AB SELECT ABSOLUTE ALPHA PORTFOLIO

After a mini-correction in mid-April, stocks regained their footing and ended the month higher. April's 1.0% total return marked the sixth straight month of gains for the S&P 500 Index, which continues to grind higher despite a long list of investor concerns. After a disappointing first quarter, the Select Absolute Alpha Portfolio performed strongly in April.

As the stock market continues to move its way higher, investors are weighing several positive and negative factors. The negatives include the growing realization that Trump faces challenges in achieving his policy agenda, some signs of moderating economic growth, and weakness in both oil prices and energy stocks. These factors have coincided with the bond-market rally and underperformance of cyclical stocks.

But several distinct positives have kept the market correction modest. For one thing, the global economy has picked up, with growth at its best level in years. Second, after a multiyear plateau, corporate profits are breaking out. And third, low Treasury bond yields are still accompanied by very narrow credit spreads. Together, these three factors suggest that the US economy will not slow further.

The March quarter is shaping up to be a great period for corporate profits. More than half of the companies in the S&P 500 have reported so far. According to an April 28 Citigroup equity research report, revenues are up by more than 6% from one year earlier and earnings per share (EPS), by over 12%. Adding to the positive landscape: EPS estimates for full-year 2017 are rising. A May 1 Bank of America Merrill Lynch report states that the percentage of companies beating their estimates for sales and earnings is on pace for the best quarter in 13 years.

Better profits in energy, financial services and technology are adding to the healthier backdrop—helped substantially by currency. The euro is modestly above its level from late 2014, and the US dollar is roughly at its early 2015 level. Currency translation—the impact of converting overseas profits back to US dollars—"shocked" corporate profits in 2014 and 2015. And they did the same thing in 2016—to a lesser extent. As long as there's not a surge in the US dollar, we seem to be entering a period of much healthier profits for the S&P 500, due partly to benign currency-translation trends.

Three stocks that would benefit from a better currency backdrop are Honeywell International (HON), McDonald's (MCD) and eBay (EBAY). Currency has little to do with why we own these stocks, but they're big positions and we've added to all of them recently.

On April 27, an activist investor announced that it owns HON and is urging management to spin off the aerospace business to enhance shareholder value. HON is our largest position, and it has done very well for us this year, rising by 13%. We don't own HON because we're expecting spin-offs—we own it because it's a well-managed, high-quality industrial with potential created by a balance sheet that we view as underleveraged.

HON reported a strong March quarter and raised the lower boundary of its 2017 EPS guidance range. With a net-debt-to-EBITDA ratio of less than 1x, HON could make a big acquisition or announce a sizable share-buyback program. Either option would boost EPS. HON trades at 18.6 times its consensus EPS of $7.06, but we feel it could earn $7.20 or more and grow its EPS by 10% or more in 2018. That's especially the case if the company deploys its excess capital.

MCD was the Portfolio's largest contributor in April. The company beat first-quarter earnings estimates by a wide margin and raised its future earnings estimates. The stock has performed extremely well and it isn't cheap on the surface—but we're enthusiastic about its longer-term prospects. New company management is driving renewed momentum in the business, as well as cutting costs, increasing financial leverage and moving to a mix that is skewed more toward franchised than company-owned restaurants.

With these actions, MCD management is using a powerful global brand to deliver low-risk, high-single-digit EPS growth or better. The stock's dividend yield of 2.7% looks attractive compared with other options in fixed income, and we expect the dividend to increase by about 10% in September. Despite the stock's sharp surge after the company reported earnings, we added to the position—now the Portfolio's second largest.

EBAY has been a strong performer for the Portfolio over the past few years. Although the stock is up by 13% so far in 2017, it was quite weak after reporting its first-quarter earnings. The company had a fine quarter: revenues and EPS topped expectations. But investors were disappointed by below-consensus guidance for the second quarter. We bought the stock aggressively, because we chalked up the disappointing earnings guidance to conservative management—we see positive trends for the company.

We view EBAY as a poor man's Amazon.com (AMZN). There's no doubt EBAY isn't growing nearly as fast as the big Internet giants like AMZN and Alphabet Inc. (GOOG). But brick-and-mortar retailers are being completely disrupted by Internet shopping today. EBAY is investing heavily in its business, and its profit growth is subdued. But the company is experiencing success and is poised to grow its revenue and operating profits by at least 6% annually going forward.

Based on where Internet stocks are trading today, and factoring in EBAY's solid growth prospects, we think the stock has significant upside. GOOG, for example, is trading at 21.7 times projected 2017 adjusted (non-GAAP) EPS. Like many other tech giants, EBAY stands to benefit from tax reform—particularly the ability to repatriate its offshore cash. EBAY's EPS growth should approach 10% in 2018. If the stock were to trade at a price/earnings multiple of 20 times a year from now, the stock would trade in the mid-$40s versus the current $33. This isn't a sure thing, but we think it could happen if business trends improve even a little.

There was very little change in the Portfolio's equity exposure in April, as has been the case throughout the year. As of April 30, the Portfolio had 65% gross long exposure and 11% gross short exposure, for a net exposure of 54%.

The top contributors to performance in April were: Alphabet, McDonald's, C.R. Bard (BCR), Honeywell International and Norfolk Southern (NSC).

The top detractors from performance in April were: Goldman Sachs (GS), Wells Fargo (WFC), CBS Corp. (CBS), Twenty-First Century Fox (FOXA) and EOG Resources (EOG).

As always, thank you for your continued support.

Kurt Feuerman
May 1, 2017