AB SELECT ABSOLUTE ALPHA PORTFOLIO

The S&P 500 Index continued its relentless grind higher in May—with a sharp mid-month correction, as we saw in April. In fact, in May, the index had its worst single-day setback since September of last year, at −1.8%. This drop stoked expectations of the long-awaited correction in stocks, but instead there was consistent buying and a move to new highs.

For the month, the S&P 500 generated a total return of 1.3%, bringing its year-to-date gain to 8.4%. The Select Absolute Alpha Portfolio generated positive absolute returns in the month.

LESS REFLATION, MORE GROWTH AND QUALITY

The Portfolio's May performance was helped by our move in recent months to reduce exposure to stocks that could benefit from reflation—more cyclically oriented firms—in favor of secular growth stocks and high-quality dividend growers. We still believe the economy is in solid shape, but it's hard to overcome several powerful deflationary forces that are driving both commodity prices and interest rates lower.

The most prominent of these forces is technology, which is changing how people live. Some refer to this as the stay-at-home economy. More and more, we can do everything from shop to bank to work while staying at home or any other place. This seismic shift is creating both disruption and opportunities.

No industry faces more disruption than traditional retailing, but there are other losers—including legacy media, commercial real estate and some packaged-goods brands. However, we think that technology disruption is—as a whole—positive for the S&P 500:

1. Based on GICS sector weightings, Technology now accounts for 23% of the index, up from 17% in 2007. This sector continues to enjoy robust growth.
2. Non-tech companies are benefiting from technology, mostly from cost-saving opportunities but also from new revenue sources. Examples include banks that need fewer branches, downward pressure on rent expense, and lower operating costs from the shift to cloud computing.
3. To the extent that technology disruption is helping to lower inflation and interest rates, it's a positive for the valuation of all stocks.

Investors remain uncomfortable with the ever-rising stock market, because valuations are high by historical standards. But as we've pointed out many times, stocks still look attractive when compared with interest rates.

There's also a lot of concern over economic growth. Before 2017, earnings-per-share growth for the S&P 500 had stalled for several years. First-quarter gross domestic product growth was subdued, oil prices are weakening again and interest rates are declining. In fact, the 10-year Treasury bond yield hit a new 2017 low of 2.16% after a below-consensus jobs report on June 2.

In our view, the current scenario is closer to a deflationary boom than an impending economic slowdown.

Yes, there are risks, including oil prices. If oil falls to new lows, it could cause some ripple effects. But, by and large, the S&P 500 seems to be a play on earnings growth, and growth is moving higher—even if reflation isn't. The weaker dollar is one new important positive. And with the Trump agenda hitting an air pocket, the flight-to-quality reaction (driving the dollar and rates lower) is actually positive for S&P 500 earnings growth.

FINANCIALS: STILL CHEAP BUT GROWTH PRESSURES ARE A CONCERN

Over the past few months, we've cut back sharply on our big bet in financials. Last year, the financials bet helped the Portfolio, but it has hurt so far this year. We still like these stocks longer term. They are very cheap on a price/earnings (P/E) basis, should continue to grow, have great balance sheets and prospects for return of capital, and could be the biggest winners from fewer regulations.

But we've been surprised at how sluggish business trends have been—something evident in both commercial lending and capital markets. Things can change quickly, though, so we're keeping big positions in J.P. Morgan (JPM), U.S. Bancorp (USB) and Bank of America (BAC). However, we've reduced exposure to financials as we wait for somewhat better earnings visibility.

We still have limited exposure to energy and materials. Instead we favor industrials, but this positioning is skewed by Northrop Grumman (NOC), our single largest position as of May 31. NOC is not really a cyclical; we view it as a unique secular grower with strong, defensive financial characteristics. Honeywell (HON), our second largest holding, is a true industrial but is very high quality: HON has a better-than-average balance sheet and a less cyclical mix of businesses. Altogether, we're clearly less exposed to cyclicals than we've been in some time.

We've added to a number of segments in recent months, including technology, healthcare and consumer discretionary. Our exposure to technology may actually be our largest ever. It includes Amazon.com (AMZN), which is listed as consumer discretionary but is a tech company in our view. Combined, technology and Internet represent 28% of the Portfolio's long holdings.

There are a wide range of business types in this segment of the Portfolio: Mega-cap Internet giants Facebook (FB), Alphabet Inc. (GOOG) and AMZN have tremendous secular growth prospects and powerful balance sheets. Legacy tech giants Microsoft (MSFT) and Cisco Systems (CSCO) have slower growth outlooks but monster balance sheets and big, growing dividends. Our semiconductor holdings include Texas Instruments (TXN), Broadcom (AVGO), Western Digital (WDC) and Micron Technology (MU); their valuations are much lower because of their cyclical nature, but business trends are extremely strong.

Over the years, we've tended to favor select consumer stocks, in particular those with franchise-like characteristics. But more recently, technology-led disruption has made this area treacherous at best. It's more important than ever to assess the potential disruption to business models. For those firms that can rise above, we think it's a good time to own consumer franchise companies.

MCDONALD'S AND SELECT CRUISE LINES: CONSUMER JUGGERNAUTS POISED FOR GROWTH

We think McDonald's (MCD) is particularly well positioned. Having already done extremely well this year, the company may need to consolidate or pull back. But there's a lot to like. The stock has dividend yields of approximately 2.5%, well above the 10-year Treasury bond yield and benefits from recent dollar weakness. And despite the stock being up sharply, the company is still aggressively buying back shares.

MCD, our third largest holding, is in the midst of an upgrade of its brand and financial targets. New management is cutting costs, raising financial leverage, converting to more franchises (asset-light) and focusing on driving improved top-line growth. Business is quite strong right now and a variety of initiatives seem promising.

One intriguing new program for MCD is delivery. This was likely an afterthought a few years back, but now it's an example of rapid technological advancements helping non-tech companies. By late 2017/early 2018, we think delivery will begin to have a very positive impact on revenues. At a valuation of 24 times its projected earnings, MCD isn't cheap. But we think chances are high for further upward earnings revisions. Also, MCD's valuation looks more acceptable when compared with both global staples and restaurant franchise stocks. The big global staple stocks with fat dividend yields are mostly growing more slowly than MCD, but they have P/E ratios that are almost as high. And the restaurant franchise stocks have much higher valuations.

Another promising area is the cruise industry, which is enjoying very strong business trends. Consumers are increasingly embracing cruises as the available options expand, and cruises are gaining popularity around the world. China, in particular, has been a substantial new source of demand. Strong pricing, low interest rates, low oil prices and a weaker dollar are all favorable variables for cruise lines.

We modestly increased net equity exposure in May by both increasing gross long exposure and reducing gross short exposure. As discussed earlier, technology is a significant disruptive force for traditional retail. In addition to our large allocation to technology stocks, we've also chosen to exploit this secular theme on the short side. We've done this through a basket of retail REITs, which represents our single largest alpha short and a modest positive contributor to performance year-to-date. As of May 31, the Portfolio was 69% long and 12% short, for a 57% net equity exposure.

The top contributors to performance in May were: McDonald's, Northrop Grumman, Alphabet Inc., Norfolk Southern (NSC) and Apple (AAPL).

The top detractors from performance in May were: Walt Disney (DIS), JPMorgan Chase, Lowe's Companies (LOW), Bank of America and Viacom Inc. (VIAB).

As always, thank you for your continued support.

Kurt Feuerman & Anthony Nappo
June 1, 2017

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