Euro high yield's bull market has not yet run its course. Attractive opportunities continue to arise for investors willing to do their homework.

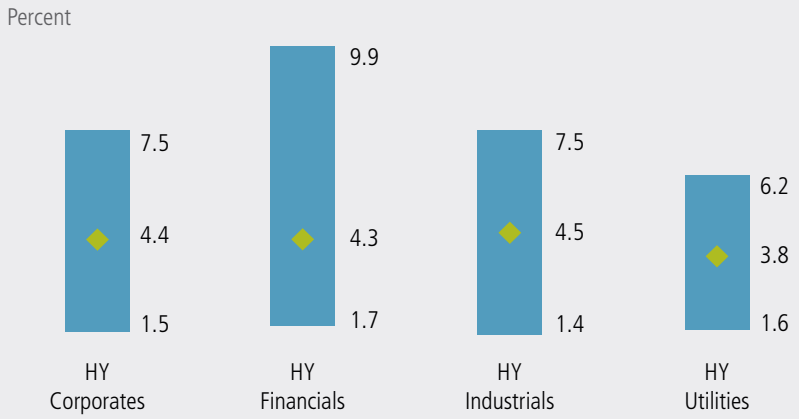
Rethinking European High-Yield Strategies

Investing in European high yield is increasingly about picking the right bonds. For those taking a selective approach, European high-yield bonds continue to provide attractive income opportunities. Thinking outside the benchmark box is more and more important.

Fundamentally Sound

Europe's high-yield corporate bond market has provided investors with stellar returns over the last few years. Recent market volatility has, inevitably, raised concerns about the return potential from here. In our view, this summer's market correction was largely sentiment-driven. It doesn't reflect a significant deterioration in high-yield company fundamentals, which remain relatively resilient. We're not expecting a marked increase in corporate defaults or a negative shift in current interest-rate expectations. While Europe's high-yield market may experience further volatility in the short term, we think this bull market has not yet run its course and continues to offer attractive investment opportunities.

Display 1: Range of Bond Yields Within the Index*



Past performance does not guarantee future results.
As of June 30, 2014
*The bottom range is the fifth percentile, the top range is the 95th percentile and the diamond is the mean of the yield-to-worst data for the indices.
High Yield Corporates is represented by Barclays Pan-European High Yield Corporate; High Yield Financials by Barclays Pan-European High Yield Financials; High Yield Industrials by Barclays Pan-European High Yield Industrials; High Yield Utilities by Barclays Pan-European High Yield Utilities. An investor cannot invest directly in an index or average and neither includes sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
Source: Barclays and AllianceBernstein

As Europe's economic rebound continues at a slow pace and regional policymakers, like the European Central Bank (ECB), remain committed to doing "whatever it takes" to support recovery and stability, monetary policy in the euro area is likely to stay extremely loose for a very long time. In this environment, we believe that euro high yield remains a compelling strategic opportunity, particularly for investors seeking relatively attractive levels of income.

Think Outside the Benchmark Box

The euro-area policy backdrop means that refinancing rates for companies are set to stay low. And our analysis suggests that corporate default rates will remain at historically low levels for at least the next 12 to 24 months. This should be supportive for European high-yield spreads and help underpin demand for European corporate bonds. But we believe that an increasingly selective approach will be needed to identify the most rewarding investment opportunities.

A big source of high-yield returns in 2012 and 2013 stemmed simply from getting "risk-on, risk-off" calls right. But broad exposure to the euro high-yield market using a benchmark-driven approach may no longer be enough to deliver attractive results. Instead, we think that euro high-yield returns will depend much more on sector and security selection, which, in turn, will rely heavily on in-depth, bottom-up analysis.

Euro High Yield Comes of Age

The good news is that the euro high-yield market enjoys sufficient depth and breadth to allow for a highly selective approach (**Display 1, previous page**).

Once firmly eclipsed by its larger and more mature US counterpart, the euro high-yield market has come of age. The market has grown from roughly €100 billion in 2010 to around €270 billion today, driven by a wave of "fallen angels" (formerly investment-grade companies that have been downgraded to the high-yield universe) and corporates' shift from bank financing towards capital markets. In the year to date, an impressive 181 new bonds have been issued, amounting to some €68.7 billion. The market has demonstrated its ability to absorb increased supply, reflecting a growing investor base. The end-result has been new return-seeking and diversification opportunities.

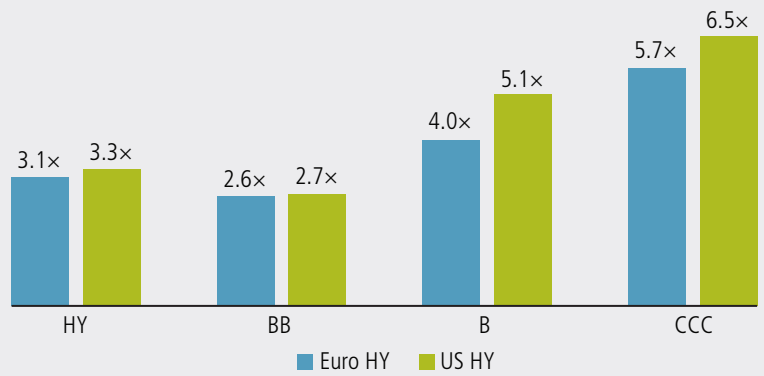
Relative Value in Europe

Against this backdrop, we believe that the euro high-yield market offers some attractive relative value opportunities when compared with its US counterpart. While Europe's economic recovery is still in its infancy and the interest-rate outlook remains very benign, the US economy is firmly in the mid-cycle stage. Company behavior in the two regions reflects where they are in their cycles.

In the US, we're seeing a greater number of "equity friendly" actions—specifically increased dividends and higher levels of leveraged buyouts and merger and acquisition activity—than in Europe. As a direct result of this trend, corporate leverage remains lower in Europe than in the US and it's continuing to decline, fueled by a continuing desire among European high-yield corporates to de-lever. As bond investors, this is music to our ears, as our rule of thumb is, first, to consider an issuer's willingness to repay and service debt and, second, that issuer's ability to do so. European issuers are both willing and able (**Display 2**).

Display 2: Comparing Credit Fundamentals—Leverage Trends Diverging

Net Leverage by Rating



Historical data for illustrative purposes only
Net leverage as of December 31, 2013
Source: Morgan Stanley and AllianceBernstein

Be Willing to Think Small

We currently see limited value in the big issuers that make up a large percentage of the market index. These have been squeezed to unattractive levels by those benchmark-following investors that flocked to take general market exposure in 2012 and 2013.

Robust investor demand and low borrowing costs have started to attract smaller players to the new issue market and they tend to pay higher interest than the larger issuers. As a result, we believe these smaller names can offer attractive opportunities, although extensive research resources are required in order to fully exploit their risk/reward dynamics (**Display 3**).

Equally, proper diversification is important when approaching this part of the market. If you're avoiding low-opportunity large issues and favoring high-opportunity smaller issues, you need to have a greater number of issues and names in your portfolio. To avoid owning too great a percentage of any issue, the smaller the issue size, the lower the percentage weighting each security should represent.

New Opportunities in Financials

Structural change and regulatory action in the financial sector are also creating new opportunities in euro high yield. Basel III requires financial institutions to bolster their core equity capital ratios, and they're doing so by restructuring their balance sheets and by issuing a new type of Tier 1 debt—Additional Tier

1 (or AT1).

Supply of these AT1 bonds is likely to be plentiful as financial institutions seek to meet the new regulatory requirements, but demand may be constrained as not all investors can buy them. They will be largely off-limits for banks and insurance companies. This suggests these bonds may be on offer at attractive spreads when supply levels start to outstrip demand. On this basis, we think AT1 bonds may prove an attractive source of returns over the next few years, though issuer selection and careful market timing will remain crucial.

The Bottom Line

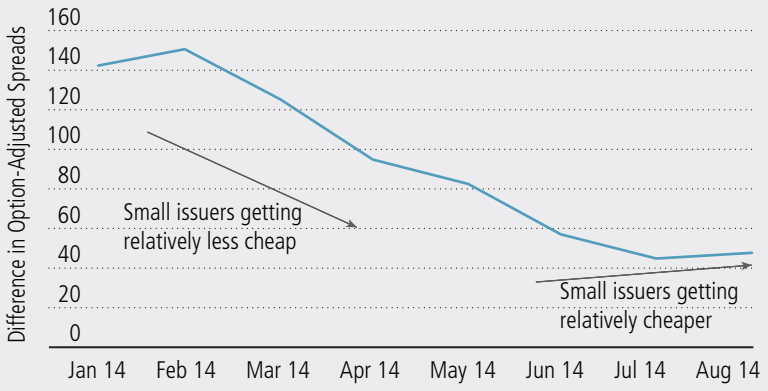
We believe that the outlook for euro high yield remains encouraging, even if investors encounter further short-term bouts of volatility. With euro zone monetary policy very likely to remain highly accommodative and high-yield companies' credit standing broadly healthy, investors remain compensated for the risk of default. This seems particularly reassuring for those seeking attractive income streams in today's current low-yield environment.

While we think that benchmark-following and primarily top-down-driven high-yield investment strategies may now have run their course, we also believe that a more discerning approach can continue to deliver attractive returns in the coming year. In our view, the expertise and the resources to analyze thoroughly corporate fundamentals and to engage with company managements on a regular basis, from both a debt and equity perspective, are likely to prove key determinants of success.

We believe that the research resources we devote to high yield are among the most extensive in our industry. And we think this gives us a real edge in exploiting the growing euro high-yield market's full potential. ■

Display 3: New Issues—Growing Gap Between Pricing of Small and Large Issuers

Spread of Small Issuers Minus Spread of Large Issuers



Historical analysis does not guarantee future results.
As of August 31, 2014
*Based on the Barclays Euro High Yield Index. Smaller issues defined as amount outstanding at less than €300 million and larger issues €300 million or above
Source: Barclays and AllianceBernstein

AllianceBernstein Limited
50 Berkeley Street, London W1J 8HA
United Kingdom
+44 20 7470 0100

A WORD ABOUT RISK

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

Interest Rate Risk: Bonds may lose value if interest rates rise or fall—long-duration bonds tend to rise and fall more than short-duration bonds.

Credit Risk: A bond's credit rating reflects the issuer's ability to make timely payments of interest or capital—the lower the rating, the higher the risk of default. If the issuer's financial strength deteriorates, the issuer's rating may be lowered and the bond's value may decline.

Allocation Risk: Allocating to different types of assets may have a large impact on returns if one of these asset classes significantly underperforms the others.

Foreign Risk: Investing in overseas assets may be more volatile because of political, regulatory, market and economic uncertainties associated with them. These risks are magnified in assets of emerging or developing markets.

Currency Risk: Currency fluctuations may have a large impact on returns and the value of an investment may be negatively affected when translated into the currency in which the initial investment was made.

Capitalization Size Risk: Holdings in smaller companies are often more volatile than holdings in larger ones.

Any references to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations. The specific securities identified and described in this presentation do not represent all of the securities purchased, sold or recommended for a portfolio, and it should not be assumed that investments in the securities identified were or will be profitable.

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