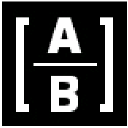

AB SELECT ABSOLUTE ALPHA PORTFOLIO

A sharp reversal in the markets' upward trend in the last two weeks of June hurt the Portfolio's results for the month. The S&P 500 Index pulled back 1.2% from its all-time high, but the Nasdaq-100 Index saw a bigger correction of 4.1% from its high. Despite this setback, the Select Absolute Alpha Portfolio delivered positive absolute returns for the second quarter.

We view the trend shift as healthy for the market overall, because it coincided with some positive economic signs that include a possible bottoming in oil prices and interest rates. We'll have to see if those bottoms are legitimate. Meanwhile, there was no bad news for the booming tech sector; it's certainly reasonable for the sector to pull back after posting such big gains.

AS THE BULL MARKET ROTATES

Sector rotation has been one constant in this nine-year bull market, perhaps more than anything else. Growth investors fared well in 2015, poorly in 2016 and great again in the first half of 2017. The $64 million question: Was the abrupt shift out of momentum stocks and into laggards in the last two weeks of June a sign of things to come?

We obviously don't know the answer, but we think the odds are decent that this is the case. We took the shift as a signal to take some profits in strong performers and to add to some laggards. For example, we trimmed but still own the following: Alphabet Inc. (GOOG), Facebook (FB), Amazon.com (AMZN), Microsoft (MSFT), eBay (EBAY), PayPal (PYPL), Texas Instruments (TXN), Broadcom (AVGO) and Micron Technology (MU). We don't believe that there's anything wrong with any of these stocks/companies and we're keeping a large tech bet in the Portfolio. But many stocks lagged as these stocks catapulted higher and higher. Some of these stocks we purchased recently, including CBS (CBS), JPMorgan Chase (JPM), Bank of America (BAC), Morgan Stanley (MS) and Norfolk Southern (NSC).

In a factor-driven market such as this, virtually all stocks in the same sector seem to move together—but we believe that stock selection ultimately prevails. We sold more AMZN than we did other tech stocks: our thinking is that maybe, just maybe, its purchase of Whole Foods Market (WFM) will complicate the story. This is a big move into brick and mortar for AMZN. Observers heralded the move as a brilliant one by a revered management team. But what if progress at WFM disappoints? Could the halo valuation also fade?

If tech is consolidating and laggards are reemerging, CBS might benefit. The stock has bounced back from its recent bottom, but it's still flat year to date despite expected 2017 earnings-per-share (EPS) growth of about 18%. As tech stocks surged in the first half, the fears around disruption in traditional media once again took center stage, as they did in 2015. Before 2015 and again in 2016, media stocks were great—the stocks aren't expensive and companies are finding ways to grow. TV advertising trends were soft in the first half, because of a secular shift from TV to Internet advertising, and other factors were at work.

But CBS has other growth drivers, including big gains in retransmission fees in exchange for its valuable content. Management is driving this growth and enhancing shareholder value through aggressive share repurchases and a soon-to-be-completed spin-off of its radio business. CBS stock trades at less than 15 times projected 2017 earnings. This seems very reasonable, given expected double-digit earnings growth projections in 2018 and 2019, as well as a high tax rate, which would position CBS well if tax reform is enacted.

ANOTHER BLOW FOR TRADITIONAL RETAIL, BUT WITH A TWIST

Perhaps the most interesting and important business event in years, in our view, was announced in mid-June: AMZN agreed to buy WFM. This move sent shock waves throughout an already beleaguered traditional retail industry. The shock and awe spilled over into the typically resilient consumer staples sector.

We've had limited exposure to retail for some time, taking a cautious view despite seemingly attractive valuations. But we had a small position in Kroger (KR), whose stock was absolutely crushed by the news—and by what occurred the day before the news. Despite posting a decent quarter with improved sales trends, the company lowered its future earnings guidance: it's choosing to invest in price and service in an increasingly competitive sector. Over the two days, the double whammy sent KR stock down a devastating 26.4%!

We sold some of our already small KR position in response to the first dose of bad news. But after the second dose, we reflected a bit on what all of this means and decided to buy the stock back in a larger exposure. Why not just eliminate KR and move on? After all, two highly admired super discounters from Europe (ALDI and Lidl) have just entered the market, Wal-Mart Stores (WMT) is flexing its muscles and now Amazon.com is set to further disrupt traditional food retail.

Walking away might be the right strategy, and we're not generally interested in cheapness without some goodness. But a twist in the news led us to buy some KR back. Sure, AMZN is set to further disrupt traditional food retail. But it's making its largest acquisition ever in order to do so—paying over 10

times EBITDA for WFM. And that EBITDA is overstated, because at current in-store prices, WFM is getting beaten badly by KR and others. KR, which gains share of traditional grocery every year, trades at six times EBITDA. Consider the grocery store as the “last mile” in the future: we’ll shop online, but will sometimes be in the store. Yes, KR will have to invest a ton of capital and resources to position itself for that future. But the company is best in class over the last mile. At these valuation levels, investors seem to be paying very little for KR’s strategic value or for the possibility that it might grow from its recently lowered base.

As for consumer staples, the AMZN/WFM news isn’t good, but it only reinforces what we already knew: the strongest distributors have been gaining leverage on branded consumer goods manufacturers for decades. WMT, Costco Wholesale (COST), AMZN, KR and others have been gradually forcing down prices for branded goods. But the strongest brands, those with low private label penetration and decent levels of innovation, will survive and thrive in our view. We still have limited exposure to consumer staples, but we’re adding to the sector as a result of the recent weakness.

AN ENCOURAGING END TO A CHALLENGING FIRST HALF FOR BANKS

Bank stocks rallied sharply in the second half of 2016, but underperformed in the first half of this year, as deflationary forces reemerged. Lower interest rates, a flatter yield curve and declining oil prices overshadowed good news from the Federal Reserve: three 25-basis-point hikes in the fed funds rate in December, March and June. Business trends, including loan growth and capital markets activity, were quite subdued in the first half of this year, so much of the benefit of higher short-term rates was offset by sluggish top-line revenue trends.

But with only two trading days left in the first half, the results from the CCAR (Comprehensive Capital Analysis and Review, the bank “stress tests”) breathed new life into the group. Dividends were boosted impressively, and buyback plans exceeded expectations. As a group, banks will return nearly 100% of earnings to shareholders through dividends and buybacks over the next 12 months. And a few of the biggest banks, including JPMorgan and Citigroup (C), will return over 100%. In other words, nearly a decade of building capital is now over.

To be sure, the CCAR results don't eliminate the risks inherent in banking. Loans can still go bad and, if interest rates stay low forever, bank margins will stay depressed. But banks are once again playing on a level field. Banks are cyclicals: the better ones are pure plays on the growth in the US economy and—to a lesser extent—the global economy. But through 2015, the industry wasn’t allowed to enjoy the upcycle because it faced two brutal forces. First, the US government kept moving the goal posts in a seemingly never-ending cycle of more and more regulation. And second, quantitative easing was squeezing bank margins.

For banks, it’s been a slow awakening from their regulatory nightmare. Dividend payout ratios have crept up to 30%–35% for most banks. That’s still low—we see it heading to 40% or more over the next few years. JPMorgan’s bold capital plan announced that the firm will return roughly 110% of earnings to shareholders over the next 12 months. But the company’s dividend payout ratio is only 35%, which means 75% will be returned through buybacks. That's promising—and so is the P/E of the stock, which is a lowly 14 times.

Buybacks at low P/E ratios increase future earnings power more than buybacks at higher P/E ratios do. That’s simple math…but it’s also powerful math. Disney (DIS) is buying back stock at 18 times earnings and McDonalds (MCD) at 24 times. Bank of America, whose buyback will be almost as big as that of JPMorgan, has a P/E of 13.5 times. As a result, both companies are set to shrink their respective share bases by over 4% in 2018.

Even assuming that top-line revenue growth is modest, the combination of shrinking shares outstanding and reduced compliance costs implies that EPS should rise nicely in the coming years. Factor in a rising dividend-payout ratio, and it becomes clear that dividends should grow impressively.

HEALTHIER HEALTHCARE RETURNS AFTER A WEAK START TO THE QUARTER

Healthcare helped the Portfolio’s performance in June. As of May 31, healthcare was outperforming the S&P 500 year to date by about 1.6%. But much of that margin was built in the first quarter; healthcare declined from mid-March through the end of May despite a market rally. So, we entered June with the sector having flattened out due to concerns about potential reforms to drug prices and the Affordable Care Act.

We started June with a modest exposure to healthcare. One reason for this was that we reduced our position in Eli Lilly (LLY) in late May/early June. We sometimes make moves in seeking to control risk and downside exposure—and this was one of those measures.

We reduced LLY because it was heading into a period of several potentially negative events, including a patent decision on a large product and data readouts on their own and a competitor’s product, which would have commercial implications. This also caused us to reduce our position in Johnson & Johnson (JNJ) for a short time during the month. As it turned out, the data readout (concerning a JNJ diabetes drug) was a “Goldilocks” outcome… good for both JNJ and LLY. The patent challenge hasn’t been decided as of the end of June.

As for healthcare, overall, pricing and reform concerns continued into early June, at which point we had added to our exposure. Managed-care companies, Aetna (AET) and UnitedHealth Group (UNH), seemed like good values to us. We had also maintained our preexisting biotech exposure; we’d been building this since last summer, when biotech began trading excessively cheap to the market and to healthcare.

Then, as mid-June neared, we saw a perfect storm for a sector rally, with five factors unfolding to provide support for healthcare:

1) On June 9, Internet stocks dropped sharply after a strong rally.

2) On June 16, the press began reporting a White House draft proposal about drug prices that seemed fairly benign.
3) On June 22, the news surfaced on a draft of the Senate health bill; it had no major surprises.
4) In mid-June, the AMZN offer to acquire WFM, along with continued poor retail results, roiled the retail and consumer sectors.
5) Interest rates continued to fall, with the 10-year Treasury yield down from 2.20% to 2.14% in the first three weeks of the month. This boosted yield-rich large-cap healthcare stocks.

In the end, healthcare rallied by more than 4% in June, with biotech stocks up 10% to 15% generally, while the S&P 500 rose by less than one percent. The Portfolio ended the month with meaningfully more healthcare exposure from where it started—and that was after we took profits on some of our exposure near month-end. We had added two-thirds of our increased sector exposure early in the month, before the “breakout” rally on June 19, so this also helped the fund’s performance.

Our net equity exposure didn’t change significantly from May to June, but it has increased since the end of the first quarter. At the end of March, the Portfolio had 67% gross long exposure and 12% gross short exposure, for a 55% net exposure. Strong performance from the fund’s long positions and the market led us to increase net exposure. Throughout the quarter, we increased gross long exposure while modestly reducing short exposure. As of June 30, the Portfolio had 70% gross long exposure and 13% gross short exposure, for a 58% net exposure.

The top contributors to performance in June were: JPMorgan Chase, Bank of America, VanEck Vectors Biotech ETF (BBH), McDonald’s and Johnson & Johnson.

The top detractors from performance in June were: Alphabet Inc., Apple (AAPL), Kroger, Campbell Soup Co. (CPB) and Norfolk Southern.

As always, thank you for your continued support.

Kurt Feuerman and Anthony Nappo
July 1, 2017

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