Continued Capital Market Turmoil

Lewis A. Sanders
Chairman and Chief Executive Officer

The turmoil in the capital markets has reached a new phase. Access to new capital by financial companies has been shut off. Thus, a vital source of strength has been lost, which has heretofore permitted many prominent financial institutions to remain financially sound during this down cycle as the capital they lost was quickly replaced. In essence, it is the loss of such access to funding that is the immediate cause of the failure of Lehman. It is what drove Merrill to seek a merger with Bank of America. And it is what is now putting intense pressure on AIG, among other financial firms.

We have made our share of miscalculations as this down cycle has unfolded over the last 15 months. Some investments caught up in this turmoil have turned out very badly (e.g., Lehman and the mortgage agencies), and others, most of which remain quite promising in the long term, are now down sharply in price. Clearly all of this has hurt investment returns.

While it is difficult to see through the dark clouds that have now formed, better times lie ahead. Our research strongly suggests that recognition of the credit losses faced by financial institutions in this down cycle is at a very advanced stage. Moreover, the overwhelming majority of the world's leading financial institutions (Lehman's fate notwithstanding) are more than adequately capitalized and positioned to absorb the additional credit losses they may face. Yes, it has turned out that this cycle was so intense as to undermine a few venerable institutions. But others will benefit from the turmoil as the industry consolidates, they gain market share, and they improve their profitability. A number of these potential beneficiaries are important investments in client portfolios.

Moreover, countervailing forces are beginning to form:

- lower oil prices, which will help to restore consumer purchasing power
- lower mortgage rates, which, in combination with lower house prices, are dramatically improving housing affordability in the US, helping to clear the market of this excess
- the launch of various government and private initiatives to deal with the surge in foreclosures in the US
- and to come shortly, moves by the world's central banks to lower interest rates and enhance liquidity (as China's central bank did today) to combat slowing economic growth now that the inflation threats are rapidly receding

We hold no illusions. There are many headwinds present in the environment that will need to run their course. So righting the economy and the capital markets will take time, but the necessary things have begun to happen.

As such, we continue to believe that we are positioned to recover investment performance in the period ahead. Some of our best periods of absolute and relative returns have been earned in the aftermath of market dislocations like the one we are now experiencing. Those recoveries have been strong enough to recoup ground lost in the down cycles and create the excellent long-term track record that our key services have compiled. Every one of those periods had its share of research misjudgments, too, just like this one has. Research is by its very nature imperfect. The idea is to get more forecasts right than wrong. When we look back at this cycle in its entirety, if history is a guide, we will have accomplished this task. Perhaps most important, we will remain true to time-tested research and portfolio management disciplines that have guided us through difficult times before.

You should know, too, that as provocative as today's headlines may seem, they are not unique. The failure of well-known financial institutions during market dislocations is actually common. In the last credit cycle, circa 1990, Drexel Burnham, then the fifth largest investment bank, failed, as did many relatively large banks in Texas and New England, plus some 2,000 savings and loans in many parts of the country. The banking industry emerged from that down cycle stronger and far more profitable than at any time before. Similarly, in the down cycle in the early 1980s, Continental Illinois proved to be a casualty, despite being at the time one of the largest banks in the Midwest and in the nation.

These failures were often foreseen, and sometimes not. But the potential of such events to surface at any time calls for a portfolio strategy not dependent on any one stock or, for that matter, any one industry. If anything, our portfolios are more diversified today than in prior down cycles.

Our message to clients, as always, is to not get caught up in the emotions of the moment, as it is so easy to do. A dispassionate analysis of the state of the world is actually reassuring, the events of the past few days notwithstanding. The global economy is still growing, now at a pace more in keeping with its capacity to grow—relieving the pressure on resources (like oil, grains, and industrial commodities) that had become so intense. As noted, the balance sheets of most financial companies are strong despite recent losses. And the balance sheets of nonfinancial companies are in the best shape they have been in for many years, owing to cautious use of cash flow during the last expansion—a pattern that extends around the globe.

Right now it doesn't feel as if any of this strength is present. The air is thick with anxiety. Risk premiums are high in every corner of the capital markets. And history makes it clear that high risk premiums can get still higher before they fall. But history also shows that investments made in moments of distress, moments when potential returns are far above their long-term averages, are typically the most rewarding, even if the payoffs take time.

And while we wait for that better time, clients should know that their accounts with us are secure. AllianceBernstein has a strong balance sheet and does not use its financial resources in ways that would expose the firm to the kind of market developments that undermined Bear Stearns or Lehman.

It is a tough time. But we have the wherewithal to see it through for our clients and for the firm. This is the time that investors are inclined to make the most counterproductive decisions—to abandon well-designed investment plans in the heat of the trauma. We all need to sense the significance of this moment, not succumb to the evident pressures, and do what it takes to turn today's turmoil and the extraordinary opportunity it is creating to our advantage. I know we can and will.

1345 Avenue of the Americas, New York, NY 10105, 1.212.969.1000

www.alliancebernstein.com

AB–9999–0908