Frequently Asked Questions

Partial Duration-Hedged Share Classes Frequently Asked Questions

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Many investors are concerned about the effects of rising interest rates on their fixed-income portfolios, especially amid a prolonged low interest-rate environment. Partial duration-hedged share classes are designed to help mitigate a portion of the interest-rate risk by reducing a Portfolio's duration. The AllianceBernstein—American Income Portfolio (AIP) offers partial duration-hedged share classes as an alternative for investors who are concerned about the impact of increasing interest rates on the Portfolio.

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1. What is duration?

Duration is the sensitivity of a bond's price to a change in interest rates. It negatively affects a fixed-income portfolio when rising interest rates cause a bond's price to drop, ultimately detracting from a bondholder's returns. On the flip side, when interest rates are falling, the effect on returns can be positive.

2. Why would investors be interested in a portfolio that hedges interest rate risk?

Interest-rate hedging attempts to reduce the impact of interest-rate fluctuations, or the interest-rate risk, on a portfolio and thereby protect investors' investment returns from rising interest rates. Duration hedging seeks to leave untouched the additional yield that is expected to be earned from taking on credit risk, or the risk that a company may default on its obligations.

3. When does it make sense for investors to consider a duration-hedged portfolio?

A duration-hedged portfolio may make sense for investors who believe interest rates will rise, as the hedge seeks to provide protection in a rising interest-rate environment. It is not appropriate for investors who believe interest rates are going to fall, since interest rate hedging would reduce the benefit experienced from falling interest rates.

4. Are there any drawbacks to investing in a duration-hedged portfolio?

Potentially, in a falling interest-rate environment, a duration-hedged portfolio may underperform because investors give up the chance to gain from the upside potential provided by a drop in rates. In addition, there is a cost for hedging duration, which may lower an investor's returns because it reduces the effective yield of the portfolio (although the actual yield paid out to investors will not be affected – see question 12). The hedging cost will vary depending on market conditions. Investors holding the partial duration-hedged classes will absorb the costs associated with maintaining the partial hedge.

5. Why consider AllianceBernstein—American Income Portfolio's duration-hedged share classes?

AB believes that AIP's level of interest rate risk is appropriate given its objective. However, if investors are concerned about the impact of interest rates on their returns in AIP in a rising interest-rate environment, then partial duration-hedged classes may provide an effective way to manage that risk. AIP's partial duration-hedged share class intends to provide investors with a return that is less sensitive to interest-rate fluctuations by reducing the duration of the overall portfolio.

6. Why only partially hedge the duration in AIP?

AIP is designed to be an all-weather dollar-denominated fixed-income portfolio that balances credit risk and interest rate risk. To this end, the Portfolio uses a multi-sector credit barbell approach, investing in both high-quality fixed-income securities, which will do well in times of market stress/risk aversion, as well as allocating to high-yield and emerging-market securities to deliver alpha when opportunities for growth present themselves. The Portfolio's investment-grade component provides some stability to returns, while its high-yield component provides income and capital appreciation potential. One of its key tenets is to balance credit and duration risk.

In our view, a fully hedged portfolio would decouple the benefits of the credit barbell strategy that has served us so well for the more than 20 years we have been managing AIP. Interest rate risk and credit risk may be negatively correlated, and so hedging interest rate risk may in some circumstances result in higher exposure to downside credit risk. Through the partial hedging, we can maintain some of the benefits of the credit barbell portfolio structure and reduce interest-rate risk by hedging only the duration associated with our US Treasury holdings.

7. How do the partial duration hedge share classes work in AIP?

The partial hedging strategy systematically targets the duration attributable to the US Treasuries held by AIP. After calculating such duration, we then enter into financial derivatives transactions such as US Treasury futures contracts to reduce the duration of the Portfolio by that amount.

For example: Assume AIP's duration is 5 years, of which 2 years of duration can be attributed to AIP's US Treasury holdings. We would then purchase 10-year US Treasury futures contracts to lower the duration for the partial hedged share classes by 2 years, resulting in a net duration of 3 for the partial hedged share classes.

8. Does this share class affect the investment strategy of AIP?

No. This share class does not alter, change or affect the underlying investment strategy of AIP, nor is it expected to affect the underlying portfolio or its other share classes. The hedge is done and maintained at the share-class level only.

9. How often are the futures contracts monitored?

The 10-year US Treasury futures contracts are monitored on a daily basis and are adjusted when the duration hedging attributable to the futures contracts no longer balances the duration attributable to AIP's US Treasury positions. Typically these contracts are rolled on a weekly basis.

10. How much does the hedge cost?

US Treasury futures are extremely liquid and relatively inexpensive compared to other hedging alternatives. As of March 2014, the cost of hedging in the partial duration-hedged share classes is expected to approximate 1% to 2% per annum. The cost of the hedge would be borne by investors in the partial duration-hedged classes and would negatively impact the NAV for the respective share classes. The cost of hedging will vary depending on market conditions.

11. When should I expect AIP's partial duration-hedged share class to outperform the portfolio?

In rapidly rising-rate environments, the partial-duration-hedged class is expected to outperform the portfolio. During modestly increasing, flat or downward interest-rate environments, it is expected to underperform the portfolio.

12. Will the distribution yield of AIP's partial duration-hedged share classes be different than the distribution yield of the unhedged share classes?

No, since the cost of the hedge is considered capital for accounting purposes, the distribution yield of the partial duration-hedged class is expected to be in line with the unhedged equivalent class. Both the partial duration-hedged share classes and the existing AT share class distributions will be declared and paid monthly.