

## MUTUAL FUNDS

# Best Small-Cap Stocks: How A Top Investor Finds Them

BY PAUL KATZEFF

The \$2.6 billion AB Discovery Growth Fund (CHCLX) is in the right place at the right time. Amid threats of tariffs and trade wars – which helped pull down the broad market sharply on Wednesday and Thursday – many investors have rotated into more small cap stocks and midcaps this year, especially growth names. And that smaller-stock pond is Discovery Growth's favorite fishing hole.

The fund's results have exceeded many of its rivals'. Over the 12 months going into Thursday, the fund's 18.65% gain topped the S&P 500's 11.33% advance. It more than doubled its midcap peers' 9% average as well, outperforming 94% of them, according to Morningstar Inc. Over the past three years, the fund's average annual gain was 14.55% vs. 13.72% for the big-cap bogey and 10.88% for its peer group.

One reason the fund has outperformed is that tariffs and trade restrictions don't impact all small cap stocks and midcaps equally.

"You have to dig into fundamentals and understand individual businesses, because some small cap stocks do have exposure to tariff and trade-war risk," said Bruce Aronow, the fund management team's chief investment officer.

### Small Cap Stocks: Trade War Impact

Even among those smaller caps seeing little if any tariff-and-trade-policy impact, some small cap stocks and midcaps are better positioned than others for superior growth. In fact, Aronow says active managers can do a better job of picking leading growth stocks than index-wed ETFs can.

"Because we're hands-on investors, we can differentiate (among smaller-cap stocks) and buy just the best," Aronow said.

Trade-related challenges for small cap stocks and midcaps have not disappeared just because worst-case scenarios with tariffs and trade wars have not come to pass. The impacts of many existing tariffs are just reaching corporate earnings reports, Discovery Growth managers say. "To date, most of the focus has been on headline risk," Aronow said. "But as we start to go through earnings season, we'll start to hear about how it is impacting businesses."

### Discovery Growth Approach

Discovery Growth's approach uses fundamental analysis to seek companies that have unique growth drivers that can fuel future earnings gains no matter what's happening in the broader economy. In addition, the fund uses quantitative modeling to confirm its fundamental analysis, Aronow says.

Investors generally see regional banks as smaller cap plays that provide insulation from tariffs and trade friction. But some regional banks are indirectly exposed to those problems if their customers are, say, manufacturers being pinched by steel and aluminum prices that are rising due to tariffs, Aronow says.

### AB Discovery Growth A



**Bruce Aronow**     **Samantha Lau**

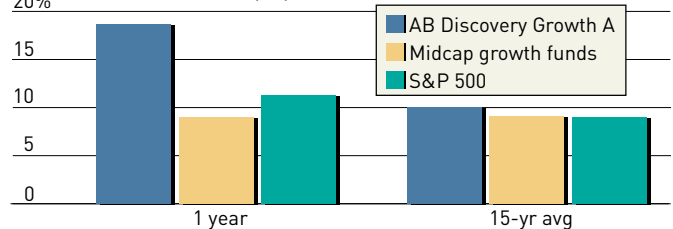
■ Max. front load: 4.25%  
 ■ Expenses: 0.99%  
 ■ Symbol: CHCLX

**Total returns** as of 10/10/18  
 2017: 32.52%     3-yr. avg.: 14.55%  
 YTD: 9.67%     5-yr. avg.: 10.80%  
                          10-yr. avg.: 16.79%

#### Sector weightings as of 8/31/18

	% of stock assets	% of S&P 500
<b>Cyclical</b>	<b>23.89%</b>	
Basic materials	2.38	2.27%
Consumer cyclical	13.00	12.18
Financial services	7.40	15.79
Real estate	1.11	2.18
<b>Economically sensitive</b>	<b>53.81</b>	
Communication services	1.07	3.24
Energy	1.81	6.00
Industrials	18.87	10.35
Technology	32.06	23.08
<b>Defensive</b>	<b>22.30</b>	
Consumer defensive	5.66	7.13
Health care	16.64	14.96
Utilities	0.00	2.83

#### Total returns as of 10/10/18



Source: Morningstar Inc.

**SVB Financial Group** (SIVB) has little such risk, he adds. Based in Silicon Valley, the bank is focused on technology. About 50% of its business stems from lending money to venture capitalists who are supporting a young tech firm. "The bank enables VCs to provide capital immediately while they are raising (an investment) fund for that business," Aronow said.

As a bonus, the bank often gets warrants in the young firms. Once companies go public, their warrants can jump in value.

SVB also does personal business with many technology workers and executives in Silicon Valley. "It establishes relationships with the high net worth population and makes incremental business with them," he said.

### Small Cap Stocks: Five Below, Advanced Micro

**Five Below** (FIVE) is a retail chain that sells discount goods to a largely teenage market. "First and foremost, we own it because it sells cool stuff for under \$5," Aronow said.

By depending on a domestic customer base, the chain is also largely immune to tariff and trade issues. "But we do need to be mindful of where they're sourcing goods," Aronow said. "We're confident they can source from locations (other than China) should sourcing become a problem."

Also, Five Below has been largely unhurt by e-commerce competition because Five's prices tend to be too tough for online retailers to beat. "In fact, they benefit to a degree from e-commerce disruption," Aronow said. With Toys R Us gone, at least for the moment, "Five Below will get a share of toy sales as the holidays roll around."

**Advanced Micro Devices (AMD)** is a new buy, whose unique growth driver is new technology. The chipmaker is aiming to leap past rivals in development of 7-nanometer CPUs. Those 7 nanometers refer to the width between circuits — in this case seven billionths of a meter. Basically, smaller space means higher power efficiency and faster speed.

Samantha Lau, the Discovery Growth manager who covers the tech sector, said, "I've been fairly cautious on the overall semiconductor cycle, so I want the semi exposure we keep concentrated in compa-

nies with unique drivers, insulated from the broader cycle. AMD's new CEO Lisa Su has been very effective in making sure products come to market on time with high quality ... They've leapt past Intel (INTC) to 7-nanometer chips. Intel is experiencing a distraction because it has no CEO (CFO Robert Swan is interim CEO), so there's a widow of opportunity for AMD to gain share."

Discovery Growth began to buy Advanced Micro in the third quarter. Its stock price has retreated more than 20% in the past month. "It was a very fast rise from 18 to 32. A 15% pullback is entirely reasonable for a stock up that much. I will not be surprised by its ability to surprise the Street on earnings and revenues in the next few quarters."

The fund's four managers each specialize in different sectors. AB mutual funds are distributed by AllianceBernstein Investments.

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### **AB Discovery Growth Fund**

**See attached AB Discovery Growth Fund Advisor Class (APGYX) fact sheet for most recent quarter-end performance and top holdings.**

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**Market Risk:** The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value.

**Foreign (Non-US) Risk:** Investing in non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. These risks are magnified in securities of emerging or developing markets.

**Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market.

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**Overall Morningstar Rating™**  
Advisor Class Shares



Rated against 540 funds in the Mid-Cap Growth Category, based on risk-adjusted returns.

## AB DISCOVERY GROWTH FUND

Advisor Class: CHCYX

### OBJECTIVE

- + Long-term growth of capital

### PRIMARY INVESTMENTS

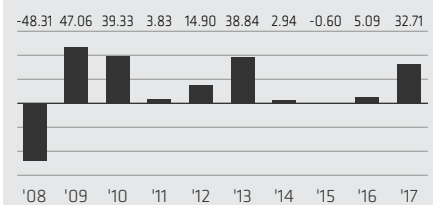
- + Small- and mid-cap stocks
- + US equities, but may invest in non-US equities
- + Normally holds 60 to 120 stocks

### FUND OVERVIEW

- + Seeks unexpected long-term growth potential from small- and mid-cap stocks
- + Greater opportunity for fundamental stock selection, since smaller stocks are followed by fewer industry analysts
- + Led by disciplined team averaging 28 years of industry experience

### ANNUAL PERFORMANCE FOR ADVISOR CLASS†

Total Return (%)



### AVERAGE ANNUAL TOTAL RETURNS: ADVISOR CLASS PERFORMANCE

	QTD	YTD	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Inception	Expense Ratios as of 10/31/17	
Discovery Growth Fund†^	7.76%	23.49%	34.61%	21.46%	13.37%	15.35%	10.91%	Gross	0.77%
Russell 2500 Growth Index	7.17	15.78	23.13	17.96	12.88	13.61	–	Net‡	0.76%
Russell Midcap Growth Index	7.57	13.38	21.10	16.65	13.00	13.46	–		
Morningstar Mid-Cap Growth Category	6.48	13.42	20.31	15.81	11.68	11.97	10.11		

The performance shown above represents past performance and does not guarantee future results. Current performance may be lower or higher than the performance information shown. You may obtain performance information current to the most recent month-end by visiting [www.abfunds.com](http://www.abfunds.com). The investment return and principal value of an investment in the Portfolio will fluctuate, so that your shares, when redeemed, may be worth more or less than their original cost. Advisor Class shares have no front-end or contingent deferred sales charges, however when purchased through a financial advisor additional fees may apply. Returns for other share classes will vary due to different charges and expenses. Performance assumes reinvestment of distributions and does not account for taxes. If applicable, high double-digit returns are highly unusual and cannot be sustained; such returns are primarily achieved during favorable market conditions.

† The performance for Advisor Class shares prior to 10/1/96, the share class's inception date, reflects Class A share performance, adjusted for differences in operating expenses. The inception date of the Class A shares is 7/7/38.

^ Reflects a 0.13% and 0.07% increase in NAV on June 8, 2016 and November 2, 2017 as a result of the Fund recording a receivable on its books and records in connection with the distributions by the Alliance Fair Fund and Bank of America Fair Fund, respectively.

‡ If applicable, this reflects the Adviser's contractual waiver of a portion of its advisory fee and/or reimbursement of a portion of the Fund's operating expenses. Absent reimbursements or waivers, performance would have been lower.

Sources: FactSet, Morningstar Inc. and AB.

**Past performance does not guarantee future results.** Morningstar ratings are specific metrics of performance and do not represent absolute performance of any fund. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance, placing more emphasis on downward variations and rewarding consistent performance. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics. The Fund was rated 5, 4 and 5 stars against 540, 483 and 342 funds in the category for the three-, five- and ten-year periods, respectively. The Fund's other share classes may have different performance characteristics.

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Investment Products Offered • Are Not FDIC Insured • May Lose Value • Are Not Bank Guaranteed

**PORTFOLIO MANAGEMENT AND YEARS OF INDUSTRY EXPERIENCE**

- + Bruce K. Aronow, 30 years
- + N. Kumar Kirpalani, 37 years
- + Samantha S. Lau, 24 years
- + Wen-Tse Tseng, 24 years

Class	Ticker	Inception Date
A	CHCLX	7/7/38
C	CHCCX	5/3/93
Advisor	CHCYX	10/1/96
I	CHCIX	3/1/05
Z	CHCZX	5/30/14

**Portfolio Characteristics & Statistics**

Assets (\$mil)	\$2,746.6
Beta (Trailing 3-year) <sup>1</sup>	1.04
Standard Deviation (Trailing 3-year) <sup>2</sup>	13.03
Weighted Avg Cap	\$8.0B
Total Number of Holdings	94
Portfolio Turnover Rate (as of 10/31/17) <sup>3</sup>	72%

<sup>1</sup> Beta measures a fund's volatility relative to its benchmark.

<sup>2</sup> Standard Deviation is a measure of the dispersion of a portfolio's return from its mean.

<sup>3</sup> Portfolio Turnover Rate is a measure of how frequently securities are bought and sold.

<sup>4</sup> Holdings are expressed as a percentage of total investments and may vary over time. They are provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned.

**Top Ten Equity Holdings<sup>4</sup>**

Company	Sector	
Exact Sciences	Healthcare	1.95%
Advanced Micro Devices	Information Technology	1.91
Teladoc	Healthcare	1.90
Five Below	Consumer Discretionary	1.89
GrubHub	Consumer Discretionary	1.79
Planet Fitness	Consumer Discretionary	1.76
Twilio	Information Technology	1.72
Bright Horizons Family Solutions	Consumer Discretionary	1.71
IDEX	Industrials	1.61
ICON	Healthcare	1.58

**Sector Breakdown<sup>4</sup>**

Information Technology	25.18%
Industrials	21.88
Healthcare	18.82
Consumer Discretionary	18.62
Financials	7.31
Materials	2.30
Communication Services	2.15
Energy	1.70
Cash and Cash Equivalents	1.34
Funds and Investment Trusts	0.70

Russell 2500 Growth Index represents the performance of small- to mid-cap growth companies within the US. Russell Midcap Growth Index represents the performance of the mid-cap growth market.

Investors cannot invest directly in indices or averages, and their performance does not reflect fees and expenses or represent the performance of any AB fund.

**A WORD ABOUT RISK**

**Market Risk:** The market values of the portfolio's holdings rise and fall from day to day, so investments may lose value. **Capitalization Size Risk (Small/Mid):** Small- and mid-cap stocks are often more volatile than large-cap stocks—smaller companies generally face higher risks due to their limited product lines, markets and financial resources.

**Foreign (Non-US) Risk:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities.

Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets.

**Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market.

**Investors should consider the investment objectives, risks, charges and expenses of the Fund/Portfolio carefully before investing. For copies of our prospectus or summary prospectus, which contain this and other information, visit us online at [www.abfunds.com](http://www.abfunds.com) or contact your AB representative. Please read the prospectus and/or summary prospectus carefully before investing.**

