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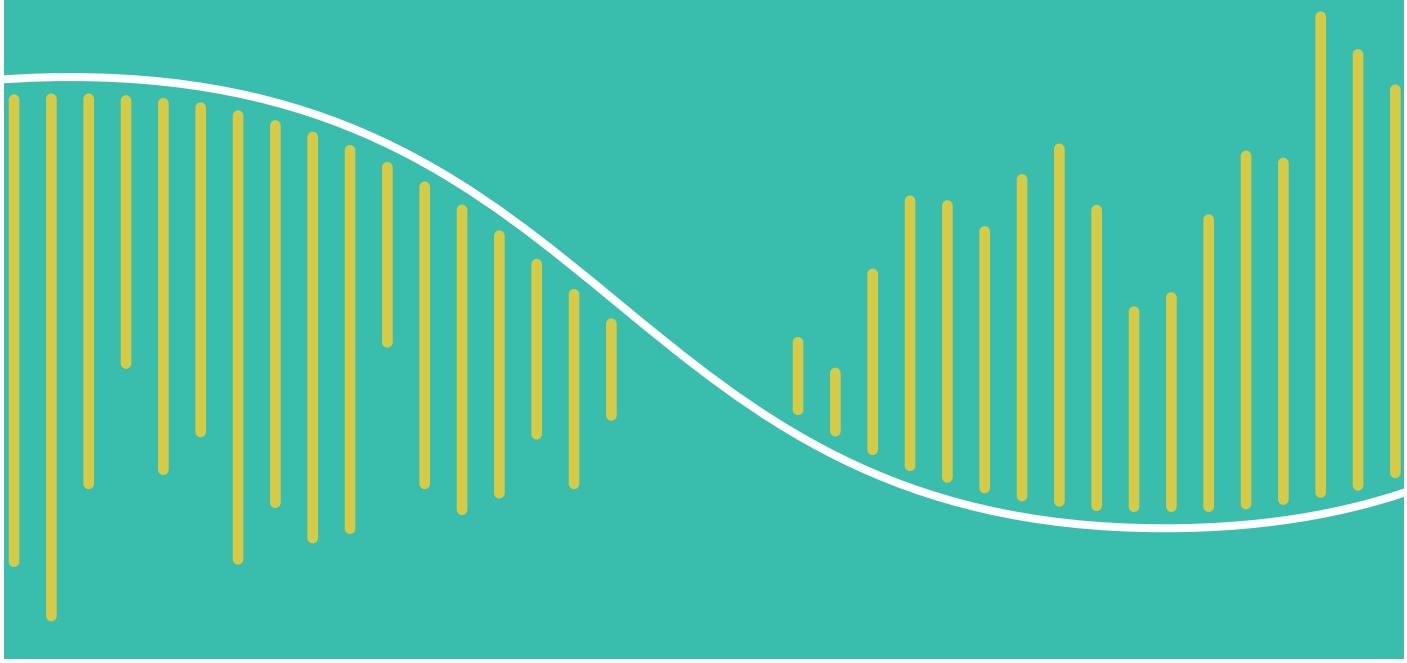
TIME TO DOWNSHIFT YOUR HIGH-YIELD PORTFOLIO



IN THIS PAPER: High yield has generated exceptional returns as it has recovered from the 2007–2008 market dislocations. Predicting future returns is difficult, but our view is that high yield remains a very attractive investment for the long run. However, to stay in the game, it may make sense to downshift the risk profile of your high-yield strategy.

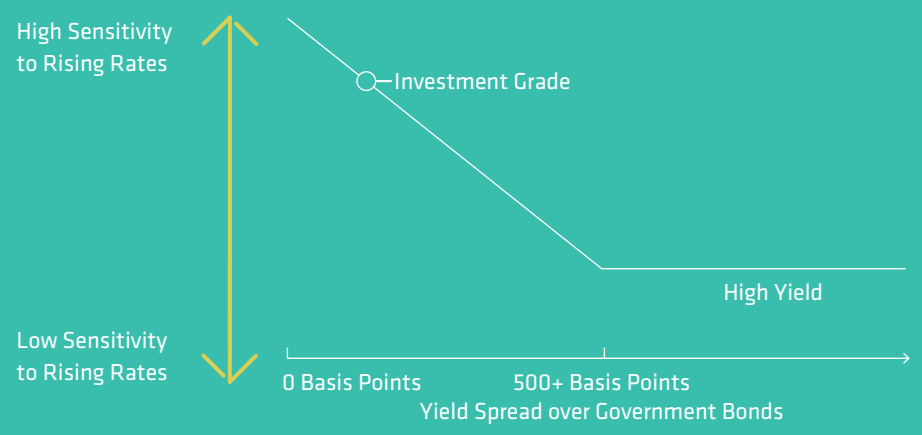
TIME TO DOWNSHIFT HIGH-YIELD RISK

High-yield bonds probably won't repeat the stellar returns they've posted since the financial crisis, but that doesn't mean it's time to get out of the market.

Yields on these bonds are attractive relative to other fixed-income investment sectors. Furthermore, our research suggests that once yield spreads on bonds exceed 500 basis points, their prices are not as vulnerable to rising government bond interest rates (*see Display 1*), making them especially attractive to investors anticipating higher government bond yields. However, it may be time to consider shifting into a lower gear, with a reduced-risk approach that can provide downside protection by employing a mix of risk-reduction strategies, including:

+ Investing in shorter-duration high-yield bonds
+ Focusing on higher-quality high-yield issuers
+ Employing hedging strategies

DISPLAY 1: HIGH-YIELD BONDS ARE LESS SENSITIVE TO RISING GOVERNMENT BOND YIELDS



Historical analysis does not guarantee future results.
"Rates" are defined as government bond yields. Data are for US investment-grade and high-yield bonds issued by corporations.
Source: Barclays and AB

INVESTING IN SHORTER-DURATION HIGH-YIELD BONDS

The shorter the duration of a bond, the less sensitive its price is to changes in its yield. In other words, in a high-yield bear market, shorter-duration bond prices will not fall by as much as comparable bonds with a longer duration.

Empirically, it can be shown that relative to the broader high-yield market:

+ Over a full market cycle, shorter-duration highyield bonds have delivered better risk-adjusted returns (*Display 2*)
+ Shortening duration provides a measure of downside protection while still delivering competitive returns through various market cycles (*Display 4, page 5*)

However, this approach must be applied and managed carefully:

+ Many longer-term high-yield bonds actually trade like shorter-maturity bonds because they can be called by the issuer—but there's no guarantee a bond will be called
+ In a high-yield bear market, many bonds that investors expect to be called may not be called, which can hurt returns

Professional active management and the use of credit default swaps (CDS) may help reduce this and other risks of investing in shorter-duration bonds.

FOCUSING ON HIGHER-QUALITY HIGH-YIELD ISSUERS

Higher-quality high-yield bonds—namely BB-rated issuers—have historically reduced risk and improved returns. This is largely attributable to the upside potential created by "fallen angels"—onetime investment-grade bonds that have been downgraded to high-yield status (*see Display 3, right*).

+ Because of forced selling by investment-grade-only portfolios, fallen angels often enter the high-yield universe extremely undervalued based on their fundamentals
+ This phenomenon is most evident in bonds that cross the sharp dividing line between BBB, the lowest investment-grade rating, and BB, the highest high-yield rating
+ As the market returns to recognizing fundamentals, this mispricing is eventually corrected—fallen angels have outperformed original-issue high yield over market cycles

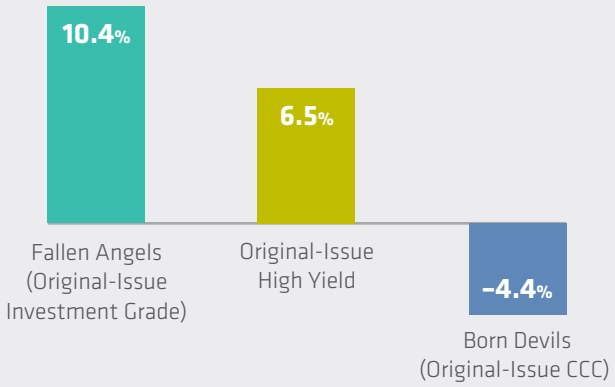
Strong research is critical to identifying bonds that are undervalued based on their underlying financial strength and for avoiding defaults and further downgrades

DISPLAY 2: BETTER RISK-ADJUSTED RETURNS THAN THE HIGH-YIELD MARKET

2000–Current	High Yield	Short-Duration High Yield	High-Quality High Yield
Duration	**4.34**	**1.85**	**4.95**
Annualized Return	7.48%	7.97%	8.15%
Volatility	10.02%	9.32%	7.86%
Sharpe Ratio	0.75	0.86	1.04

Past performance does not guarantee future results.
As of December 31, 2014
High-yield data are represented by Barclays US High Yield Index. High Quality High Yield is represented by Barclays US High Yield-BB Index. Short Duration High Yield is represented by Barclays US High Yield Index members with an option-adjusted duration of one-to-three years. All data are month-end. An investor cannot invest directly in an index or average and they do not include sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
Source: Barclays and AB

DISPLAY 3: MARKET INEFFICIENCIES PROVIDE OPPORTUNITIES
Annualized Total Returns



Past performance does not guarantee future results.
From January 1, 1997 through April 30, 2011.
Data are for US investment-grade and high-yield bonds issued by corporations.
Source: Barclays, Merrill Lynch and AB

EMPLOYING HEDGING STRATEGIES

Hedging strategies can also reduce the risk of large losses resulting from extreme events. These strategies almost always require sacrificing some yield, but using them can create greater latitude by allowing the portfolio to exploit and benefit from securities that might otherwise have unfavorable risk profiles.

+ Hedges can include puts on equity indices and buying protection on individual issuers, bond indices and interest-rate options
+ Hedging creates flexibility: for example, combining a longer-term high-yield bond with a hedge may create a better risk-return trade-off than buying a shorter-term high-yield bond alone

Hedging isn't "buy-and-hold", such strategies must be properly implemented and managed. A manager using options, for instance, must monitor their changing nature over time.

OTHER RISK-REDUCING STRATEGIES

Tapping into a Broader Opportunity Set: Noncorporate high-yield opportunities can also deliver attractive risk-adjusted returns and reduce portfolio volatility.

Diversifying Across Issuers: The high-yield market involves substantial issuer-specific risk. Taking concentrated security-specific bets can be rewarded at times, but we also seek to exploit systematic opportunities. Our research shows that enough diversification across issuers can keep problems with one issuer from undermining such opportunities.

Creating Synthetic High-Yield Exposure: Where suitable short-duration bonds are not available, investors can create synthetic credit exposure using CDS. These exposures mimic three-year or five-year high-yield bonds, which can be ideal for a high-yield strategy seeking to lower volatility by shortening duration.

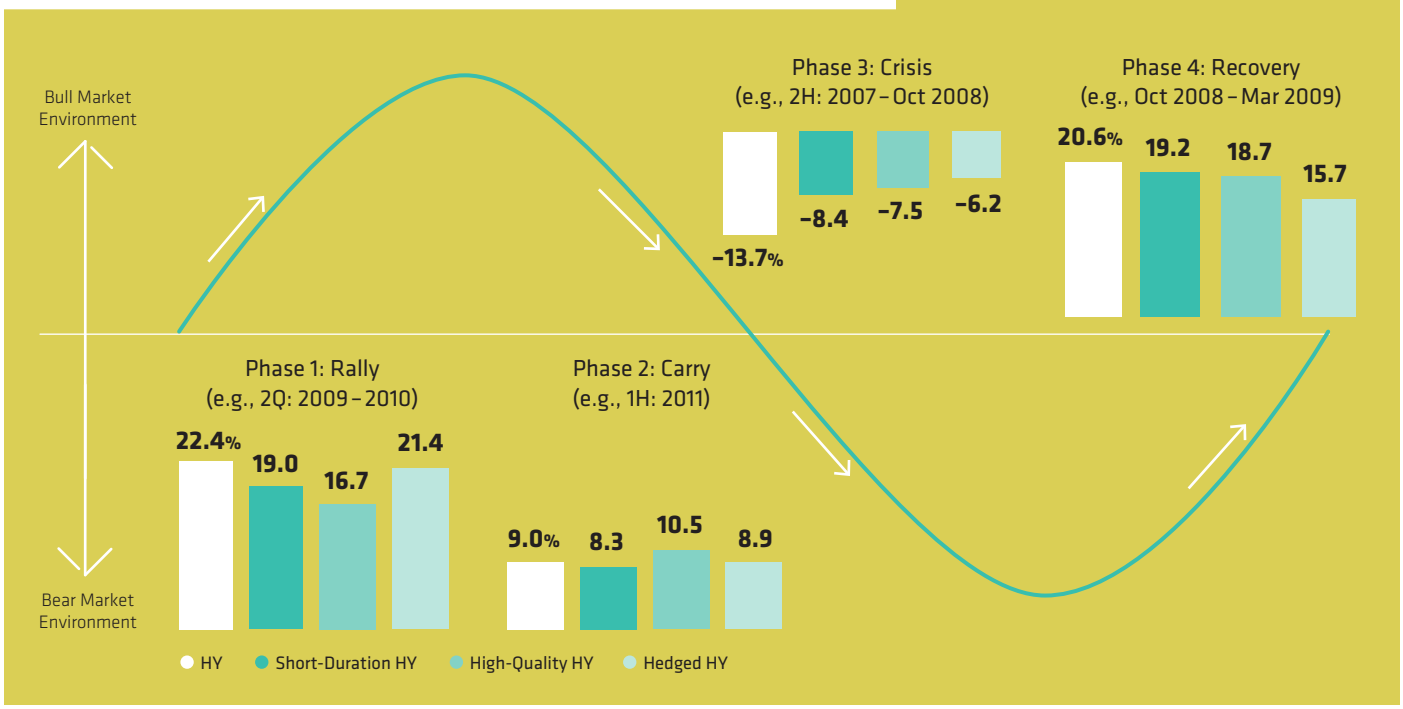
+ Synthetic high-yield exposure also removes extension risk—the risk that high-yield bonds are not called
+ The use of CDS also allows an investor to diversify across a broader range of issuers than physical bond issuance might allow

LOWER-VOLATILITY HIGH YIELD— EFFECTIVE OVER TIME

According to our research, the best approach is to apply all of these risk-reduction strategies in an actively managed framework. Such a high-yield strategy can still offer yield and total return potential that are higher than those of most other fixed-income options. While Display 2, page 3 shows that both shorter-duration and higher-quality high-yield strategies have historically lowered volatility and increased return over the long term, Display 4 illustrates how these risk-reduction strategies behaved during different phases of the market cycle (e.g., after the global financial crisis).

+ Risk-reducing strategies trail the market in the rally phase (Phase 1), as we experienced in 2009–2010.
+ The carry phase (Phase 2) is characterized by stable bond prices, with high-yield bond returns mainly generated by interest coupons. During this phase, risk-reducing strategies tend to provide downside protection in the event of a widening of the credit spread or the next market crisis, without sacrificing much return versus the broader high-yield market.
+ During the crisis phase (Phase 3), risk-reduction strategies have historically outperformed the broader high-yield market.
+ During the recovery phase (Phase 4), high-yield spreads tighten and often the issuers with the weakest fundamentals, who were punished most severely in the crisis phase, recover most strongly. Therefore, risk-reducing strategies historically have underperformed during the recovery phase.

DISPLAY 4: EFFECTIVENESS OF RISK-REDUCING STRATEGIES OVER A MARKET CYCLE



Past performance does not guarantee future results.
High yield is represented by Barclays US High Yield 2% Issuer Constrained. Short-duration high yield is represented by Barclays US High Yield 2% Issuer Constrained members with an option-adjusted duration of one to three years. High-quality high yield is represented by Barclays US High Yield 2% Issuer Constrained-BB. Hedged high yield is represented by the Barclays US High Yield 2% Issuer Constrained with 15% of its yield spent on tail-risk hedges using 5% out-of-the-money S&P puts. Returns are average annualized returns from January 1993 through June 2011. An investor cannot invest directly in an index or average, and yields shown do not include sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.
Source: Barclays, Bloomberg and AB

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