The tech bubble was born of greed. The safety bubble was born of fear. But it’s still a bubble—and unlikely to last.

Desperately Seeking Safety

Despite strong stock returns in 2012, investors remain skittish about stocks and continue to pour their money into seemingly safe assets. We see danger in this headlong rush to “safety.”

Stock markets rallied globally in 2012 and have doubled from their early 2009 bottoms. Volatility has subsided to nearly normal. But uncertainty about a wide array of macroeconomic issues and the lingering trauma of 2008 have continued to spur investor flight to assets that appear to be “safe”: from stocks to bonds; from actively managed stocks to index funds; and from active growth and value to equity income funds (Display 1).

By bidding up the prices of these already expensive assets, investors are creating a safety bubble. That’s most evident in Treasury bonds, but we think pricing for stocks with high dividend yields is also approaching a bubble-like level.

In addition, the rising valuations of high-dividend-yielding stocks are distorting the composition of stock-market indexes at a time when investors are fleeing to the apparent safety of index funds and exchange-traded funds (ETFs). Thus, index portfolios, too, have become much riskier than most investors realize.

Resisting the temptation to follow the crowd can be lonely and difficult. Many investors have profited handsomely by following the crowd in recent years. That’s because the current mania for seemingly safe assets has been a self-fulfilling prophecy, which is typical of “crowded trades” (trades in which most investors are on the same side). But ultimately, crowded trades reverse, and investors who rushed in stampede out. Often, they crush others in the process.

We think there’s a better way to seek safety. But before I explain, let’s take a good look at the various manifestations of the safety bubble.

From Cash to Bonds to “Safe” Stocks

In the earliest stage of the credit crisis, terrified investors fled to the safest of financial assets—cash. But once a global banking crisis was averted, cash yields near zero prompted torrential flows into bonds. Since the beginning of 2008, investors have poured more than $1 trillion (net) into US-domiciled bond funds, while selling nearly $250 billion in stock funds.

The headlong rush into bonds continued in 2012 despite 10-year Treasury yields below 2%, their lowest level since George Washington was president (Display 2, next page). These extraordinarily low yields primarily reflect the Federal Reserve’s concerted efforts in recent years to stimulate the economy by...
buying Treasuries and mortgage bonds. De-risking by individual and institutional investors alike has also pushed down bond yields. Bonds are now richly priced relative to expected economic growth and inflation.

We believe that bonds play important roles in most portfolios: They provide income, help preserve capital, and diversify stock exposure. But after five years of massive capital flows into bonds, bonds don’t provide as much income or capital preservation potential as usual.

In seeking short-term capital preservation, investors have been paying no attention to what counts over the long term: total return. The Federal Reserve recently announced that it is unlikely to normalize policy for five years, so bond returns will be low for quite some time.

At today’s ultralow yields, bonds are not just a poor source of income—they are also less likely to preserve capital. Yields have almost nowhere to go but up, which would push bond values down. (Yields could fall temporarily—most likely in the event of another shock.)

Of course, investors know that bond yields are skimpy today. To boost yields, many are tilting their bond portfolios to longer-duration bonds and high-yield corporate and municipal bonds.

We think this is not the right time to increase bond duration. Rising interest rates would hurt long bonds far more than intermediate bonds, and today, long bonds don’t offer a large yield pickup to compensate for that risk.

As for high-yield bonds, they are risk assets, comparable to stocks and real estate. To the extent that investors understand that, the flows into high-yield bonds may represent efforts to re-risk, as well as gain yield. For more on high-yield bonds and other high-yielding securities, see page 4.

Is Indexing Really Safe?
Where investors are sticking with stocks, they are seeking safer-seeming types of stocks, as can be seen from the huge flows out of actively managed stock portfolios into stock index funds, and the shift to high-dividend-yielding stocks.

People think stock index funds are safe because they are low cost, seldom lag their benchmark, and have returned more than most managers for the last five years. They also tend to be more diversified than active managers.

But that doesn’t necessarily make them safe. Index funds can become highly concentrated in individual stocks or sectors, because most market indexes are capitalization weighted. That is, as stocks and sectors become more expensive, their weight in the index grows.

Smaller markets can be concentrated in just one or two hot stocks: Nokia once made up about 90% of the Finnish market index; Nortel, about 27% of the Canadian market index; and Vodafone, about 14% of the UK market index. Since few active managers would take the risk of investing that much in any one stock, active managers generally avoided the huge losses the indexes incurred when the tech and telecom bubble burst.

Even indexes of the much bigger US and global markets can become concentrated in a favored sector, country, or theme. The technology sector ballooned to more than 29% of the S&P 500 in 2000. Over the next two years, the sector’s return was less than negative 56% (Display 3). Financial stocks tumbled even more sharply in the two years after their index weight peaked in early 2007. Similarly, Japanese stocks plunged after their weight in the MSCI World Index peaked at 44% in late 1989.
Today’s favorite market theme lies in so-called safety stocks—particularly those with high dividend yields. At their peak in September 2012, these stocks had a 44% weight in the S&P 500, their largest weight since 1970 and far above the historical norm. What we don’t yet know is how high-dividend-yielding stocks will perform over the next few years.

Are High-Dividend-Yielding Stocks Safe?
The phrase “safe stocks” is an oxymoron. All common stocks are volatile, and none of them promise return of principal at a specified time. Nonetheless, some stocks do offer the protection of a high dividend yield and relative stability.

Typically, these are stocks of mature firms in less cyclical sectors, such as utilities, telecom, and consumer staples. They can pay out much of their earnings in dividends because they have limited opportunities to invest for growth and they don’t need to hold much cash as a defense against a cyclical downturn.

High-dividend-yielding stocks tend to hold up better in crises, when investors seek near-term safety, because investors garner more of their return up front through dividend payments, rather than from future growth. In the deep market drop in 2008 and early 2009, and in the smaller episodes of panic since then, high-dividend-yielding stocks beat the market by wide margins. As a result, these stocks—and portfolios with outsized allocations to them—are likely to trade down with bonds if interest rates rise. A tilt to high-dividend-yielding stocks thus increases the correlation of stocks and bonds in a portfolio, reducing the diversification benefit that provides real protection. Once again, investors’ search for safety may be self-defeating.

High-dividend-yielding stocks also tend to be highly sensitive to interest-rate risk, often because they are mature firms with high debt burdens. As a result, these stocks are likely to lag the market, perhaps for an extended period.

In fact, they are willing to pay a premium to own utility stocks whose long-term earnings growth is likely to be negative.

When investors become more confident and willing to pay for growth, higher-yielding stocks are likely to lag the market, perhaps for an extended period.

What Investors Have Fled
In their pursuit of safety, investors have fled stocks, particularly actively managed stock strategies. We think this has created substantial opportunity.

Today’s very low bond yields make stocks very attractive by comparison. Last summer, in “The Case for the 20,000 Dow,” I explained the fundamental rationale for our conviction that stocks offer good—though somewhat below-average—return potential over the next 10 years, and more than twice their normal potential premium to bonds.

We believe this argument still holds. We estimate that stocks will outperform bonds by nearly six percentage points a year. Here’s why.

The S&P 500’s dividend yield was 2.3% at the end of 2012, well above the 1.7% yield on 10-year Treasuries. Even if

<table>
<thead>
<tr>
<th>Component</th>
<th>Index</th>
<th>Long-Term Avg.</th>
<th>Peak Year</th>
<th>Index Share at Peak</th>
<th>Component Performance Two Years After Peak</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>S&amp;P 500</td>
<td>12.4%</td>
<td>1980</td>
<td>30.0%</td>
<td>(51.1)%</td>
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<tr>
<td>Japan</td>
<td>MSCI World</td>
<td>17.4</td>
<td>1989</td>
<td>44.0</td>
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<td>S&amp;P 500</td>
<td>12.5</td>
<td>2000</td>
<td>29.2</td>
<td>(56.2)</td>
</tr>
<tr>
<td>Financials</td>
<td>S&amp;P 500</td>
<td>9.8</td>
<td>2007</td>
<td>22.3</td>
<td>(63.6)</td>
</tr>
<tr>
<td>High-Dividend-Yielding Stocks</td>
<td>S&amp;P 500</td>
<td>34.7</td>
<td>2012</td>
<td>44.0</td>
<td>?</td>
</tr>
</tbody>
</table>

Past performance does not guarantee future results.


Source: FactSet, Morgan Stanley Capital International (MSCI), Standard & Poor’s, The University of Chicago, and AllianceBernstein.
What About Other High-Yielding Securities?

Investors assuming that income equals safety have been searching for income (or yield) in all sorts of places. Here are a few examples of high-yielding securities that have gained popularity recently. The first three are special types of high-dividend-yielding stock, each focused in a single sector and often highly leveraged. The fourth, high-yield bonds, is more diversified, but also tends to be highly leveraged.

**Master Limited Partnerships** (MLPs) have been among the best performing investments over the last three- and 10-year periods because they gained first from the run-up in energy prices, and then from the pursuit of income.

Under the US tax code, these publicly traded partnerships must pay out 90% of their earnings from a few qualified, mostly energy-related, businesses. As long as they do, they don’t have to pay federal or state taxes, which also boosts their yields.

But in the end, MLPs are equity interests in energy firms and should be judged versus the common stocks of energy firms. The common stocks typically offer lower yields but higher capital appreciation potential from reinvesting for growth. MLPs pay out so much of their earnings that they can’t reinvest for growth without raising capital; most have a lot of debt.

Investors seeking yield have bid up MLP prices so high that their yield advantage over energy common stocks has shrunk. Investors either think earnings reinvested for growth will be wasted or that a bird in the hand is worth two in the bush.

The relationship between energy MLPs and stocks is volatile. We think that at current relative valuations, MLPs are not a safe investment.

**Real Estate Investment Trusts** (REITs) are like MLPs for real estate, offering the same yield and tax advantages. Today, we find global REITs reasonably priced versus history and relative to bonds—but less attractive versus most other stocks.

REITs have soared, slumped, and rebounded over the last decade with the real estate market, but over the longer term, REITs have generally had equity-like returns with less volatility.

At Bernstein, we include REITs in the real asset portion of our fully diversified portfolio constructions for tax-exempt accounts, sourcing the allocation from stocks and bonds. Our smaller-cap value equity team may include select REITs in portfolios when it finds them attractively valued.

**Preferred stocks** typically pay much higher dividends than the common stocks of the same firms, which gives them a bond-like character. They typically don’t trade up much during stock market rallies, but they tend to trade down with stocks in a market crisis.

Why? Preferred stock falls between bonds and common stock in a company’s capital structure. That is, a company in liquidation pays bondholders before preferred stock holders, and common stock holders get whatever’s left (if anything). As a result, preferred stocks typically have lower credit ratings than bonds of the same company. Preferred stock issues are very concentrated in the financial sector, because preferred stock counts as Tier 1 regulatory capital for banks.

**High-yield bonds** have historically delivered higher returns and higher volatility than investment-grade corporate and sovereign bonds, but lower returns and lower volatility than stocks. High-yield bonds have been diversifying to both stocks and bonds.

Bond managers understand that higher yields don’t make high-yield bonds “safe.” Their yield advantage reflects greater credit risk, typically as a result of above-average leverage. Our taxable bond portfolios invest opportunistically in high-yield bonds; they held sizable positions in them in 2009, 2010, and 2011, when their extremely high yields more than compensated for the risk. As declining risk and massive flows pushed high-yield bond prices up and their yields down, we took gains on many holdings, trimming the sector’s weight in portfolios close to neutral.

Our research suggests that a small strategic allocation to high-yield bonds is appropriate for some investors. We also sometimes use them opportunistically to diversify stock market risk. Given their risk character, we source allocations to high-yield bonds from stocks.

In sum, most higher-yield securities come with greater risk, which is logical. These securities may be appropriate for some investors, but not for safety’s sake.
for equity income funds, which emphasize high-dividend-yielding stocks. Investors fled value and growth funds because they did poorly (particularly in 2008 and 2011) and because these funds are inherently more long-term oriented. (For details, see “Going the Distance: Long-Equity Strategies in Short-Tempered Markets,” AllianceBernstein, 2012.)

Growth strategies typically offer little yield: Most of their potential return comes from future capital appreciation related to expected growth in earnings. This makes growth look risky in the current uncertain environment. Today, growth strategies offer above-average premium potential, in our view.

At the same time, deep value stocks seem unsafe to investors with too little faith in the future to wait for a turnaround in company performance or the resolution of some controversy. Thus, the weight of low price-to-book stocks (defined here as stocks trading at a 20% or greater discount to the price-to-book of the S&P 500) has fallen to about 25% of the S&P 500, far below their 31% long-term average weight (Display 4). In our view, the opportunity in such stocks is now greater than it has been at almost any time in decades.

Index investors today run the risk of being slammed both by having too much exposure to high-dividend-yielding stocks and too little exposure to the low price-to-book stocks and high growth stocks that we believe are poised to lead once the search for safety abates.

How Will It End?
Massive inflows make bonds, index funds, high-dividend-yielding stocks, and other high-yielding securities meet our definition of crowded trades: investments attracting widespread and rapidly growing ownership and enthusiasm. If sentiment turns, broad-based selling pressure could make it very hard for investors to get out, even at depressed prices.

We can’t know when or why the safety bubble will end, or how quickly valuations will normalize. Broadly speaking, the turn will come when fear no longer drives the markets.

Clearly, investors are no longer as paralyzed by fear as they were in the wake of the Lehman Brothers collapse in September 2008. But the market rebound since then has been punctuated by a series of smaller reversals, indicating that investors remain quite nervous. And capital is still flowing out of stocks and into bonds.

The safety bubble in bonds and more bond-like stocks could burst quickly if global economic growth accelerates and interest rates spike. That would drive bond prices down—and be good for most stocks. Or, the bubble could gently

Display 4: The S&P 500 Is Skewed to High Yield and Away from Low Price-to-Book
Percent of S&P 500 Market Cap

Through November 2012
Low Price-to-Book defined as stocks trading at a discount of 20% or more to the cap-weighted average for the S&P 500; High Dividend Yield defined as stocks with yields 20% or more greater than the cap-weighted average for the S&P 500; data smoothed over three months
Source: Center for Research in Security Prices, FactSet, and AllianceBernstein

earnings don’t grow for 10 years and stock prices and dividends don’t change, stocks will outperform bonds. With average earnings growth and valuations rising just halfway back to their historical norm, stocks would deliver much higher returns than bonds.

Of course, stock-market returns could be much worse than we expect, particularly in the short term, if earnings drop or inflation soars. But stock-market returns could also be much better, if innovation boosts productivity growth.

The flight to apparent safety in index funds, meanwhile, has created an unusually large opportunity in actively managed stocks, in our view. It has distorted the major stock indexes by putting heavy selling pressure on the stocks that active managers own and by putting heavy buying pressure on the stocks that active managers do not own. Display 1 shows that the very high net outflows for value and growth funds in recent years coincided with large inflows for equity income funds, which emphasize high-dividend-yielding stocks.
deflate, if the economy continues to be anemic and interest rates remain low.

Perhaps it has already started to deflate. The S&P 500’s 16.0% return in 2012 beat by far the 4.2% return of the Barclays Capital US Aggregate Bond Index and the 1.3% return of the “safe” utilities sector. Relative returns for active strategies have also improved recently.

A Better Path to Safety
There are several key lessons to take from the discussion above.

Don’t join the crowd in chasing performance. The temptation to buy whatever has recently done best and sell whatever has done poorly is natural—but dangerous. Its destructive power is evident in the poor results of the average US investor (Display 5). The average stock-fund investor has garnered less than half the return of the S&P 500 over the 20 years through 2011, and the average US bond-fund investor has garnered a tiny portion of the Barclays Capital US Aggregate Bond Index.

The main reason for these poor results is that investors repeatedly sold managers and asset classes that did poorly to buy managers and asset classes that did well. Investors buy high and sell low. That’s a recipe for failure that too many investors continue to follow, as Display 1 shows.

Today, we think the better path to safety includes resisting the temptation to seek safety at any price. Instead, we recommend maintaining exposure to stocks, remaining in active strategies, and, in particular, focusing on total return, not just short-term yield. That is, it means seeking the capital appreciation that can come from long-term growth potential and misvaluations.

But don’t buck the crowd entirely. Crowded trades are comfortable, and they can continue to attract capital for a long time. Arguably, the crowded trade in technology stocks was evident in early 1999—yet the sector continued to outperform massively until March 2000.

We at Bernstein started talking about the safety bubble more than a year ago. It has persisted longer than we expected, but there are signs of a turn at hand. We think that investors who give up on stocks and active management will leave a lot of money on the table when the turn comes.

Stay diversified. Maintaining thoughtful diversification is critical. It’s important to maintain exposure to a broad range of asset classes, styles, and themes, and to rebalance to avoid overexposure to crowded trades when the reversal comes.

At Bernstein, we help you to remain diversified between stocks and bonds, and to diversify further, if appropriate, with allocations to real assets and hedge funds. We’ve increased the diversification of the style exposures within your stock portfolios, adding stable stocks to value and growth, and smaller caps to large.

Adapt to changing risks and potential returns. The markets are always moving; risk and potential return always shift. Our Dynamic Asset Allocation service seeks to provide a smoother experience...
by continually weighing short-term risk against potential return. An important task at any time, it is crucial now, when the macroeconomic and policy outlooks remain highly uncertain and volatility could easily flare up. We expect this approach to add to returns in down markets, but lag modestly in up markets. So far, it has performed in line with this objective, stabilizing portfolio returns. Our active security-selection strategies also seek to lean into opportunity when opportunity appears most enticing. We generally dial down active risk when the opportunity appears to be more muted.

Maintain a long-term view. Investors who focus on near-term safety define safety as avoiding a large loss. That's fine with respect to money needed in the near term, perhaps to make a down payment on a house or pay for a child's college tuition. But there's a second risk that long-term investors have to weigh: the risk that they will not have the money they need at some point in the future. Our active security-selection strategies also seek to lean into opportunity when opportunity appears most enticing. We generally dial down active risk when the opportunity appears to be more muted.

But the right side of Display 6 shows that with bond-heavy allocations, there's a larger risk that the couple will run out of money, even if they limited their annual withdrawals to just 3% of the portfolio's starting value, adjusted for inflation. Many investors are now so focused on the risk of short-term loss that they are ignoring the risk of running out of money. We think that course is not safe.

Display 6 also shows that the asset allocations dominated by stocks pose a greater risk of large losses along the way than of running out of money. In the late 1990s—and to a lesser extent in the middle of the past decade—investors excited by long-term return potential paid little heed to the risk of losses. That course wasn't safe, either, as many learned to their regret.

We believe that the better path to safety starts with identifying your long-term goals and determining the core capital you need to fund them. Then, you need to commit enough capital to stocks to meet your spending goals, without exceeding your tolerance for risk.

We at Bernstein can help you identify the asset allocation best suited to your circumstances and your short- and long-term goals. But remember, the critical issue is to strike the right balance.

As the Rolling Stones said, “You can’t always get what you want. But if you try sometimes, well you just might find, you get what you need.”

Display 6: What’s Really Safe?

<table>
<thead>
<tr>
<th>Probability of Peak-to-Trough Loss of 20% over the Next 10 Years*</th>
<th>Probability of Running Out of Money†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks/Bonds</td>
<td>Long-Term Risk</td>
</tr>
<tr>
<td>&lt;2%</td>
<td>2%</td>
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<tr>
<td>2%</td>
<td>15%</td>
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<td>36%</td>
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</tbody>
</table>

As of September 30, 2012

*Projections indicate the probability of a peak-to-trough decline in pretax, pre-cash-flow cumulative returns of 20% over the next 10 years. Because the Wealth Forecasting System uses annual capital market returns, the probability of peak-to-trough losses measured on a more frequent basis (such as daily or monthly) may be understated. The probabilities depicted above include an upward adjustment intended to account for the incidence of peak-to-trough losses that do not last an exact number of years.

†Represents the probability of running out of money for a 65-year-old retired couple spending 3% inflation-adjusted per year; assumes top marginal federal and 6.5% state tax rates

"20/80" modeled as 20/80/0 (global stocks/municipal bonds/hedge funds); "40/60" modeled as 37/56/7;

"60/40" modeled as 52/34/14; "80/20" modeled as 63/16/21

Based on Bernstein’s estimates of the range of returns for the applicable capital markets over the periods analyzed. Data do not represent past performance and are not a promise of actual future results or a range of future results. See Notes on Wealth Forecasting System on the back cover for further details.

Source: AllianceBernstein
Notes on Wealth Forecasting System
The Bernstein Wealth Forecasting System® (WFS) is designed to assist investors in making a range of key decisions, including setting their long-term allocation of financial assets. The WFS consists of a four-step process: (1) Client Profile Input: the client’s current assets, income, expenses, cash withdrawals, tax rate, risk tolerance, goals, and other factors; (2) Client Scenarios: in effect, questions the client would like our guidance on, which may touch on issues such as which vehicles are best for intergenerational and philanthropic giving, what his/her cash-flow stream is likely to be, whether his/her portfolio can beat inflation long term, when to retire, and how different asset allocations might impact his/her long-term security; (3) The Capital Markets Engine: our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indexes, not Bernstein portfolios), as well as their unpredictability; and (4) A Probability Distribution of Outcomes: based on the assets invested pursuant to the stated asset allocation, 90% of the estimated returns and asset values the client could expect to experience, represented within a range established by the 5th and 95th percentiles of probability. However, outcomes outside this range are expected to occur 10% of the time; thus, the range does not establish the boundaries for all outcomes. Further, we often focus on the 10th, 50th, and 90th percentiles to represent the upside, median, and downside cases.

Asset-class projections used in this paper reflect initial market conditions as of September 30, 2012. They include the following median forecasts of 30-year compound rates of return: US diversified stocks (represented by the S&P 500 Index), 8.2%; US value stocks (represented by the S&P/Barra Value Index), 8.4%; US growth stocks (represented by the S&P/Barra Growth Index), 7.9%; US small/mid-cap stocks (represented by the Russell 2500 Index), 8.3%; developed international stocks (represented by the Morgan Stanley Capital International [MSCI] EAFE Index of major markets in Europe, Australasia, and the Far East, with countries weighted by market capitalization and currency positions unhedged), 8.7%; emerging market stocks (represented by the MSCI Emerging Markets Index), 6.9%; hedge funds (represented by diversified hedge fund asset class), 6.3%; municipal bonds (represented by AA-rated diversified municipal bonds with seven-year maturities), 3.0%; and inflation (represented by the Consumer Price Index), 3.0%. Globally diversified equity portfolios are an annually rebalanced mix of 21% US diversified, 21% US value, 21% US growth, 7% US small/mid-cap, 22.5% developed international, and 7.5% emerging markets.

An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein’s estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

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