AllianceBernstein

Time to Downshift Your High-Yield Portfolio?

High yield has generated exceptional returns as it has recovered from the 2007–2008 market dislocations. We've recently seen a meaningful retracement of spreads and an increase in volatility. 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 (**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

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:

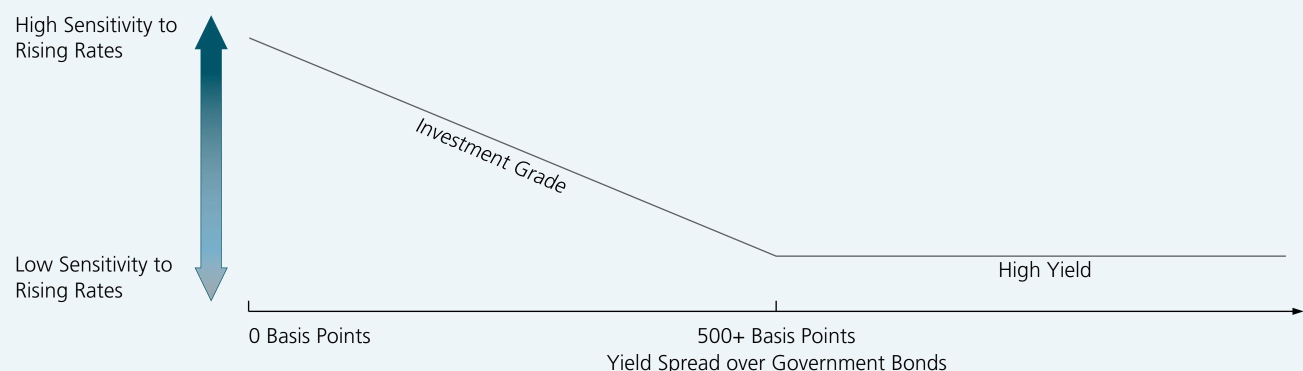
- Over a full market cycle, shorter-duration high-yield bonds have delivered better risk-adjusted returns (**Display 2**)
- By shortening duration, investors give up relatively little return in the carry and recovery phases of the market cycle, and outperform significantly in the crisis phase of the cycle (**Display 4**)

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

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 Capital and AllianceBernstein

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- 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 (**Displays 2** and **3**).

- 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.

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 a shorter-term high-yield bond

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: Non-corporate 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

Display 2

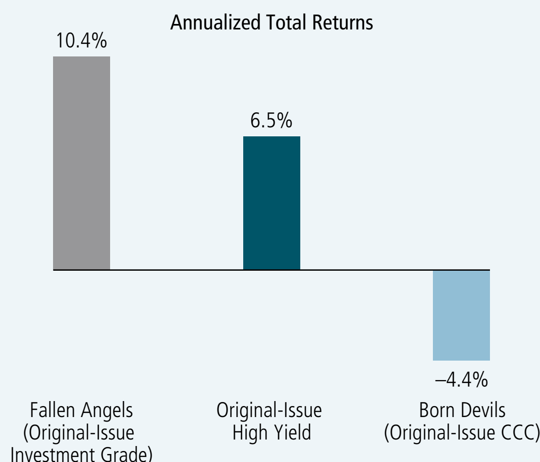
Volatility Reduction: Better Risk-Adjusted Returns than the High-Yield Market

1993–Current	High Yield	High Yield 1–3 Year	High Yield BB	High Yield with Hedging Strategies*
Annualized Return	8.25%	8.55%	8.91%	7.88%
Volatility	9.93%	8.42%	7.39%	9.23%
Sharpe Ratio	0.83	1.02	1.21	0.85

Past performance does not guarantee future results.
High-yield data are represented by the Barclays Capital US High Yield 2% Issuer Constrained Index. 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.
**High Yield with Hedging Strategies represents the Barclays Capital US High Yield 2% Issuer Constrained Index with 15% of its yield spent on tail-risk hedges using 5% out-of-the-money S&P puts. As of 30 June 2011*
Source: Barclays Capital, Credit Suisse and AllianceBernstein

Display 3

Market Inefficiencies Provide Opportunities



Past performance does not guarantee future results.
Data are for US investment-grade and high-yield bonds issued by corporations and analysis completed for the period from 1 January 1997 through 30 April 2011.
Source: Barclays Capital, Merrill Lynch and AllianceBernstein

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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 the investor to diversify across a broader range of issuers than physical bond issuance might allow

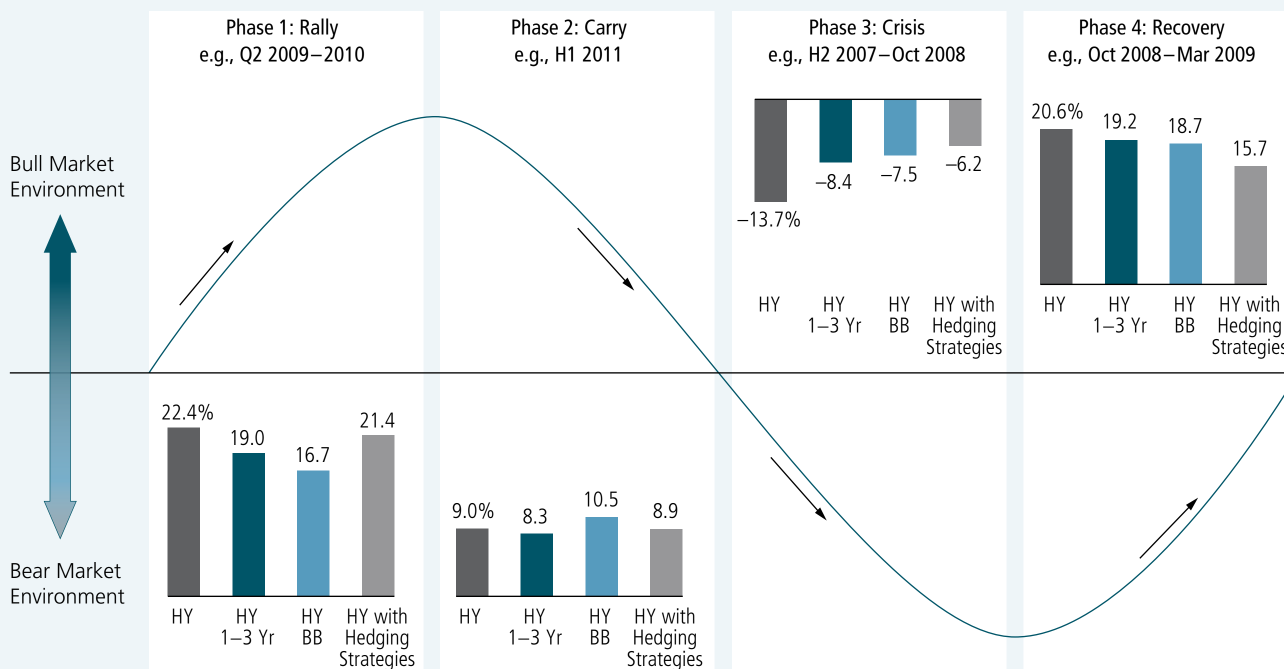
Lower-Volatility High Yield—Effective over Time

According to our research, the best approach is to apply all of these risk-reduction strategies in an actively managed framework, constantly balancing risk reduction against return potential. Such a high-yield strategy can still offer yield and total return potential that's higher than most other fixed-income options—while **Display 2** 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.

- Volatility-reducing strategies trail the market in Phase 1 and 4. Phase 1 is the rally phase, which we saw in 2009–2010 and won't likely see again for some time. Phase 4 is the recovery phase, where high-yield spreads tighten and often the issuers with the weakest fundamentals, who were punished most severely in the crisis phase, recover most strongly
- Phase 2, the carry phase, is characterized by stable bond prices, with high-yield bond returns mainly generated by interest income—"coupon clipping." Despite sacrificing some yield, none of the three risk-control strategies has historically given up much return versus the broader high-yield market during Phase 2, and, in return, they provide downside protection in the event of credit spread widening or the next market crisis
- In Phase 3, the crisis phase, all three risk-reduction strategies outperform the broader high-yield market

Display 4

Effectiveness of Low Volatility Strategies over a Market Cycle



Past performance does not guarantee future results.

High Yield is represented by the Barclays Capital US High Yield 2% Issuer Constrained Index. High Yield 1–3 Year is represented by the Barclays Capital US High Yield 2% Issuer Constrained Index members with an Option Adjusted Duration of one-to-three years. High Yield BB is represented by the Barclays Capital US High Yield 2% Issuer Constrained-BB Index. High Yield with Hedging Strategies is represented by the Barclays Capital US High Yield 2% Issuer Constrained Index 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 to June 2011. 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 Capital, Bloomberg and AllianceBernstein

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12-0394

INS-6745-0212

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