# The Paradox of Growth Investing

- The market rewards companies that beat earnings expectations
- "Dynamic gap" is the difference between the market's expectations for growth and what a company actually delivers
- We build portfolios using a dynamic gap approach to growth investing



AllianceBernstein
Investments

# Growth Investing Is Hard (And Mean Reversion Doesn't Help!)

Investors have a lot of growth products to pick from. Morningstar, for example, lists more than 1,600 mutual funds that fall within the "growth" style box.[1] Although investors have many growth funds to choose from, they don't have many successful growth fund options: only 27% of these funds received four- or five-star ratings, and only 21% have outperformed the S&P 500 Index over the last three-year, five-year and 10-year periods.[2] Successful growth investing is not as straightforward as it might seem.

## What's So Hard About Growth Investing?

Growth investing faces two primary hurdles. The first is the overwhelming power of something called mean reversion—the tendency of growth rates, stock prices or returns to eventually revert toward their long-term averages, even after impressive growth periods. The farther away from the average, the greater the chance that a number will return toward it.

There are a lot of reasons why a company's earnings-growth rates might taper off, but they lead to the same conclusion: mean reversion is like a magnet that eventually pulls everything around it back to the average. It tells us that growth companies able to grow much faster than their peers will eventually grow only slightly faster and finally grow only as fast.

Mean reversion makes it challenging for even very good growth companies to sustain superior earnings growth.

[1] As of December 31, 2006

[2] Statistics compiled using Premium Fund Screener at www.morningstar.com

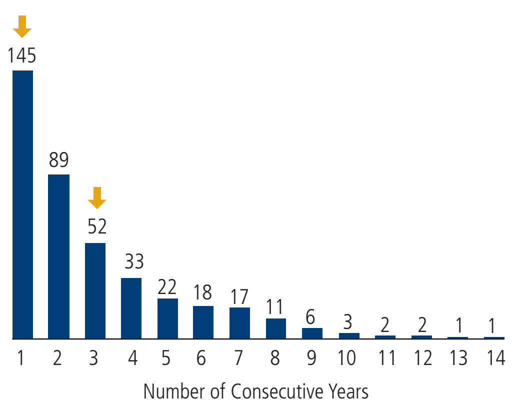
# Is It Better To Grow Fast…Or Faster Than Expected?

To demonstrate mean reversion, we tracked the earnings growth of the companies in the S&P 500 Index over time. We started in 1990, when 145 companies were able to grow faster than 10%. We wondered how many of these companies would be able to maintain that 10% growth over the next three years.

The answer was somewhat disappointing: only 52 companies—a little more than one-third—were able to maintain this pace. Understandably, even more companies stumbled when we raised the bar to require them to grow even faster or for longer periods.[1] Clearly, mean reversion is a powerful undertow in the sea of growth investing.

Beware the Earnings Undertow: Sustaining Growth Is Hard

Companies Sustaining 10% Growth
1990–2004*




**Historical analysis does not guarantee future results.**
*Universe: S&P 500 Index companies in 1990. An investor cannot invest directly in an index. See back panel for index descriptions.
Source: AllianceBernstein analysis

### The Challenge of Fulfilling Great Expectations

The second hurdle for growth investors lies in the definition of "superior" growth companies. Traditionally, growth investing involves picking companies that the market believes will grow the fastest. But our research has identified a flaw in this popular approach that may lead investors to disappointment instead of success.

Our analysis has shown that companies with the highest expected growth rates routinely underperform companies with the lowest growth expectations.

[1] According to AllianceBernstein research, the pattern described here is generally reflective of the last 25 years of data.

### Which Company Do You Want to Invest In?

| | Forecasted Growth | Actual Growth | Likely Impact on Stock Price |
|---|---|---|---|
| Company A | 15% | 17% | ↑ |
| Company B | 27% | 25% | ↓ |

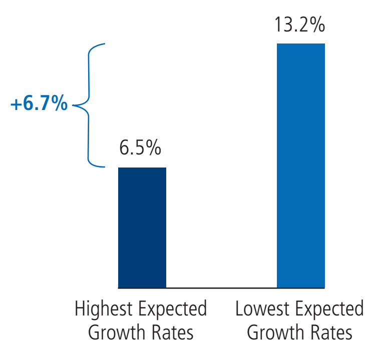
## Counterintuitive Choices

Consider two companies: Company A, which the market expects to grow at 15%, and Company B, which is expected to grow at 27%. Which one should you invest in? What if Company A actually produced 17% earnings growth while Company B actually grew at 25%? Company B might seem like the logical choice, but it's likely that company A was actually the better performer.

How did the slower-growing company win? Because A's earnings growth was 2% higher than expectations while B's fell short. The key driver of outperformance isn't earnings growth but earnings growth relative to the market's expectations.

### Beating Expectations Matters

Annualized Return* of U.S. Growth Universe




**Past performance does not guarantee future results.**

*Data from 1982 through 2004; returns are annualized. The growth universe was defined by ranking a universe averaging 821 large-cap U.S. stocks by the annualized I/B/E/S forecast for five-year EPS growth. "Highest Expected Growth Rates" represent the top 20% of stocks based on growth forecasts. "Lowest Expected Growth Rates" represent the lowest 20%.

Source: Compustat, CRSP, I/B/E/S, MSCI, Worldscope and AllianceBernstein

Instead of a direct link between high-earnings-growth forecasts and outperformance, we found the opposite.

## Challenging the Conventional Wisdom

We've found that companies with the *lowest* expected growth rates actually end up producing *higher* stock returns.[1] We analyzed the historical returns of a large group of stocks for which earnings-growth expectations were wide-ranging. If traditional wisdom held true, we should have found a direct relationship between high-earnings-growth forecasts and outperformance.

Instead, we found the opposite: companies that analysts expected to do the least—those in the bottom 20% of growth expectations—performed better than companies in the top 20% of expectations.

[1] For both short-term and long-term earnings-growth forecasts

# Dynamic Gap: Resolving the Growth Investor's Paradox

Growth investors seem to be stuck between the proverbial rock and a hard place. On one hand, simply buying stocks with the highest growth expectations can lead to failure. But on the other hand, buying stocks with low growth expectations isn't exactly growth investing. So how do growth investors win?

We believe that the key to successful growth investing isn't finding companies that are expected to grow the *fastest*, but finding companies that will grow *faster than expected*, and in the process repeatedly surprise the market. We refer to this series of earnings surprises as "sustainable surprise."

We've found that stock prices have tended to follow earnings surprises—when a company was enjoying a period of positive earnings surprise its stock tended to outperform. The more such surprises, the better the performance.

According to our analysis, companies that announced at least three positive earnings surprises in a row outperformed a broad basket of stocks by almost three percentage points a year, on average.

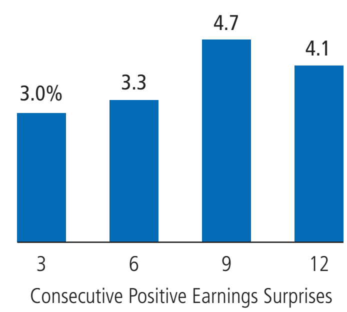
## Behavioral Biases Create Opportunities

But how can these pockets of underestimated growth persist? If a company continues to exceed the market's earnings estimates, why doesn't the market simply adjust its thinking?

The root cause can be found in the behavioral biases of analysts that make them slow to adjust to new growth patterns, creating a gap between the market's perceptions and a company's actual performance. At AllianceBernstein, we call this phenomenon the "dynamic gap" and it forms the foundation of our growth investment philosophy.

The More Positive Surprises, the Better the Performance

Annualized Outperformance vs. Broad Stock Universe




**Past performance does not guarantee future results.**

Data from February 1977 through December 2004; returns are annualized, and the return premium was calculated relative to a basket of stocks representing the union of the S&P 500 Index, the Russell 1000 Index and the stocks covered by AllianceBernstein analysts.

Based on a portfolio analysis that measures the impact of autocorrelation of earnings revisions on relative performance vis-à-vis the number of positive revisions a given company produces. The chart shows the cumulative incremental performance boost to every sequential positive revision. Portfolios were formed on an equal-weighted basis; analysts' revisions are relative to the capitalization-weighted S&P 500. An investor cannot invest directly in an index. See back panel for index descriptions.

Source: CRSP, I/B/E/S and AllianceBernstein

The dynamic gap is the difference between the market's expectations for earnings growth and what is actually delivered.

## Our Growth Investment Philosophy: Exploiting the Dynamic Gap

To understand our unique approach to growth investing, it's helpful to take a closer look at the earnings-growth cycle. In the chart below, we've illustrated the cycle for a fictional company. Over time, as the company grows, expands and matures, its earnings growth (shown by the solid blue line) tends to rise and fall.

As the company's earnings growth picks up, it may grow faster than analysts expect and catch the market off guard. As a result, the company's actual earnings growth may repeatedly beat market expectations (the consensus estimates shown by the dotted lines). We refer to this difference between expectations and reality as the dynamic gap—a gap that creates a substantial opportunity for investors with the knowledge and research expertise to take advantage of it.

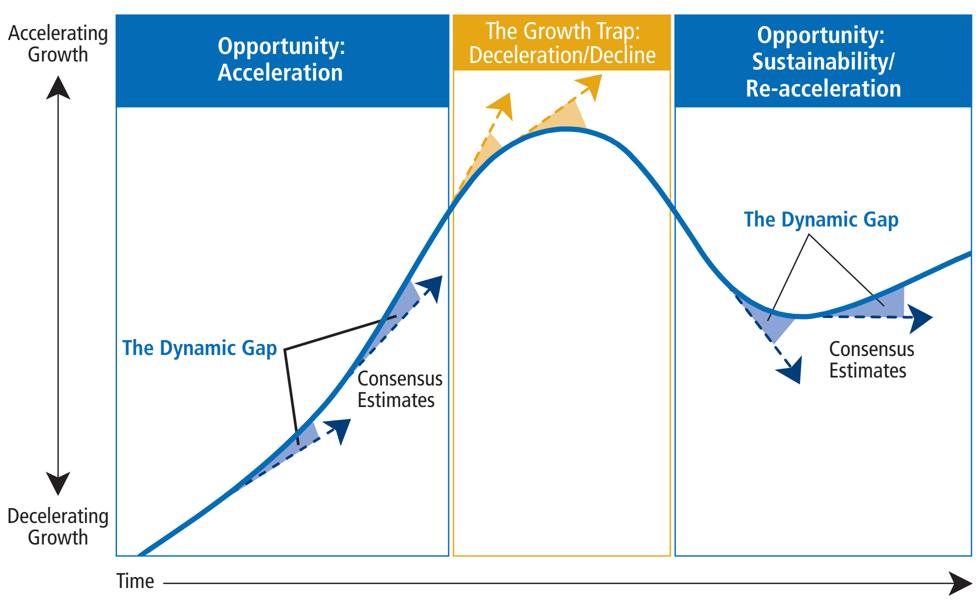
Exploiting the dynamic gap is the essence of our growth philosophy. We believe that identifying companies with the potential to generate sustainable earnings surprises is the key to successful growth investing.

## What Makes the Gap Dynamic?

The gap is dynamic because a company's growth rate and the market's growth estimates fluctuate constantly. The gap is always in motion, sometimes widening and sometimes narrowing.

Eventually, market estimates catch up with the company's actual growth rate and the gap closes. If expectations overshoot what can actually be delivered, the stock is poised for disappointment—creating a "growth trap," which we highlight in the middle section. But some companies are able to begin producing positive earnings surprises once again, creating another opportunity to take advantage of the dynamic gap.

Dynamic Gap: AllianceBernstein's Singular Framework for Growth Investing



# Putting Research to Work: Building a Portfolio with Dynamic Gap

Our analysis of the dynamic gap has helped us to enhance our growth-investing framework. And it underscores one of the key drivers of our success as a growth manager: an unwavering commitment to applying world-class research in managing our portfolios.

Our commitment is evidenced in many ways. For example, we've built a robust forecasting tool that helps our analysts identify companies with the ability to produce positive dynamic gaps. Instead of using traditional measures to find growth companies, we've developed and refined new ones that are more often associated with companies that generate sustainable earnings surprises.

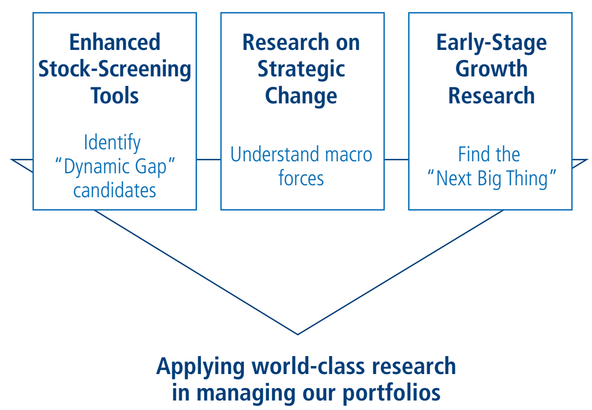
## Research Innovation Fosters a Fresh Perspective

Besides refining our stock-screening tools, we've also invested heavily in research innovation. We've created a dedicated Research on Strategic Change group that seeks to understand big macro forces—such as the broadband revolution or the emergence of China—that are difficult to dimension single-handedly.

We've also established an Early-Stage Growth Research team that we've charged with finding the "next big thing"—emerging innovation on the cusp of becoming commercially viable.

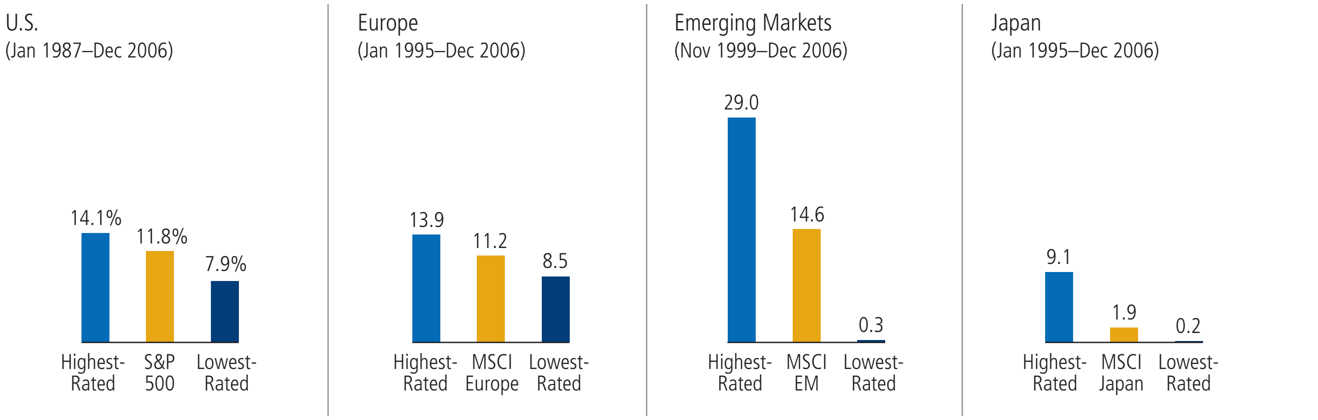
We've made an unwavering commitment to applying world-class research in managing our portfolios.

Commitment to Research



### Measuring the Impact of Research

Annualized Returns




**Past performance does not guarantee future results.** Annualized returns in local currency as of December 31, 2006. The performance shown above is intended to illustrate the equity analysis process used by AllianceBernstein growth analysts and does not represent the actual performance of any AllianceBernstein fund or portfolio, nor does it reflect fees and expenses that would apply to a mutual fund investment. The rankings are not publicly available, have not been audited by any third party, and no investor can purchase a portfolio based on these rankings. The performance does not reflect portfolio constraints that would apply to an actual investment, such as investment objective, investment guidelines and diversification requirements. The rating system is based on the securities tracked by our growth analysts. Highest-rated, or 1-rated stocks, are believed to be among the best in an analyst's coverage; Lowest-rated, or 3-rated stocks, are believed to be among the worst in an analyst's coverage. The returns are based on an equal-weighted average of the returns of the equity research team's individual recommendations and are rebalanced monthly for U.S., Europe and Japan, and bi-weekly for Emerging. The rating system is proprietary to AllianceBernstein, is not indicative of the performance of any AllianceBernstein portfolio and the degree to which such internal research is utilized may vary between strategies. An investor cannot invest directly in an index. See back panel for index descriptions.

Source: MSCI, Standard & Poor's and AllianceBernstein

## Research Has Its Rewards

Our continued investment in an already strong research effort has produced benefits that are explicit, tangible and reproducible. As shown above, our growth research is clearly doing exactly what it is supposed to do. Our analysts' highest-rated stocks have outperformed both the relevant index and also the lowest-rated stocks.

We believe that this track record demonstrates the ability of our growth research analysts to identify companies poised for success versus those vulnerable to the riptide of mean reversion. But to us, the ultimate indicator of our success as growth investors is the satisfaction of our clients.

Our growth team has a demonstrated history of successful fundamental research and security analysis around the world.

AllianceBernstein is one of the largest and most established growth managers in the investment-management industry. We manage over $100 billion in growth assets for retail, institutional and high-net-worth clients.

We've received global recognition for research and investment-management excellence. We're particularly proud of having been highly ranked in a 2005 Greenwich Associates study that polled institutional clients and consultants—among the most discriminating stakeholders in the investment industry. Our U.S. growth-equity services ranked in the top 3% among peers, and our international-growth services were ranked in the top 15%.[1] Our growth services are an important part of a suite of diversified investment solutions that we've designed to help our clients build and preserve their wealth.

Our investment services come in a variety of platforms to suit individual needs, including:

- Mutual Funds
- Separately Managed Accounts
- Subadvisory Services
- Education Strategies
- Retirement Services

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[1] Source: Greenwich Associates Survey of U.S. Institutional Clients and Consultants, 2005. Percentile ranking is calculated using the Greenwich Quality Index, which measures the business performance of investment managers, as judged by institutional consultants. The 2005 peer group included 160 domestic equity investment managers, 195 international equity investment managers and 90 bond managers.

At AllianceBernstein, we realize that investors have choices for the management of their growth assets, and we value being the manager of choice for many trusted advisors.

Speak to your financial professional today to learn more about how AllianceBernstein's Growth Equity Services can help you reach your goals.

Index descriptions: The S&P 500 Index is an unmanaged index of 500 U.S. companies and is a common measure of the performance of the overall U.S. stock market. The Russell 1000® Index measures the performance of the 1,000 largest U.S. companies based on market capitalization. The MSCI Europe Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in global emerging markets. The MSCI Japan Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Japan.

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