Alliance Bernstein

Addressee

This paper is addressed to the Officers and Pensions Committee of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund (“the Fund”). It should not be released or otherwise disclosed to any third party except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

The paper considers Alliance Bernstein’s mandate.

Background

Alliance Bernstein commenced management of a UK equity mandate on behalf of the Fund on 10 June 2005. The mandate was initially funded at the level of approximately 14% of Fund assets. The mandate was never re-balanced (e.g. after the broad equity setback in 2008/9 when the manager had also suffered significant underperformance relative to benchmark) and no new money was allocated (due to persistent performance issues), so the proportion of assets had fallen to under 11% of Fund assets by the start of 2012. Recently, the Committee determined to use some of the mandate as a source of funds for new absolute return mandates. As a consequence, Alliance Bernstein’s mandate will reduce to approximately 7.5% of Fund assets.

Alliance Bernstein’s performance

The relative performance of active managers is highly sensitive to their style of management and the extent to which the portfolio they manage mirrors the shape of their benchmark index. Depending on the prevailing conditions, the style impact can be very significant. Alliance Bernstein’s UK mandate follows a “value” style discipline, although it adopts a quite deep variation of that style.

Alliance Bernstein’s mandate is benchmarked against the FTSE All-Share index. In the following table, we compare UK index returns, along with Alliance Bernstein’s performance. MSCI are an index provider like FTSE, but they are a competitor. The index constituencies of FTSE and MSCI are not directly comparable, so the MSCI index return and the average of the MSCI value and growth indices will not necessary be the same as the FTSE return. For example, the figures in the table below for the MSCI indices are behind the FTSE All-Share index result for every period. The one year, three year and five year columns in the table use calendar year data (i.e. periods ending 31 December 2011). The 3 months data is for the quarter ending 31 March 2012.

	3 months %	1 year (%)	3 years (% p.a.)	5 years (% p.a.)
Alliance Bernstein	6.3	-6.6	6.9	-4.8
FTSE All-Share	6.1	-3.5	12.9	1.2
MSCI UK index	4.7	-1.8	12.0	0.4
MSCI UK Value	3.7	5.2	11.0	-0.5
MSCI UK Growth	5.6	-6.9	12.9	3.0

[The MSCI Value and Growth Indices are constructed using an approach that provides a precise definition of style using eight historical and forward-looking fundamental data points for every security. Each security is placed into either the Value or Growth Indices, or may be partially allocated to both (with no double counting). The objective of this index design is to divide constituents of the underlying MSCI index into respective value and growth indices, each targeting 50% of the free float adjusted market capitalization of the underlying market index.]

The style indices in the final two rows of the above table show that there can be huge variations in return due to style, even over a period of 12 months. MSCI data would suggest that Value outperformed Growth by 12% in 2011. The second thing to note is that Alliance Bernstein's portfolio did not participate in this style reversal. This is partly a result of the absence of any precise definition of what might constitute value.

Indices and managers' portfolios are not mirrors. The style differential that occurred at index level in 2011 may have been due to an investor shift to large capitalisation stocks with more defensive qualities and higher dividend security – a feature of the UK equity market in 2011 – rather than a shift towards "value". Alliance Bernstein's portfolio has benefited from some of this, e.g. from overweight positions in Vodafone and AstraZeneca last year. But its portfolio also suffered from holdings in cyclical stocks such as the miners Xstrata and Rio Tinto, capital equipment manufacturers like Cookson Group, and Barclays PLC, which fell sharply in price over Q3 of 2011. Cookson Group and Barclays were two of the strongest performers in the portfolio, each rising by 35% in Q1 of 2012.

We would consider this degree of price volatility to be irrational, but symptomatic of market conditions. Price movements of this magnitude are driven by changes in sentiment rather than a change in fundamentals. Nevertheless, we recognise that, while this may be an explanation of Alliance Bernstein's performance, it does not provide any evidence of why the performance should be expected to improve.

Portfolio characteristics

The mandate is benchmarked against the FTSE All-Share index. Although there are over 620 constituents in the index, it is heavily concentrated with the 10 largest stocks accounting for 41% of the index. Indeed, Shell and BP alone account for 13% of the index. The FTSE 100 component comprises 84.3% of the index.

Alliance Bernstein's portfolio is even more concentrated. There are 44 holdings. Shell and BP together account for 17.4% of the portfolio. The top five holdings account for 37% of the mandate and the top 10 account for 57.4% of the mandate. Six of the 44 stocks, accounting for 5% of mandate value, are non-UK stocks. These holdings are consistent with the terms of their mandate.

Alliance Bernstein may contend that they are exercising considerable conviction in their stock selection, running such a concentrated portfolio. It is certainly true that the mandate is well diversified by sector. Nevertheless, we believe that the extent of stock specific concentration is too high and that the portfolio would benefit from holding significantly less concentrated holdings in individual securities. To some extent, the manager could argue that the index is already very concentrated by security and their objective to outperform the index introduces some constraints on their portfolio construction. Nevertheless, they operate with a high tracking error which would suggest that they consider the portfolio is only very loosely constrained by benchmark.

Conclusions

Other managers following a value style discipline have struggled over a number of years. The spectrum of managers covered within the value style, however, does mean that some have made stronger recent recoveries than Alliance Bernstein. That does not mean that we would advocate that clients switch from one active "value" manager to another.

Our principal reason for recommending that the Fund maintain assets in Alliance Bernstein's mandate has been based on two principal reasons:

- That equity markets are extremely dysfunctional in their pricing of individual equities; and
- That there appears to us to be significant value embedded in the portfolio, which would be foregone if the Committee were to terminate the mandate and crystallise the losses.

At the same time, we recognised that the Committee would be uncomfortable maintaining the mandate at its near 11% allocation, which was why we recommended reducing the mandate allocation to 7½% of Fund assets.

As we have stated before, there are no guarantees about when or whether Alliance Bernstein's performance will recover. We believe there is potential for the recovery to occur, but that it is likely to take a change in equity investor attitude for that to occur.

This recovery appears different from past cycles. The period of recovery could be prolonged. There is an enduring lack of growth. Investors appear more inclined to back growth where they can find it and to pay a premium for it. When growth disappoints, e.g. Tesco's earnings announcement in Q1 of 2012, the share price underperforms sharply. Meanwhile, investors struggle to place their trust in balance sheets (one plank of value investment) preferring harder evidence of growth in earnings or dividends.

As a consequence, it is likely that the value opportunity in the market is growing. However, "cheap" stocks can become yet cheaper until investors can identify some visibility of recovery. In the current challenging environment, this could yet take some time, with no guarantees attached.

We do recognise that determining the approach to take with the residual Alliance Bernstein mandate is a very difficult decision for the Committee. Nevertheless, they have already taken some steps by reducing the size of the mandate, thereby limiting its impact at total fund level.

We will be pleased to answer questions about this note at the forthcoming meeting.

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3 May 2011

For and on behalf of Hymans Robertson LLP

Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.