

With some stability returning to the US housing market, we think this is the time to focus on the longer-term value opportunities the crisis has created.

Housing: Perspectives on Opportunity

As the US housing market stabilizes, we are bullish about the longer-term opportunities, while our in-depth research helps us to navigate the nearer-term risks.

The crisis in the US housing market has had a massive impact on the global economy, and the shape and pace of its eventual recovery have critical implications for investors. The debacle that began with a bubble in housing has generated a blizzard of statistics and commentary that has left many investors, not to mention economists and governments, bewildered about what each new set of numbers portends and which developments are most important.

Despite formidable obstacles, the global economy and the US housing market are showing signs of stabilization (*Display 1*). The uncertainties ahead demand a dispassionate, research-based assessment of housing and how it is likely to affect the investment landscape over the next 12 to 18 months and beyond. Our research suggests that it is time for investors to shift their focus from avoiding the fallout from the crisis to seeking out the opportunities it has

left in its wake, while making sure to be adequately compensated for the nearer-term risks.

Our Outlook

We believe that the US housing market is in a stabilization phase and we are headed toward a gradual, but probably sluggish, recovery.

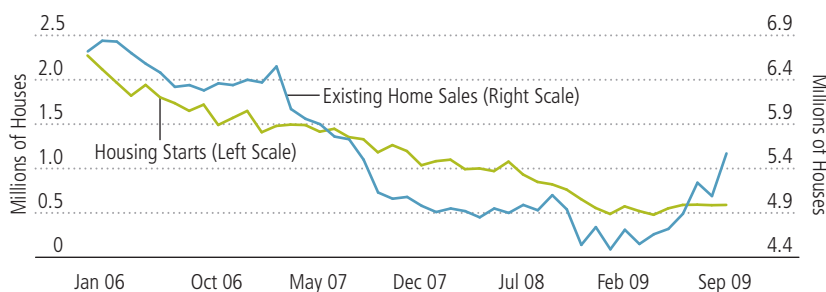
The market remains glutted with excess supply, foreclosures continue and the broader economy is still under strain. In addition, the commercial real estate market has lagged the residential market and is in an earlier stage of its down cycle, which could add a lingering drag even as the residential market improves.

But as we monitor the housing market on the critical issues of price, excess inventory and affordability, we believe that the worst is over. And our value investment team's longer-term view is more bullish than its near-term outlook.

The prerequisites for a recovery appear to be in place. Housing has become markedly more affordable than it was during the bubble, and sales volumes are picking up. While there is still a glut of houses that will take time to be absorbed, this fact appears to be widely understood.

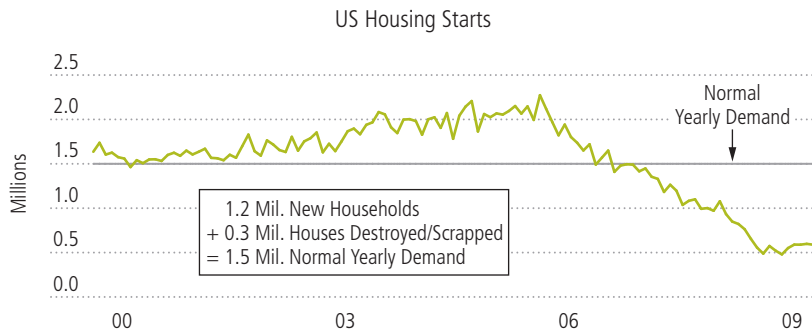
The inevitable recovery has extensive implications for stock selection. Its impact reaches far beyond the obvious

Display 1
Housing Market Is Starting to Stabilize



Historical analysis does not guarantee future results.
Through September 30, 2009
Source: Moody's Economy.com, National Association of Realtors and US Census Bureau

Conditions Are Right for Absorbing Excess Housing



Historical analysis does not guarantee future results.

Through September 30, 2009

New residential construction (privately owned), seasonally adjusted, annualized; normal yearly demand reflects approximate number of households formed per year in normal times due to population growth and immigration, plus an average of 300,000 units of housing destroyed annually that need to be replaced.

Source: Moody's Economy.com, US Census Bureau and AllianceBernstein

banks and homebuilders to areas that include suppliers of materials, appliance makers and retailers, even those with little direct connection to housing. These opportunities have been playing a growing role in our value portfolios.

The Road to Ruin

By now, most investors understand that easy credit combined with financial innovation led to a speculative bubble in housing in the US and in many other parts of the world (see sidebar: "Not Just a US Phenomenon," page 5). Taking advantage of relaxed lending standards and novel types of loans, many people bought houses they couldn't afford, often for investment purposes. At the same time, banks and mortgage brokers found inventive ways to move increasingly questionable loans off their books by packaging them into complex securities that spread the risk throughout the global financial system. But it soon became clear that risk diffused was not risk defused.

Plunging real estate values created chaos in the global financial markets and left both bank and consumer balance sheets under pressure. In the US, the crisis has wiped out some \$5 trillion of home equity, roughly 10% of total household net worth. One in seven US homeowners now owes more on his house than it is worth.¹ This makes selling or refinancing nearly impossible, and it creates an incentive for additional defaults. The sweeping devaluation of both real estate and securities, combined with a grim job market, has made consumers cautious about spending.

Our Bottom-Up Analysis: What's Built in Vegas, Stays in Vegas

Our housing analysis begins, as it does for any industry, with the basics of supply and demand. Commonly cited statistics, such as the number of houses listed for sale or the number of houses that change hands, offer clues, but their value is limited because they tend to describe symptoms, not causes. And the overview

that they offer can miss one of the defining traits of real estate, which is that it is inherently and profoundly local. Houses can't simply be transplanted to someplace where demand is better: What's built in Vegas, stays in Vegas.

We take as granular a view as the data allow, studying regions, metropolitan areas, and even the details of a large, anonymous database of individual loans to understand the dynamics behind the statistics and create bottom-up models of the broader market. Looking at detailed loan-delinquency data, for instance, helps our fixed-income team model the likely timing and number of future foreclosures. We also break supply into its fundamental components: the existing inventory of unoccupied housing and new housing construction. In looking at demand, our baseline is the rate at which new households are being formed by young adults, marriages, divorces, immigration and shifting employment.

The key elements our value team has been studying on both a regional and composite level include supply/demand dynamics, affordability and the policies of banks and governments.

Supply and Demand

Easy lending and the assumption that house prices would keep rising inflated demand to well above historical norms, and builders responded to the clamor for new houses, second homes and investment properties.

The building spree has left the country awash in excess houses, leading to a dramatic drop in housing starts. We

¹Deutsche Bank, Moody's Economy.com and US Federal Reserve Board

estimate that about 2.5 million houses need to find occupants for vacancy rates to return to normal. There are about 1.2 million new households formed each year, though this rate is typically lower in difficult economic times. At the same time, about 300,000 houses are demolished or otherwise removed from the housing inventory every year (*Display 2, previous page*). With both housing starts and new household formation below normal, we would expect it to take two to three years for the current excess inventory to be absorbed.

We expect regional differences to be significant, since overbuilding was far more pronounced in Phoenix, for example, than in Chicago. Additionally, some of the excess is in outlying areas that are likely to be ignored by buyers for the next couple of years.

Pricing and Affordability

Pricing and affordability, of course, are key determinants of consumer behavior. Pricing tends to grab the headlines, and pricing trends can have a significant impact on consumers' sense of financial well-being and, thus, on their spending. But it is the more subtle issue of affordability that can have the most profound effects. Affordability is a reflection of a number of factors, including prices, interest rates, insurance costs, taxes, prevailing wages and median income levels. Here again, regional differences can be striking.

Pricing is a central element of affordability, and prices ran up far more dramatically in Miami, for example, than in Denver. Price declines have also shown significant regional variation, with the markets that saw the largest rises

generally experiencing the sharpest declines (*Display 3*). For example, prices in Miami rose 94% between 2003 and 2006 and fell 48% between mid-2006 and mid-2009. In most cases, the declines have not fully erased the increases, and house prices remain above 2003 levels.

It is important to note that our measure of affordability is based on a traditional 30-year fixed-rate mortgage. On that basis, prices at the peak of the bubble would have been out of reach for many of the people who were, in fact, able to buy houses using newer, nonstandard types of financing. Low initial payments made exorbitant, and ultimately unaffordable, house prices seem manageable at first. With such financing now unavailable, our analysis suggests that prices nationally may not have fully troughed, but affordability has improved significantly (*Display 4, next page*).

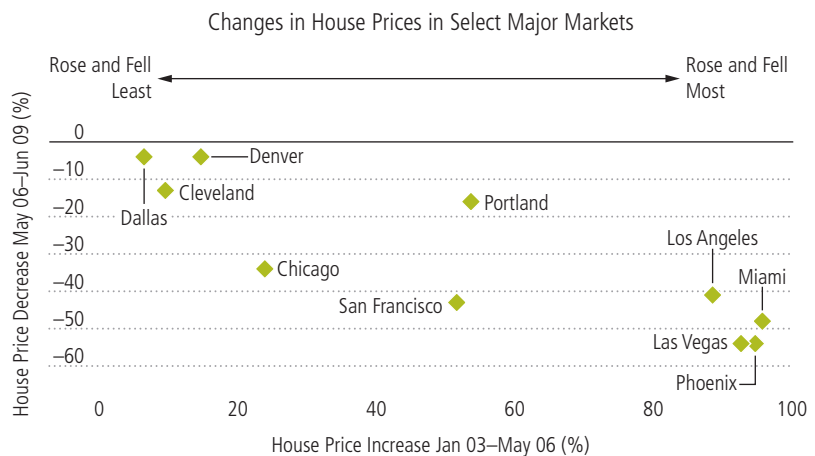
Another important component of affordability that we monitor is the relative cost of owning compared with renting. This is a key consideration for many potential buyers, and even when owning seems attractive, potential buyers may stick with renting if they expect house prices to keep dropping. Comparing owning with renting produced conclusions that reinforce the results of our other analysis.

Bank Actions and Government Policies

The policies of banks and governments clearly have a profound impact on housing markets. Indeed, government policies dating to the 1990s were instrumental in setting the stage for the US boom. Loose regulation of lending standards and increased credit through the government-sponsored mortgage agencies Fannie Mae and Freddie Mac helped bring more middle- and lower-

Display 3

Regional Variations: The Markets That Rose Most Crashed Hardest

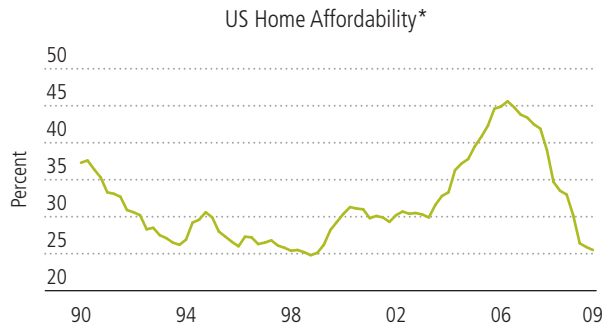


Historical analysis does not guarantee future results.

As of June 30, 2009

Source: Moody's Economy.com, S&P/Case-Shiller Home Price Indices

Homes Are More Affordable Now



Impacts on Affordability

	Jun 08–Jun 09	Impact on Affordability
Mortgage Rates	–100 b.p.	Improved
House Prices	–15%	Improved
Median Income	–3%	Impaired
Net Impact	–8%	More Affordable

Historical analysis does not guarantee future results.

Through September 30, 2009

*Affordability reflects the estimated annual ownership costs for a median-priced home as a percentage of median income. Costs consist of estimated after-tax principal and interest payments, maintenance, insurance and foregone interest on the cash used for a down payment. Weighted average for the 104 largest metropolitan statistical areas, which account for 70% of all homes in the US.

Source: Fiserv, Freddie Mac, Moody's Economy.com, National Association of Realtors, S&P/Case-Shiller Home Price Indices, US Census Bureau, US Federal Reserve and AllianceBernstein

income households into the housing market with down payments well below the traditional 20%. Once the frenzy took hold, home ownership rates soared to an unprecedented peak of more than 69% (Display 5). The subsequent bust has lowered the ownership rate, but it remains far above historical norms, suggesting continuing pressure on the market.

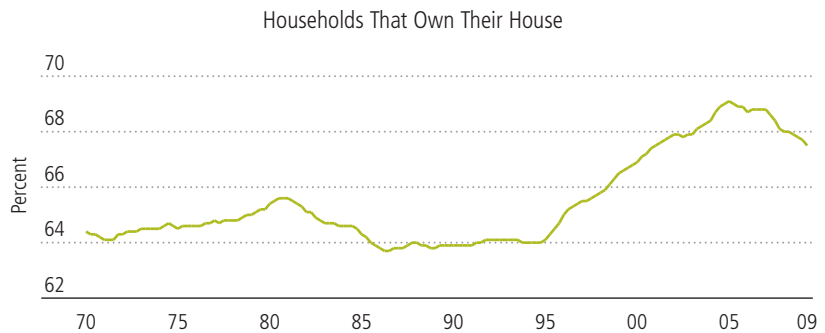
With the crisis upon us, US government actions are having mixed effects. Tax breaks for first-time buyers and low mortgage rates stemming from the government's purchases of debt from Fannie Mae and Freddie Mac are undoubtedly helping to spur demand and support prices. However, government efforts to avert foreclosures through moratoriums and loan modifications have been less effective. Through

September 30, 2009, about 500,000 of the 3.6 million seriously delinquent mortgages had been modified under the federal incentive plan.²

Foreclosures, which put houses back on the market at depressed prices, are one of the most critical trends we are monitoring. Because deserted, devalued

Display 5

Home Ownership Rates Soared



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Through June 30, 2009

Rolling 12-month average

Source: Moody's Economy.com and US Census Bureau

²Moody's Economy.com, Mortgage Banker's Association and US Treasury Department

houses can spoil neighborhoods, foreclosures have serious effects even on houses that are not for sale.

Looking up the pipeline, we see that banks have issued a growing number of default notices to troubled homeowners and that the problem is not limited to the extreme cases in Florida and California. Nationwide delinquency rates are more than triple the norm (*Display 6, next page*). It is also significant that fewer borrowers are catching back up once they have become delinquent. In addition to the economic pressures that have made catching up difficult or impossible for many homeowners, there is little incentive to do so for those who owe substantially more than their houses are worth.

Given that foreclosure often takes months to complete, there is a substantial number of distressed properties that have yet to go through the process. Our fixed-income research suggests that the peak could come as soon as the first half of 2010, and the effect is likely to be amplified by the seasonal slowness of the housing market in the winter.

However, countervailing forces are already helping to blunt the surge. In addition to government efforts to avert foreclosures, banks want to avoid flooding the market with foreclosed properties and taking too many loan losses at once. Thus, although delinquencies are still rising, foreclosures are being spread out over a longer period, which smooths the effect (*Display 7, next page*). This dynamic supports our expectation of continued stabilization and a slow recovery, with foreclosures beginning to ease by the second half of 2010.

Not Just a US Phenomenon

The housing bubble and the subsequent crisis were not confined to the US. Similar dynamics have played out around the world. Although regional differences are substantial, many parts of western Europe are now struggling with the same supply gluts, foreclosure problems and affordability issues that face the US market.

In the UK, for example, excess supply did not become much of a problem, but prices spiked dramatically. Nominal house prices more than tripled between the late 1990s and their peak in 2007. The average house price remains at 4.5 times the average gross annual income of a man working full time, compared with a trough level of 3 times. Thus, affordability remains a key impediment to a recovery in the UK.

In Ireland and Spain, excess supply is the key issue. By the end of 2007, housing starts in Ireland had more than doubled from the levels of the late 1990s as low interest rates coincided with freer lending and a surge in immigration and employment. In Spain, a popular market for vacation homes, housing starts nearly doubled over the same period.

Spain now has roughly 1.1 million to 1.4 million excess homes. Assuming that housing starts remain depressed and foreign buyers remain scarce, it could take as long as six years to fully absorb that inventory. Spanish banks that have foreclosed are now putting significant numbers of houses on the market, which is likely to add to the pressure there.

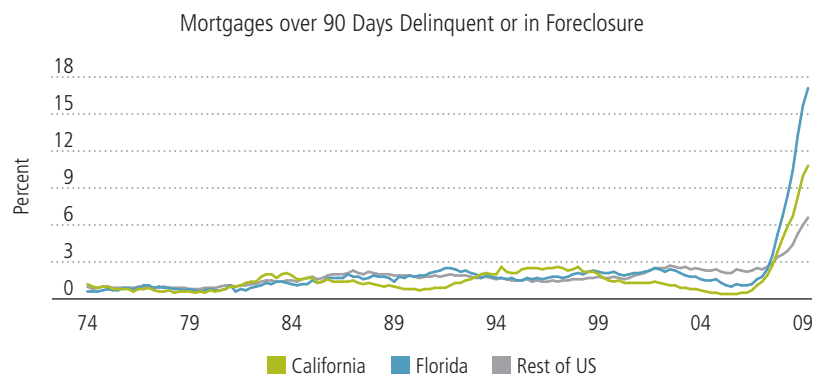
In France, by contrast, the crisis has been comparatively mild, in part because French lenders were far less eager to abandon their traditionally stringent lending standards. In addition, relatively extensive government safety nets make foreclosure a far less immediate threat for French workers who lose their jobs.

As with our analysis of the US, distinctly local market conditions are critical to identifying potential investments and risks. Additionally, government approaches to both monetary policy and direct intervention may vary dramatically by country. In studying housing markets outside the US, we use methodology similar to that used in the US. We call upon our extensive research resources in markets around the world to untangle the local forces that will create investment opportunities. ■

Sources: Bank of Spain, Banco Bilbao Vizcaya Argentaria, France: National Institute of Statistics and Economic Studies, Halifax House Price-to-Earnings Index, International Monetary Fund, Ireland: Department of the Environment, Heritage and Local Government, Nationwide, Spain: National Institute of Statistics and AllianceBernstein

Display 6

A Nationwide Delinquency Epidemic



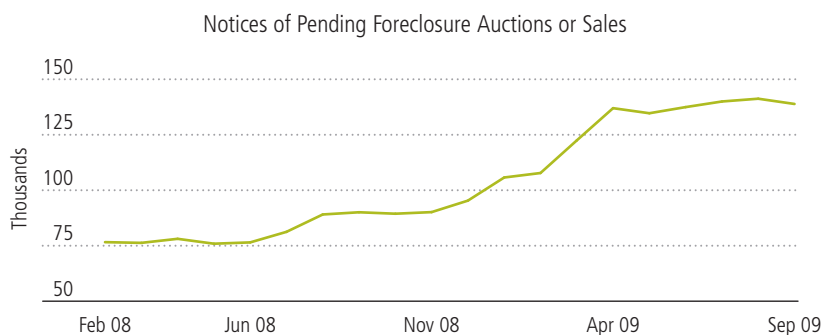
Historical analysis does not guarantee future results.

Through June 30, 2009

Source: Moody's Economy.com and Mortgage Bankers Association

Display 7

Foreclosure Sales Are Leveling Off



Historical analysis does not guarantee future results.

Through September 30, 2009

Rolling two-month average, by month

Source: RealtyTrac

Investment Implications

While we doubt that prices will rebound rapidly or reach their peak levels in the foreseeable future, we expect stabilization and a gradual but very substantial recovery in sales volumes and housing starts, which are one-half to two-thirds below normal. Although it is in a fragile early stage, this process has already begun. Despite the severity of the

recession, few segments of the economy offer such a large long-term growth potential just by returning to normal.

To be sure, there are risks to our forecast that a slow-moving recovery is starting to coalesce. On the positive side, the recovery could gain momentum more quickly than we expect if the job market and consumer confidence rebound

rapidly, or if government actions increase. On the negative side, a sudden spike in inflation or interest rates could seriously undermine a nascent recovery.

Given its view that the near term still carries substantial uncertainty but the long-term upside is compelling, our value team's approach has been to seek out the strongest players in the sectors that have been punished by the housing debacle. This includes homebuilders, suppliers of housing-related products such as appliances and building materials, select retailers and financial firms. The housing debacle has created substantial opportunities among companies whose balance sheets, geographic diversity and track records suggest that they could, if necessary, weather an extended and uneven recovery and emerge with improved market share.

Select builders and building-products companies appear to offer tremendous long-term potential. Our focus here has been on buying the longer-term opportunities at prices that we believe will compensate us for the possible nearer-term risks. We took advantage of the relatively modest prices during the spring to build overweight positions in builders.

We look closely at each potential investment's geographic footprint and its ability to weather what may be an extended period of volumes well below trend. We also evaluate each company's potential to gain market share and the relative merits of its competitors, which includes researching private builders and their lenders. Leading publicly traded

builders currently appear to have an advantage over their privately held rivals. The strongest have access to the reviving capital markets, while private builders rely more heavily on weakened regional lenders.

We have sought out builders whose solid cost controls suggest that they have less need than their rivals for a quick and decisive rebound in house prices. This has led our value portfolios to invest in companies with strong footholds in areas such as Washington, DC, or parts of Texas, where government jobs or other demographic and economic factors offer a measure of stability that can help offset hardships elsewhere. Some of our investments have already made market-share gains in their regions.

In assessing appliance makers, tool-makers and housing-related retailers, we use our forecasts about the shape and degree of the recovery in new home construction and housing sales to help us model which companies might return to more typical earnings power even in a sluggish recovery. We have been somewhat less aggressive in this area, given more limited potential for large shifts in market share.

We are monitoring our exposure to the financial sector closely now that there

appears to be less catastrophic downside risk. However, we have been wary of the weaker banks, particularly regional banks. They still appear vulnerable to the powerful but slow-moving current of foreclosures that will continue to flow through the market for some time.

Many of them have kept construction and housing-related loans, often made to weaker private builders, on their books. And they remain exposed to the still-deteriorating commercial real estate market.

Our value team feels more confident that many of the diversified financial institutions involved in the securities market have already absorbed much of the impact. Over the past 18 months, many large banks and insurance companies have taken huge write-downs on the value of their securities tied to real estate and other loans. Despite breathtaking losses in this “mark-to-market” process, select investment banks and insurers have retained strong balance sheets and diverse business mixes.

Many of these themes are beginning to make their way into our various investment strategies, and we anticipate that as the cycle evolves, opportunities arising from the bursting of the housing bubble will continue to play an important role in our value portfolios.

Conclusion

Although a recovery is clearly coming, history suggests that house prices are likely to overshoot on the downside, just as they did on the upside. In the near term, foreclosures have yet to peak, and the recovery may proceed in fits and starts.

However, our analysis indicates that the time has come to begin looking beyond the near-term risks and toward the long-term opportunities. There is little doubt that many profitable investment opportunities are being created in the wake of the housing bubbles in the US and abroad. With construction and related activity so far below long-term norms, we believe that substantial potential is evident. ■

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