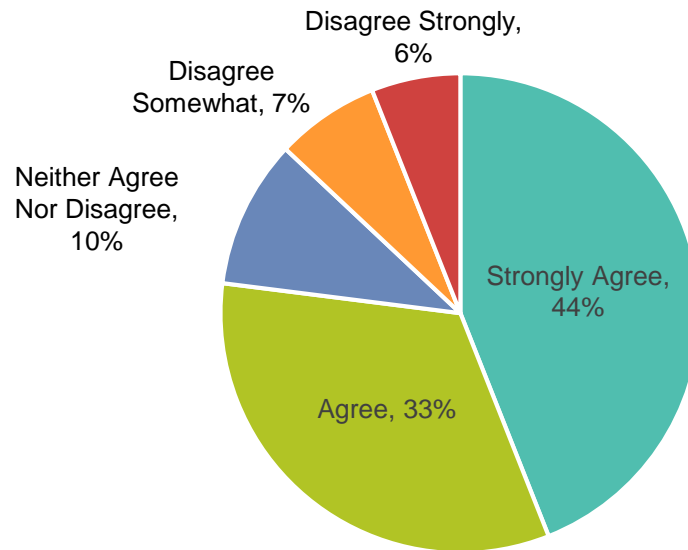
Source: Broadridge *FundFile*, McKinsey & Company, Inc., Global Sustainable Investment Alliance *Global Sustainable Investment Review 2016* and 2014

Asset Owners are Committed to Responsible Investing

Belief that Addressing Sustainability Issues is A Responsibility

To what extent do you agree or disagree with the following statement: “Asset owners have a responsibility to address global sustainability issues through their investments”

100% = 116 Respondents

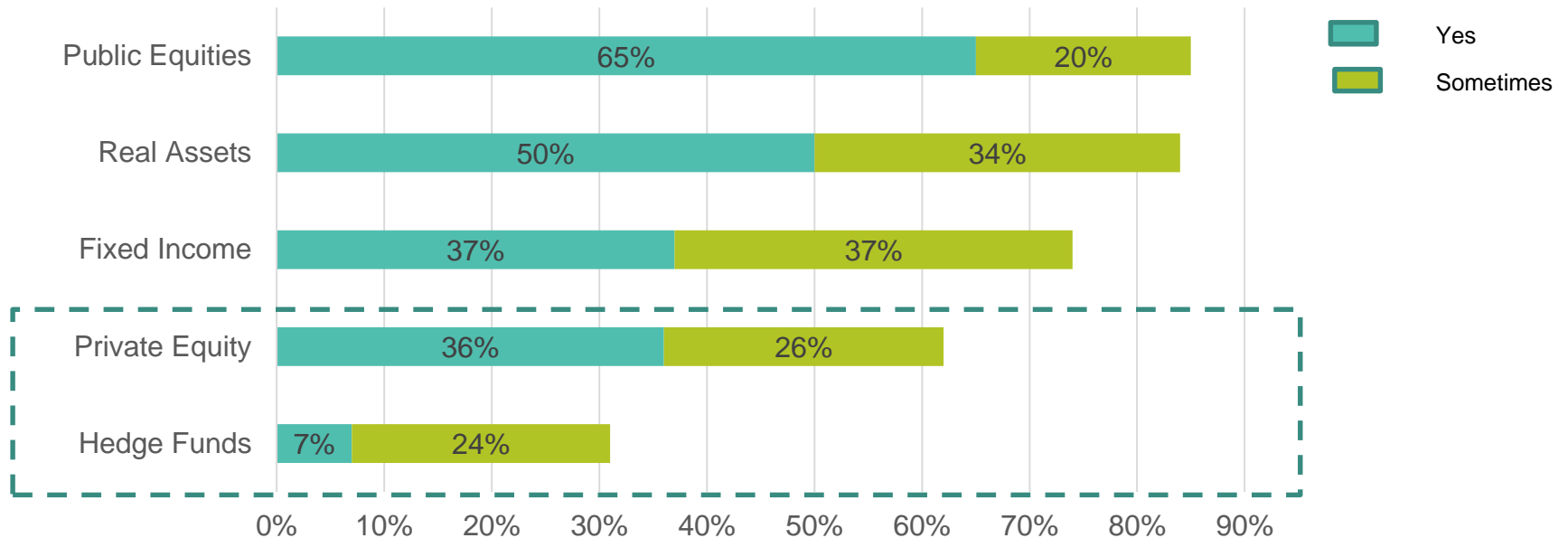


Source: Morgan Stanley, *Sustainable Signals: Asset Owners Embrace Sustainability* (2018). Based on a survey of 118 public and corporate pensions, endowments, foundations, sovereign wealth entities, insurance companies and other large asset owners globally.

Future Growth Likely to be Driven by Private Equity and Hedge Funds

Unmet Demand by Asset Owners for Quality SRI Strategies and Managers

In your experience, in which sectors has your organization been able to find quality sustainable investing strategies / managers? (n=74)



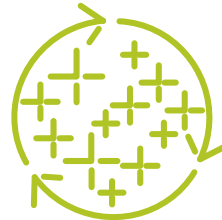
Source: Morgan Stanley, *Sustainable Signals: Asset Owners Embrace Sustainability* (2018). Based on a survey of 118 public and corporate pensions, endowments, foundations, sovereign wealth entities, insurance companies and other large asset owners globally.

Responsible Investing Requires an Active Approach



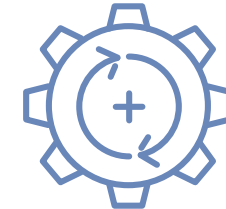
Responsibility Introduces a Third Dimension

Corporate social responsibility introduces investment considerations beyond investors' goals for return and risk.



Investing Responsibly Adds Complexity

Financially motivated decisions by corporations can impact society and the environment. Similarly, decisions by corporations to behave responsibly can impact financial performance and investment outcomes.



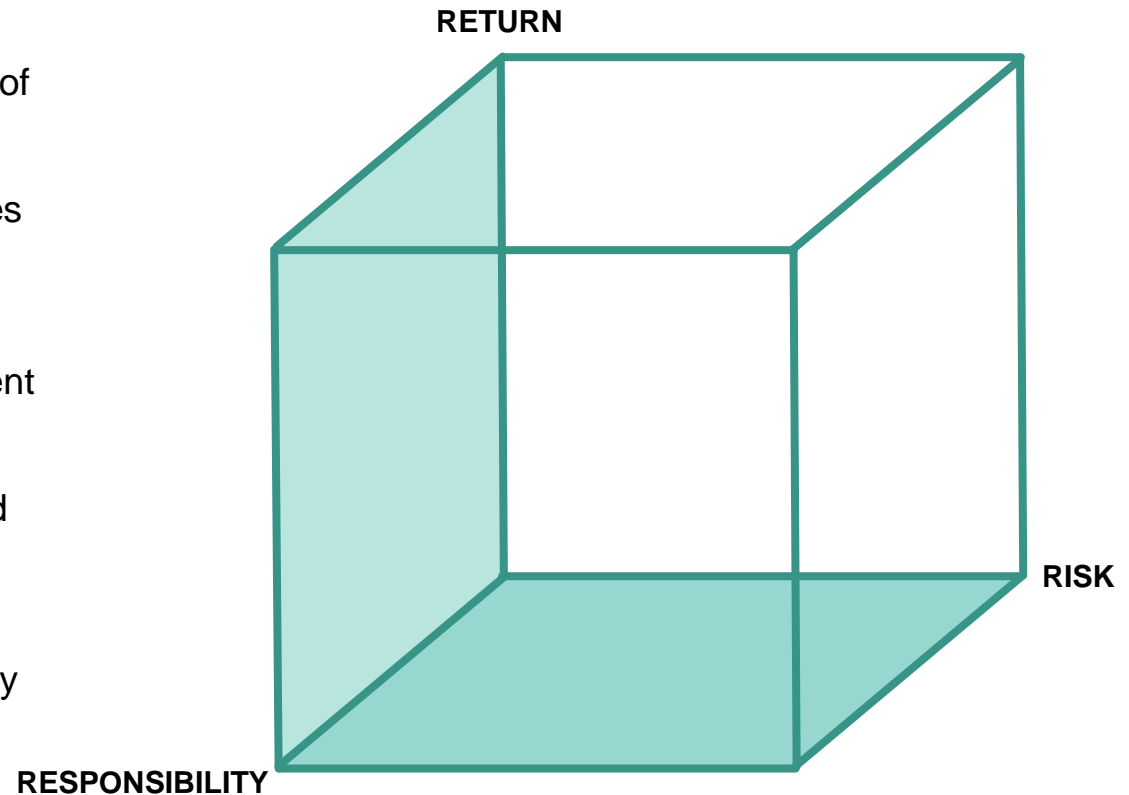
Mechanical Approaches Have Inherent Shortcomings

Conventional, rules-based approaches fall short in managing trade-offs, improving corporate behavior, and identifying investment opportunities.

Responsible Investing is Inherently More Complex than Traditional Investing

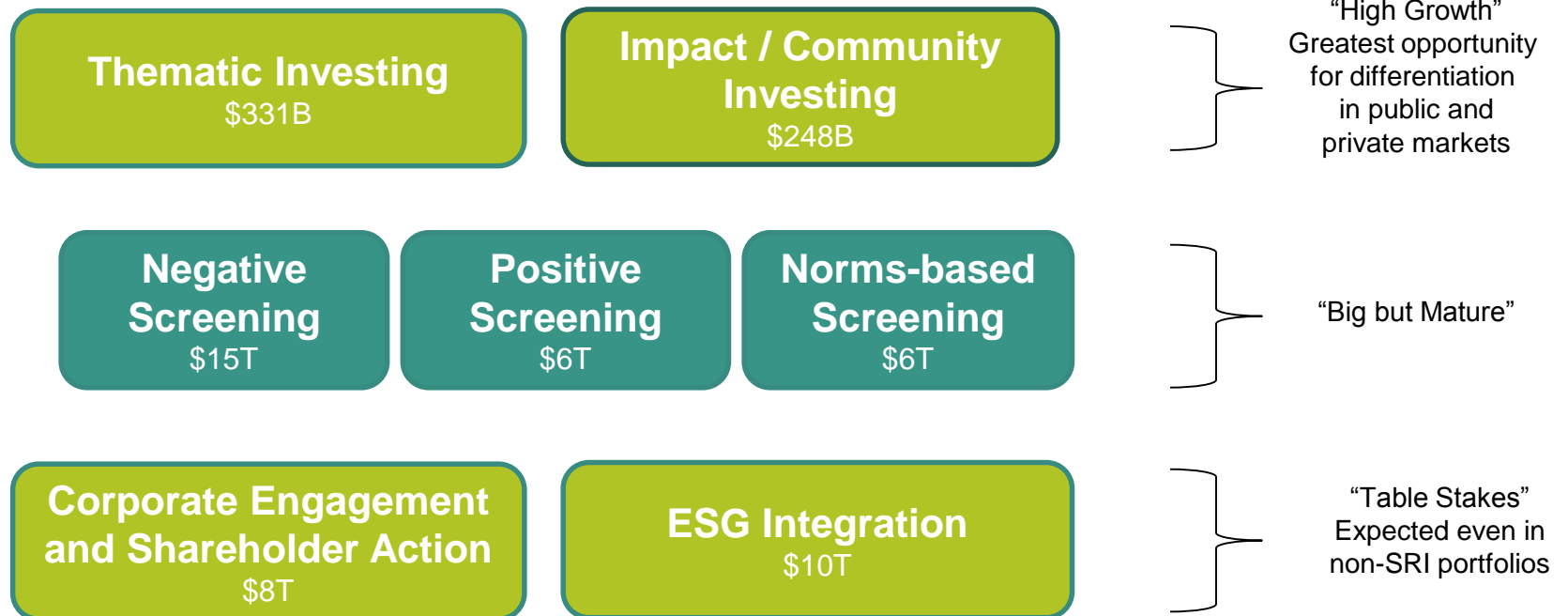
Active Management Can Balance Objectives on All Three Dimensions

- Recognizes three dimensions instead of two
- Helps uncover investment opportunities and risks
- Offers tools to manage trade-offs and engage constructively with management on important ESG issues
- Exploits inefficiencies in ESG data and reporting
- Enables shareholders to influence companies to behave more responsibly



Responsible Investing Includes Diverse Strategies That Can be Used Alone or In Combination

Approaches to Responsible Investing Global Assets Under Management, \$US



Source: Global Sustainable Investment Alliance 2016 *Global Sustainable Investment Review*
Strategies are not mutually exclusive

Responsible Investing Strategies Address Different Objectives

Alignment with Investor’s Goals for Responsibility, Risk and Return is Critical

Objectives of Commonly Used Responsible Investing Strategies

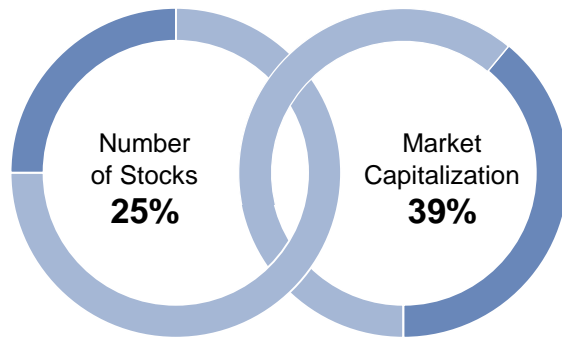
	Achieve Positive Outcomes	Align with Mission or Values	Influence Corporate Behavior	Avoid Bad Actors	Manage Risk or Volatility	Generate Excess Returns
Thematic Investing	★	★		★		★
Impact/Community Investing	★	★		★		★
Negative Screening		★		★	★	
Positive Screening		★		★		
Norms Based Screening	★	★		★		
Corporate Engagement and Shareholder Action			★			★
ESG Integration					★	★

Source: Global Sustainable Investment Alliance 2016 Global Sustainable Investment Review, AB Analysis

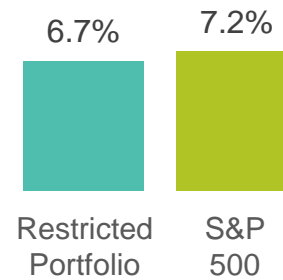
Screening Remains Popular, but Can Have Unintended Consequences

Broad Screens Typically Add Risk While Detracting from Returns

Percent of Universe Excluded with Broad Screens



Annualized Cap Weighted Returns



Annualized Volatility



Source: Standard & Poor's, AB analysis

All data shown from January 2007 to January 2017. Screens exclude companies with any exposure to tobacco, alcohol, defense, gambling, guns, Sudan, pornography, fossil fuels and nuclear power

Targeted Screens Limit Negative Impact on Risk and Returns

Impact of Broad vs. Narrow Screens on Return, Risk and Responsibility

Dimension	Metric	Broad Screen*	Targeted Screen**	S&P 500
% of Universe Excluded		39%	10%	0%
Return	Annualized return (cap-weighted)	6.7%	7.2%	7.2%
Risk	Annualized volatility	16.3%	15.2%	15.1%
Risk Adjusted Return	Return/Risk Ratio	0.41	0.48	0.48
Responsibility	ESG Score (equally-weighted)	4.45	4.50	4.50
Tracking Error		2.5%	0.6%	N/A

Past performance does not guarantee future results. There can be no assurance that any investment objectives will be achieved.

January 2007 to January 2017

*Broad Screens include companies with any exposure to the 9 most common exclusions imposed on US responsible equity funds

**Narrow Screens excluded only those companies with material involvement in these business activities

Source: MSCI, AB Analysis

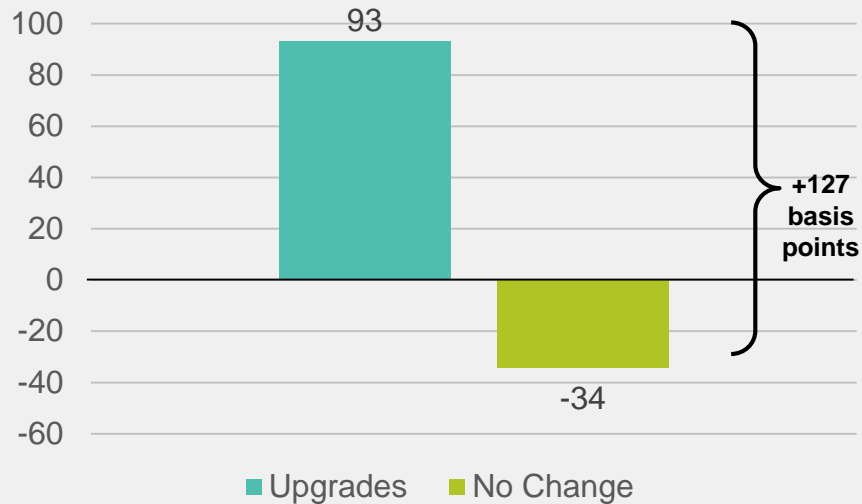


Research Can Be Used to Find Improvers, not Just Top Performers

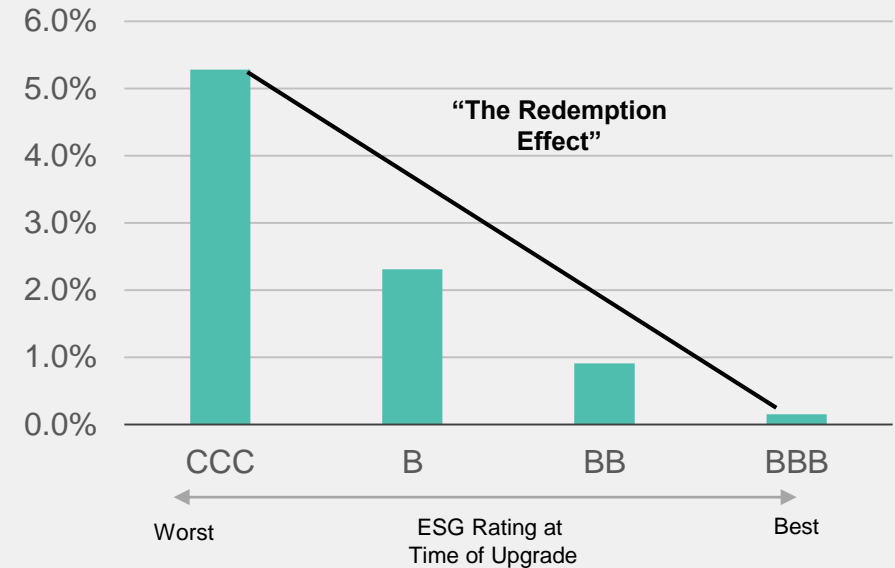
Upgrades for Poorly Rated Firms Are Rewarded Most

Excess Forward Return vs. Equal-Weighted S&P 500

Basis Points



Excess Forward Returns for Stocks with Two-Notch ESG Upgrade vs. Equal-Weighted S&P 500

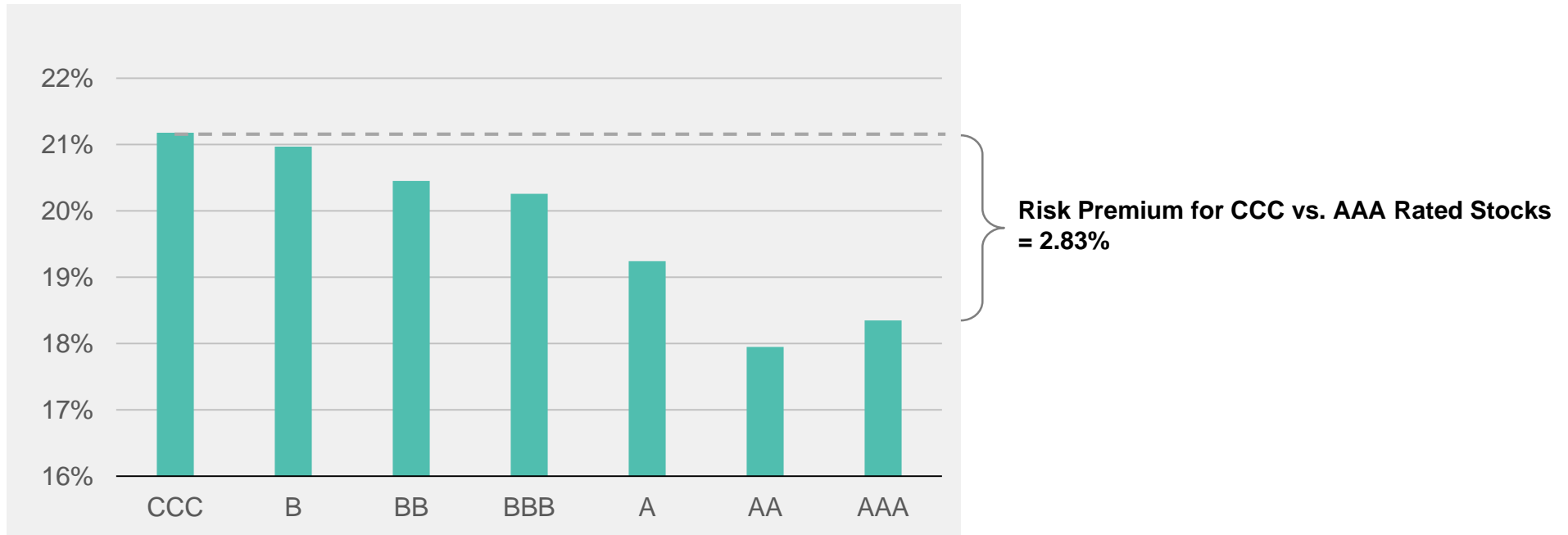


Forward returns for the next 12 months following a change in rating
January 1, 2017 through December 31, 2016
Source: MSCI, S&P and AB analysis



ESG Ratings Are A Useful Indicator of Risk...

Stock Specific Risk by ESG Rating Cohort S&P 500



January 2007 to July 2017
Source: MSCI, S&P and AB analysis

Thematic Investing Can Uncover Growth Opportunities

UN Sustainable Development Goals + Deep Fundamental Research is a Powerful Combination

Investing in Clean Water



Aligns with UN Sustainable Development Goals



Leading to Differentiated Investment Insights



Responsible US Equities (RE-USE)

Using Quantitative and Fundamental Approaches to Balance Return, Risk and Responsibility

Portfolio Summary

- + Designed for clients seeking to invest responsibly in their 'core' large cap equity allocation
- + Derived from the highest conviction holdings in AB's equity strategies and optimized for return, risk and responsibility*
- + Balanced and persistent exposure to multiple factors with long-term premia
- + Seeks to invest responsibly across multiple environmental, social and governance parameters
- + Transparency in reporting performance on the dimension of responsibility using key performance indicators

Portfolio Characteristics**

Holdings

- + Number of Holdings ~ 85
- + Annual turnover = 35-50%

Return and Risk Metrics

- + Target return premium: 1.0 – 1.5%
- + Tracking error: ~ 3.5%
- + Information Ratio: 0.4

Benchmark

- + S&P 500

Past performance does not guarantee future results. All portfolio statistics, characteristics and holdings are subject to change.

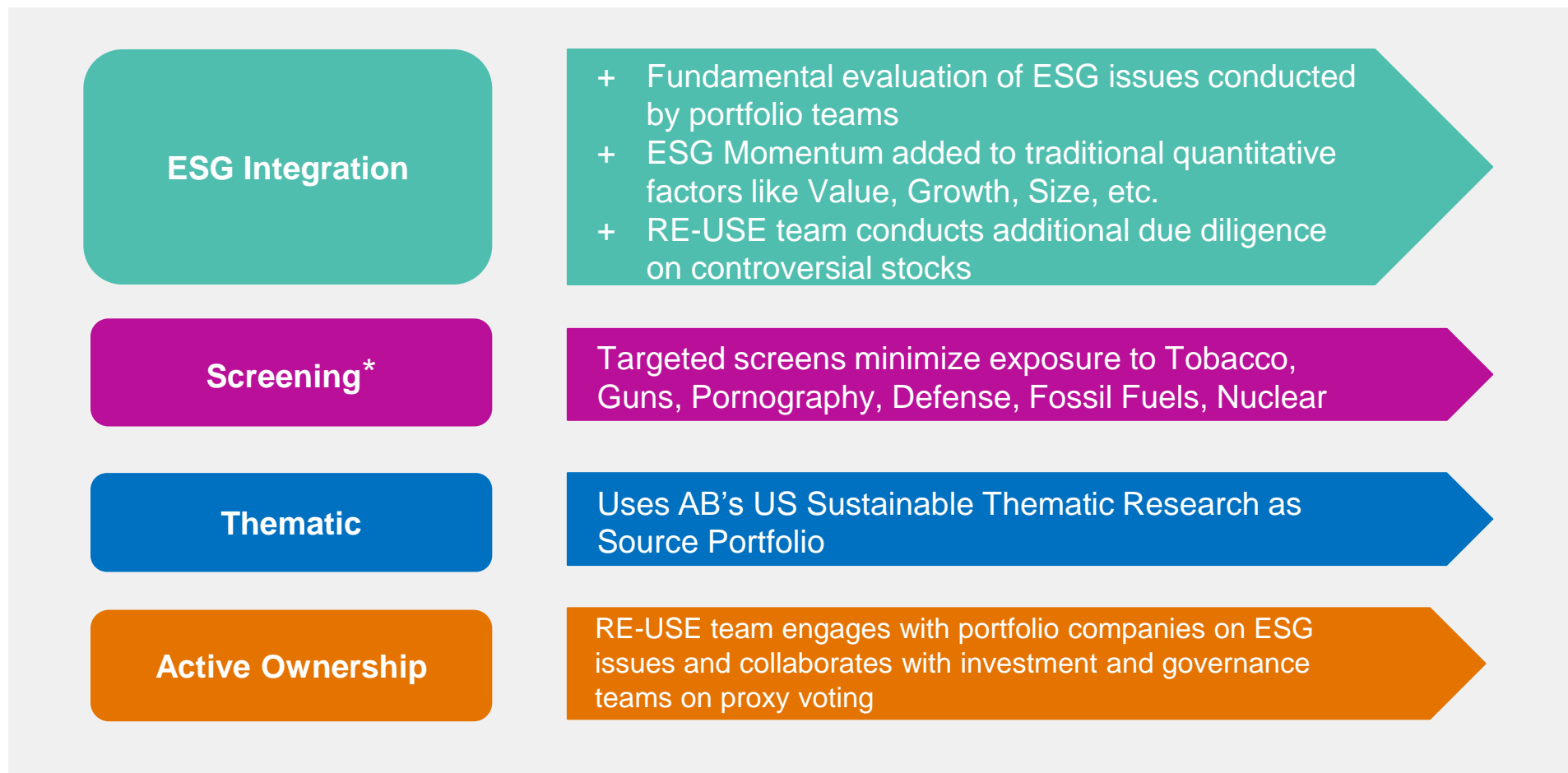
*Source portfolios include US Strategic Value, Relative Value, Large Cap Growth, Concentrated Growth, Strategic Core, Select Equities, Core Opportunities, Sustainable Thematic and US Equity Income

**Based on 2008-2017 back test.



Responsible US Equities (RE-USE)

Implementing Multiple Strategies to Incorporate Responsibility

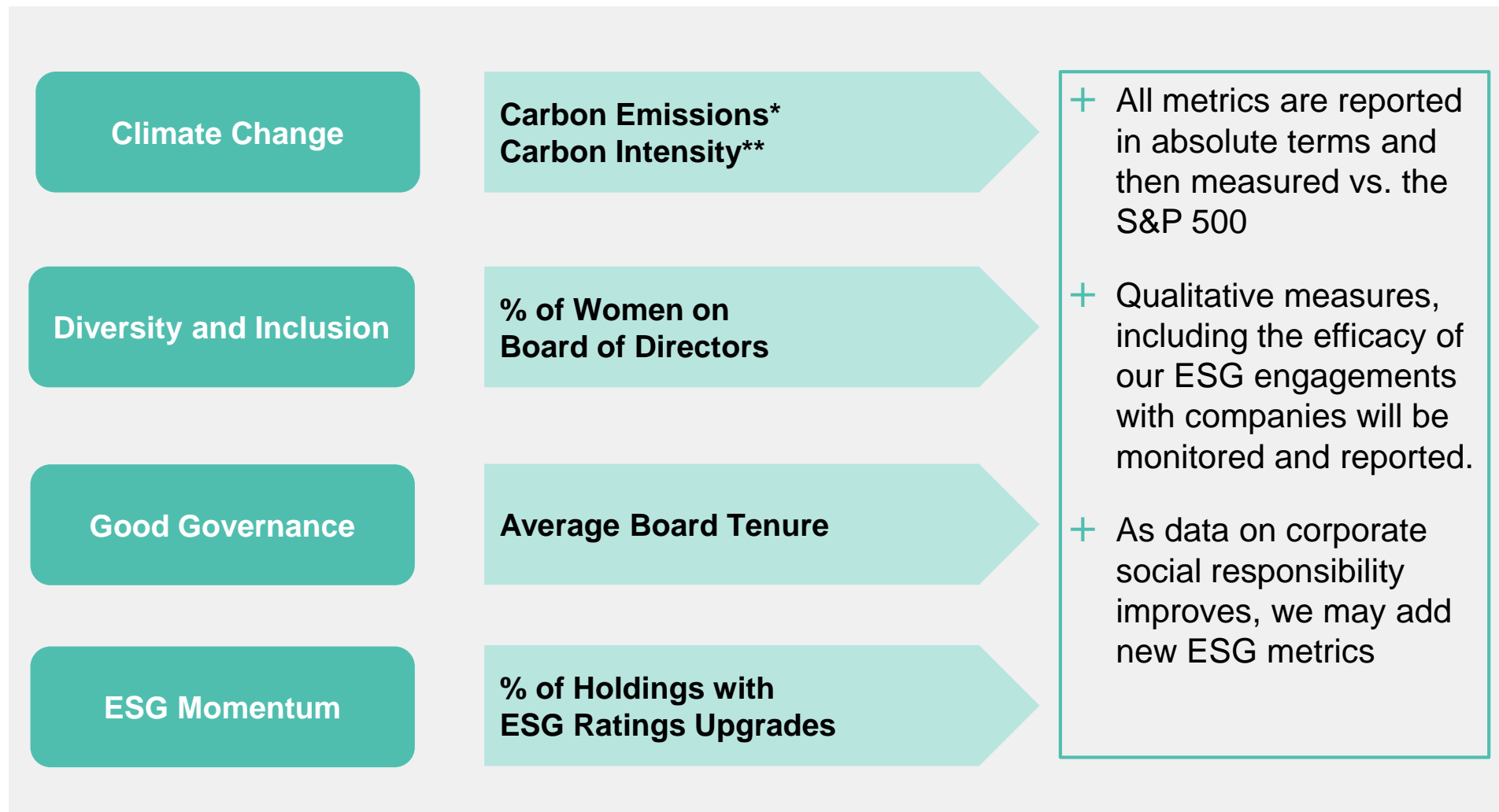


For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.

*Screening eliminates from the investment universe companies that generate >5% of total revenues from tobacco, defense, guns, pornography and nuclear power. For fossil fuels, the exclusion is based on revenue-adjusted carbon emissions (T CO₂ / \$M in revenue) > median for all companies that have any exposure to fossil fuels.

Responsible US Equities (RE-USE)

Transparency and Accountability on ESG Metrics



For illustrative purposes only.

*CO2 emissions / \$M Sales

**CO2 emissions / \$M Invested



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Questions and Answers