THE CASE FOR INTEGRATED, ACTIVE WEALTH MANAGEMENT

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Investor dissatisfaction with poor performance, high fees, and conflicts of interest are driving the wealth-management industry in two seemingly different directions. We think there’s a better way.

**THE CHALLENGE**
The benefit of private wealth comes with a challenge: How best to manage it? Personal and emotional considerations matter but can be hard to explain and quantify. There are a dizzying array of strategies, brands, and people to choose from, yet to most investors, they all look the same.

In the pages that follow, we attempt to demystify how wealth managers work and to explain how Bernstein’s “integrated” approach is not just different but structurally advantaged, versus the “outsourced” approach that prevails among advisors, consultants, and wealth offices serving affluent families. We also discuss the trade-offs between active and passive investing, which are more complex than the conventional wisdom suggests.

For 50 years, Bernstein’s business has focused exclusively on investment research and management. Today our relationships include multigenerational families, executives, entrepreneurs, entertainers, and not-for-profit organizations.

How we work with clients depends on their needs. For many clients, we deliver solutions tailored to their specific financial goals, taking into consideration all their assets, business interests, and liabilities. To others, we provide distinctive, targeted strategies in which they invest alongside institutions from around the world (Display 1).

This paper focuses on how our integrated approach helps clients achieve outcomes such as lifetime spending, generational wealth transfer, and charitable giving by balancing risk and return objectives. However a client elects to work with us, we aim to stand out on the merits of aligned interests, accountability for results, and transparent fees.

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**DISPLAY 1: HOW WE WORK WITH OUR CLIENTS**

**Integrated Solutions**
- Diversified
- Risk-Managed
- Driven by Client Objectives

**Targeted Services**
- Driven by Specialized Research
- Thematic
- Opportunistic

Integrated portfolio customized to each client’s wealth-management goals

*For illustrative purposes only
Source: AB*
WHY BERNSTEIN?
What makes Bernstein different is straightforward: We are an investment manager. The simplicity of this response often surprises people who assume that all wealth advisory firms are the same—if not in skill, then at least in intent. This important misperception is at the heart of why wealth managers often disappoint their clients.

Let’s start with some background: The industry that serves wealthy families is highly fragmented but clustered around two types of firms and a common approach to investing. Using an approach often referred to as “open,” most wealth advisors don’t actually invest their clients’ money. Instead, they outsource investment management to third parties. We will examine this in more detail in the next section.

At one end of the wealth-management spectrum are large banks, brokers, and insurance companies. The size and resources of these firms convey a feeling of stability and safety that some find appealing. The competing client interests inherent in firms with multiple lines of business, however, are less well understood.

These conflicts were plainly evident in remarks by the chief executive of a leading global investment bank at an event in 2015. He described wealth management as the “ballast” of his company and the securities business (underwriting stocks and bonds and creating structured products) as “the engine room.” “We are in the business of facilitating capital flows between issuers (companies) and investors,” he added, describing the firm’s wealth-management division as a “distribution (sales) platform” for products created on behalf of corporate clients.1

At the opposite end of the spectrum are small, independent wealth advisory firms and family offices. This part of the industry has seen significant growth in the wake of the financial crisis, which tarnished the reputations of many banks. But independence often brings deficits in scale, scope, and expertise.

Bernstein is part of AB, a global research and investment firm; Bernstein clients benefit from the skill and experience of the firm’s entire global research and investment complex: nearly 3,500 employees in 20-plus countries around the world. We may all play different roles, but everyone at our firm is devoted to achieving successful investment outcomes for our clients, and to making every client feel like our only client. (See “Aiming for Outcomes: The Destination” on page 8.)

WHY NOT OUTSOURCE?
Bernstein’s sole focus on managing money and our global expertise make us different from other wealth managers. We believe that our integrated approach to investing makes us better. (Display 2, next page.)

2Our multi-manager hedge-fund services are an exception. Our research suggests that broad diversification across and within hedge-fund categories is needed for these investments to provide their potential benefits. See “Demystifying Hedge Funds: Taking a Rigorous Research Approach,” Bernstein, 2012.
Outsourcing is compelling in principle, but in practice its structural flaws become apparent and often lead to disappointing outcomes. The allure is twofold: access to investment managers with strong recent track records and the flexibility to fire underperformers. While this sounds good, it often results in portfolios that hold too many securities, are insufficiently diversified, and are prone to poor timing decisions.

Consider an allocation to large-cap US stocks benchmarked to the S&P 500. With diversification in mind, an outsourced investment process would typically distribute a client’s capital among at least four different outside managers who employ strategies such as growth, value, core, and low volatility. All the investment managers would be chosen for their stellar recent track records, of course, since few wealth advisors ever recommend out-of-favor strategies poised to recover (Display 3).

With 75 to 100 holdings typically found in each of the four portfolios, the client account ends up with some 300 to 400 securities, versus 500 in the benchmark. Whatever might make each strategy individually compelling is diluted in aggregate to resemble something closer to the index than an actively managed strategy. To beat a benchmark after fees, an investment portfolio needs to differ from its benchmark. Outsourcing to several large, diversified portfolios works against this.

Despite holding many securities, outsourced portfolios often provide less diversification than meets the eye. While the four different investment strategies are intended to provide diversification, their strong recent track records can often be explained by a common characteristic, or factor. When this common factor falls out of favor, the promise of diversification doesn’t just fail, it backfires.

DISPLAY 2: CHOICE IN PARTNERING WITH A WEALTH MANAGER

![Display 2: Choice in Partnering with a Wealth Manager](image)

Source: AB

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For more on this topic, see “Conviction and Consistency,” Seth J. Masters, Joseph G. Paul, and Stuart C. Rae, Bernstein, 2016.
And because advisors can remove underperforming third-party managers in the wake of disappointing results, they often do just that. However, since advisors rarely terminate managers after a strong run, they usually make these decisions at precisely the wrong time. Try as they may, it’s impossible for third-party wealth advisors to deeply understand an external investment manager’s process and how much of its recent success (or failure) is a product of luck versus skill, or just momentary timing. In fact, academic studies show that terminated managers end up outperforming the ones that replaced them in the years that follow.4

Unlike outsourced portfolios with hundreds of uncoordinated stock holdings, a typical Bernstein account will have a large-cap US equity allocation of about 75 stocks at a given time, avoiding the excessive diversification that wastes capital (Display 4). Research insights from dozens of our firm’s industry-leading analysts and portfolio managers go into stock selection. Then, the stocks are integrated in a portfolio construction process that is more evolved than legacy, style-based approaches. Our focus on factor characteristics such as quality, value, growth, and momentum results in portfolios that are structurally advantaged in stock selection and position sizing.

*Display 3: Past performance does not predict future manager results*

*Previous Three Years*  
- Best Performing Managers  
- Median Managers  
- Worst Performing Managers  

*Next Three Years*  

For illustrative purposes only, but based on research that showed most top-quartile investment managers did not remain in the top quartile in subsequent years  
Source: AB

*Display 4: Open architecture tends to overdiversify, wasting capital*

*Capital Allocation: All Holdings*  
- Open Architecture Portfolio  
- Strategic Equities  
- Wasted Capital  
- High-Conviction Holdings  

For illustrative purposes only  
Source: AB

Our integrated approach also enables us to efficiently manage volatility and taxes in real time, with complete information (see “Aiming for Outcomes: The Journey” on page 9). And because there is no middleman, our clients pay a single, fully transparent fee that generally results in lower costs.5 Outsourced approaches have two fees: one for the wealth advisor and another, less transparent set of fees for the third-party investment managers. As a result, clients often pay more and get less than they realize.

No firm gets everything right all the time, but Bernstein clients get what they bargain for (Display 5).

WHY BOTHER WITH ACTIVE?
Over the last several years, disappointing active-manager returns, especially in “outsourced” portfolios, have prompted a decisive shift toward passive index strategies, such as exchange-traded funds (ETFs). While passive investments can play an important role in some portfolios, we believe their rising popularity reflects near-ideal investment conditions for them in recent years, as well as a marketing message that understates their complexity and risk.

The conventional wisdom supporting passive strategies focuses on three main ideas. Let’s look at each in turn.

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5Bernstein fees are calculated based on specific asset allocations and the total value of assets under management. Our fee schedule is available on request.

Past performance is not necessarily indicative of future results.

The performance of the taxable Bernstein Moderate Growth Historical Advice (after fees) is presented for illustrative purposes only. The performance shown is simulated to reflect the annualized, net-of-fee returns of Bernstein’s recommended asset allocation for clients with a moderate growth profile using Bernstein investment services. No representation is being made that an investor will, or is likely to, achieve a return similar to the result shown here. For more information, see Notes on Performance Statistics at the end of this document.

US municipal bonds are represented by the Lipper Short/Intermediate Blended Municipal Fund Average; US stocks, by the S&P 500. The average US-stock-fund investor captures investors in US-registered stock funds, which may include funds that invest in whole or in part in non-US stocks.

There can be no assurance that working with a financial advisor will improve investment results. Investors cannot invest directly in indexes. The results for the average US-muni-fund and US-stock-fund investors are in the Dalbar study “Quantitative Analysis of Investor Behavior” (QAB), 2017. QAB calculates investor returns as the change in mutual fund assets after excluding sales, redemptions, and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses, and any other costs, annualized over the period.

Source: Dalbar, Lipper, S&P, and AB

Bernstein fees are calculated based on specific asset allocations and the total value of assets under management. Our fee schedule is available on request.
“Active managers can’t beat the market.” A recent study by Vanguard reported that over the past 20 years, just 29% of active US mutual funds outperformed their stated benchmarks, net of fees and expenses. This seems low, until you consider that no index fund outperforms its benchmark after fees in any time frame.

Importantly, not all active managers are the same. The costs associated with active management make it mathematically impossible to beat a benchmark if the underlying investments don’t differ sufficiently from the benchmark. While many supposedly active managers are prone to hugging an index, simple measures like “active share” offer investors a straightforward way to identify the “closet indexers.”

Active share is measured on a scale of zero to 100, where zero is exactly like an index, and 100 is entirely different. One academic study found that the investment industry’s active share is just 30% in aggregate. It’s no wonder the average active fund struggles to add value, net of fees, for its investors.

But averages can be misleading. The investment portfolios commonly held in Bernstein client accounts have active share values that start at 70% and go up to nearly 100%. In conjunction with our factor-driven portfolio construction process, our research-driven, high-conviction security selection gives Bernstein clients reason to expect above-average performance over the course of an investment cycle.

We believe the rising popularity of passive investments reflects near-ideal investment conditions for them in recent years.

“ETFs are cheap.” While most large-cap stock index ETFs can be purchased for considerably less than their actively managed counterparts, there is a wide price range in each category, and the index benchmark isn’t always clear. For example, only three out of 83 US large-cap blend ETFs track the S&P 500. The more that index strategies move away from broad benchmarks toward specific investment themes, sectors, or regions, the more expensive they tend to be.

There’s no disputing that index ETFs have delivered strong absolute returns in the years following the global financial crisis of 2008, which has helped fuel their recent popularity. Their success from 2009 to 2014 was not just a product of low fees. Many observers fail to appreciate that the postcrisis period was a highly unusual investment environment during which stock-market returns compounded at an above-average rate, and that from 2012 to

(continued on page 10)
AIMING FOR OUTCOMES: THE DESTINATION

It’s human nature to assess progress. But to know where you are, you must first know where you are going. With this idea in mind, Bernstein allocates client capital on risk-based principles. In single investment strategies and in portfolios that span asset classes, our goal is always the same: the most efficient trade-off of risk and return.

The client’s desired outcome is the benchmark that matters most.

For many of our clients, this endeavor begins with a core-capital analysis, using our Wealth Forecasting System (Display 7). The objective is to provide a foundation for informed investment decision-making by modeling outcomes and probabilities of loss under a variety of different scenarios.

For individuals and families, we apply the concept of core capital to day-to-day cash flow needs, which then determine the amount of surplus capital available for generational transfer, philanthropy, or investment in assets with a different risk profile. For the endowments and foundations we serve, we apply the concept to distributions and spending. Once complete, and until a client’s circumstances change, a core-capital analysis guides investment decision-making and provides a basis for evaluating future progress.10

The client's desired outcome is the benchmark that matters most. This is why our website, bernstein.com, shows results relative to conventional indexes, as well as to goals. When someone asks our clients about their results, our greatest hope is that they can respond (at a minimum), “I’m on track.”

10For more on this topic, see “The Right End of the Telescope,” Seth J. Masters, Bernstein, 2015.

The Bernstein Wealth Forecasting System® is based upon our proprietary analysis of historical capital-market data over many decades. We look at variables such as past returns, volatility, valuations, and correlations to forecast a vast range of possible outcomes relating to market asset classes, not Bernstein portfolios. While there is no assurance that any specific outcome suggested by the model will actually come to pass, by quantifying the possibilities of achieving financial goals under changing, and sometimes extreme, capital-market conditions, the tool should help our clients make better choices.

Source: AB

10For more on this topic, see “The Right End of the Telescope,” Seth J. Masters, Bernstein, 2015.
AIMING FOR OUTCOMES: THE JOURNEY

Over the last 20 years, investors enjoyed close to a 6% return from a safe portfolio consisting of 100% taxable bonds. Over the next 20 years, we expect that the same outcome will require at least a 50% allocation to stocks, bringing much more variability in short-run returns. With this in mind, one challenge we face today is connecting our clients’ return goals with the level of volatility they are willing to accept.

Bernstein’s proprietary Dynamic Asset Allocation (DAA) service was created to manage and reduce portfolio volatility. DAA achieves this by tactically adjusting the weight of return-seeking or risk assets in a portfolio to achieve a specific range of volatility.

For the sake of simplicity, consider a strategic asset allocation of 60% stocks and 40% bonds. A client invested in this allocation is signing up for annualized volatility of 8% to 11% over the long run.

Recognizing that volatility can be higher or lower in the short run, DAA uses sophisticated volatility forecasting tools to increase or lower the portfolio allocation, and riskier, return-seeking assets, such as stocks, to keep realized volatility within the target range.

When the DAA team predicts low volatility, a normal 60/40 allocation might tick up to 65/35, with the idea that the client can take on a bit more risk and realize a greater return while remaining in their preferred volatility range. The same is true in reverse: If the DAA team expects higher volatility, it would adjust a portfolio to a more conservative asset mix, say 55/45 (Display 8).

We’ve found that smoothing the bumps along the way gives investors the confidence to stay invested and take the risk needed to achieve their goals. DAA marks its seventh anniversary in 2017, but we believe it has never been more important.

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**DISPLAY 8: DAA ADJUSTS WEIGHTS WITHIN BROADLY DIVERSIFIED ALLOCATIONS**

Past performance is not necessarily indicative of future results.
Through December 31, 2016
*Allocations are based on a moderate growth portfolio with a normal target of 56% global stocks, 4% real assets, and 40% bonds. The current target is 59% global stocks, 5% real assets, and 36% bonds.
Source: AB

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¹Volatility measures the choppiness of a return pattern for a given asset. It can reflect the fundamental risk associated with an asset but also captures investor sentiment. Volatility is important to understand and manage because it can lead to poor timing decisions (buying high and selling low).
²For more on this topic, see “Storm Tracking,” Seth J. Masters and Daniel J. Loewy, Bernstein, 2015.
2014, volatility was historically low. Generally speaking, conditions like these are the product of extreme market sentiment—either fear or greed—and tend to under-reward differentiated insights at the stock level for a period of time.

Unfortunately, asset values can’t go straight up forever. In 2014, Bernstein began to anticipate an extended period where returns would be lower and more volatile than they had recently been. We also noted that historically, periods of low returns and high volatility have rewarded research-driven active managers, because they are better able to profitably express their analytical views. While this has started to play out, we believe we are still in the early stages of this new investment setting.

The modest return environment we expect will be particularly challenging for index investors who will only get what the market gives, with no hope of doing better. Worse, the most popular passive investments track capitalization-weighted indexes that are heavy with the stocks that recently outperformed and are at risk for a pullback. These strategies are also unable to take advantage of opportunities when volatility spikes and strong companies get cheap along with weaker ones. Sometimes you get what you pay for and still end up disappointed.

“ETFs are simple and low risk.” We know it’s anything but simple to time manager selection in outsourced investment approaches, and it’s nearly impossible for active managers with low active share to beat their benchmark. So it’s no surprise that many investors see passive strategies as a comparatively simple way to avoid these pitfalls. But there is no free lunch with investing, and ETFs simply present different risks to consider.

What makes index ETFs cheap, in part, is that they are systematic strategies. That is, their approach to both security selection and construction is rules-based and requires little to no human intervention to execute. Unfortunately, this makes them susceptible to concentration risk when sectors or stocks become popular and trade at higher valuations than their fundamentals merit. Good examples are Internet companies in the late 1990s, and energy companies more recently. In these cases, index ETFs had to keep buying shares of companies when analytical insight or common sense might have suggested otherwise.

Another example of ETF risk was apparent on August 24, 2015, when the global markets plunged. That day, some ETFs reported trades down 30% to 45%, far below the value of the underlying securities; and 118 ETFs halted trading. ETFs failed to deliver the liquidity they had promised. Some investors tried to trade and, fortunately, couldn’t. Others were not as lucky. They traded successfully at prices that were massively disconnected from their underlying components and suffered huge losses.

Passive strategies in assets such as high-yield bonds have also proven riskier and less rewarding than marketers would have you believe. Since inception, the largest high-yield benchmark has lagged the average active fund manager by 2%, annualized.

Again, Bernstein sees a role for passive investments in some situations. We just don’t think they are the simple, low-risk investment panacea that many people believe them to be.

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**Index ETFs are backward looking.**

What makes them cheap also makes them susceptible to concentration risk.

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13For more on this topic, see “Greed, Fear, and the Creation of Opportunity,” David Barnard, Bernstein, 2015.
14Source: Barron’s, BlackRock, ETF.com, Forbes.com, Morningstar, USA Today, The Wall Street Journal, and AB
15For more on this topic, see “No Contest: In High Yield, Active Funds Beat ETFs,” Gershon Distenfeld, CONTEXT/The AB Blog on Investing, August 17, 2015.
THE BERNSTEIN ADVANTAGE
For 50 years, Bernstein has delivered for families, foundations, and not-for-profit organizations. Over time, our approach to working with clients has evolved and will continue to evolve. But what we stand for is the same as on the day we were founded.

Bernstein’s unique combination of benefits includes:

- Consistent, risk-based approaches to investment outcomes
- Individually tailored asset allocations and portfolios
- World-class research expertise across asset categories and geographies
- Direct investment in a range of high-conviction, limited-capacity institutional portfolios
- Integrated volatility and tax management
- Fully transparent fees
- Personal service

We aspire to be AHEAD OF TOMORROW® in everything we do for clients. This is ambitious, since everyone’s long-term goals are different, and trade-offs between investment risk and return are always changing. But Bernstein clients are in the capable hands of a global firm that has stood the test of time. Drawing on our culture of relentless ingenuity, accountability, and teamwork, we stand ready to help our clients achieve their financial goals and enjoy the confidence their wealth should afford them.

Want to Learn More?

CONTEXT
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NOTES ON THE BERNSTEIN WEALTH FORECASTING SYSTEM
The Bernstein Wealth Forecasting System™ uses a Monte Carlo model that simulates 10,000 plausible paths of return for each asset class and inflation and produces a probability distribution of outcomes. The model does not draw randomly from a set of historical returns to produce estimates for the future. Instead, the forecasts (1) are based on the building blocks of asset returns, such as inflation, yields, yield spreads, stock earnings, and price multiples; (2) incorporate the linkages that exist among the returns of various asset classes; (3) take into account current market conditions at the beginning of the analysis; and (4) factor in a reasonable degree of randomness and unpredictability.

NOTES ON PERFORMANCE STATISTICS
The performance shown for Bernstein Moderate Growth Historical Advice is a simulation intended to illustrate the investment experience of a Bernstein taxable client who was invested in a 60% equity/40% fixed income (municipal bond) allocation of Bernstein investment services. The specific allocations have changed over time as new investment services were introduced, or as a result of changes in Bernstein’s asset-allocation recommendation. This simulation is presented for illustrative purposes only, and no representation is made that an investor will, or is likely to, achieve profits or experience losses similar to those shown. The specific allocations beginning in January 1991 and additional information regarding the calculation of performance are available upon request.

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