

June 11, 2014

# Bond Strategies for the Next Rate Cycle

Breaking away from traditional bond management to improve outcomes

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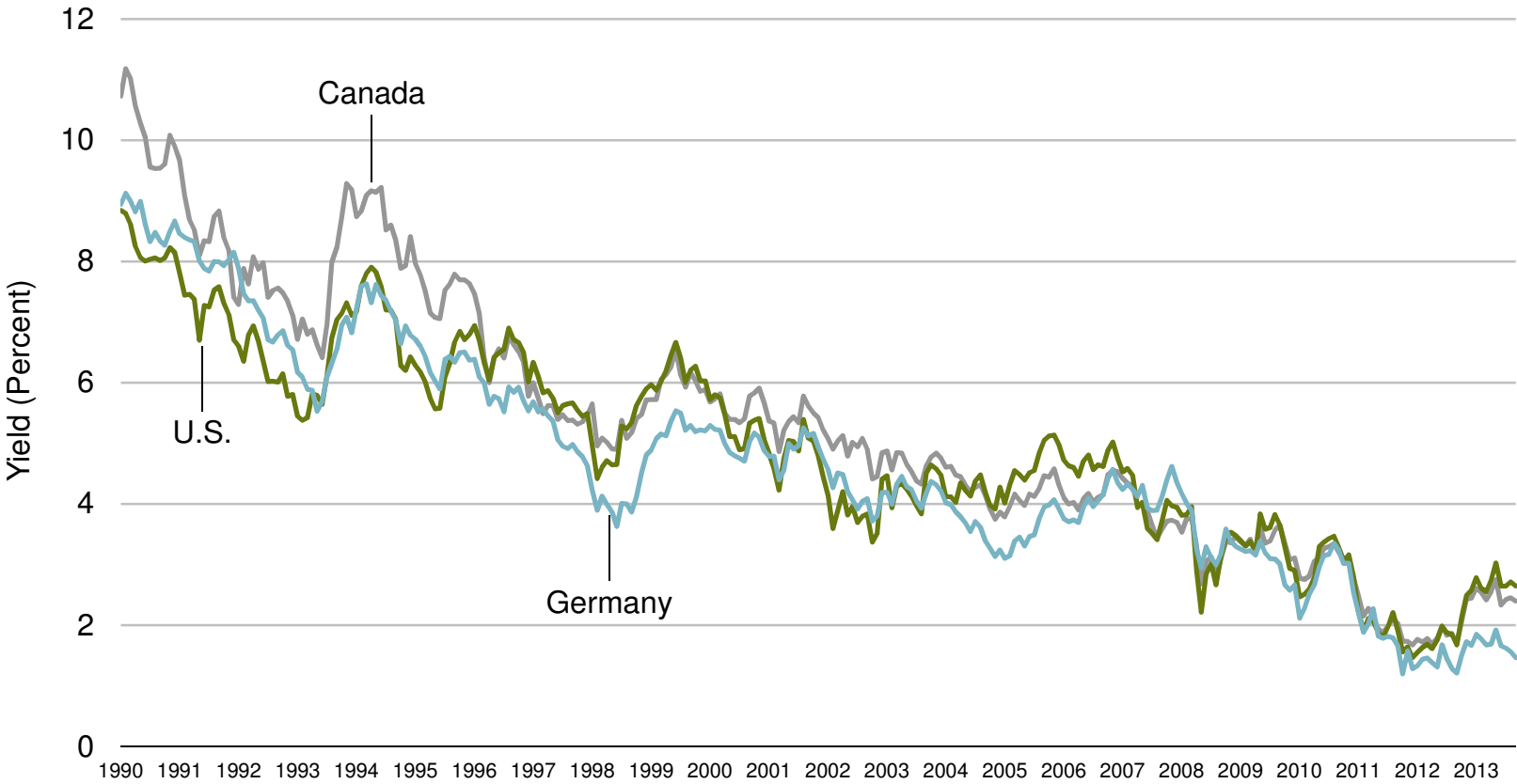
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# Bond Strategies for the Next Rate Cycle: Overview

- A transition is underway in the bond market—at a challenging time
  
- Improving outcomes will mean breaking from traditional techniques:
  - I. Delivering more balanced beta
  
  - II. Hedging against extreme events
  
  - III. Identifying alpha strategies with better convexity

# Challenges Abound for Bond Investors: Low Yields

## 10-Year Government Bond Yields

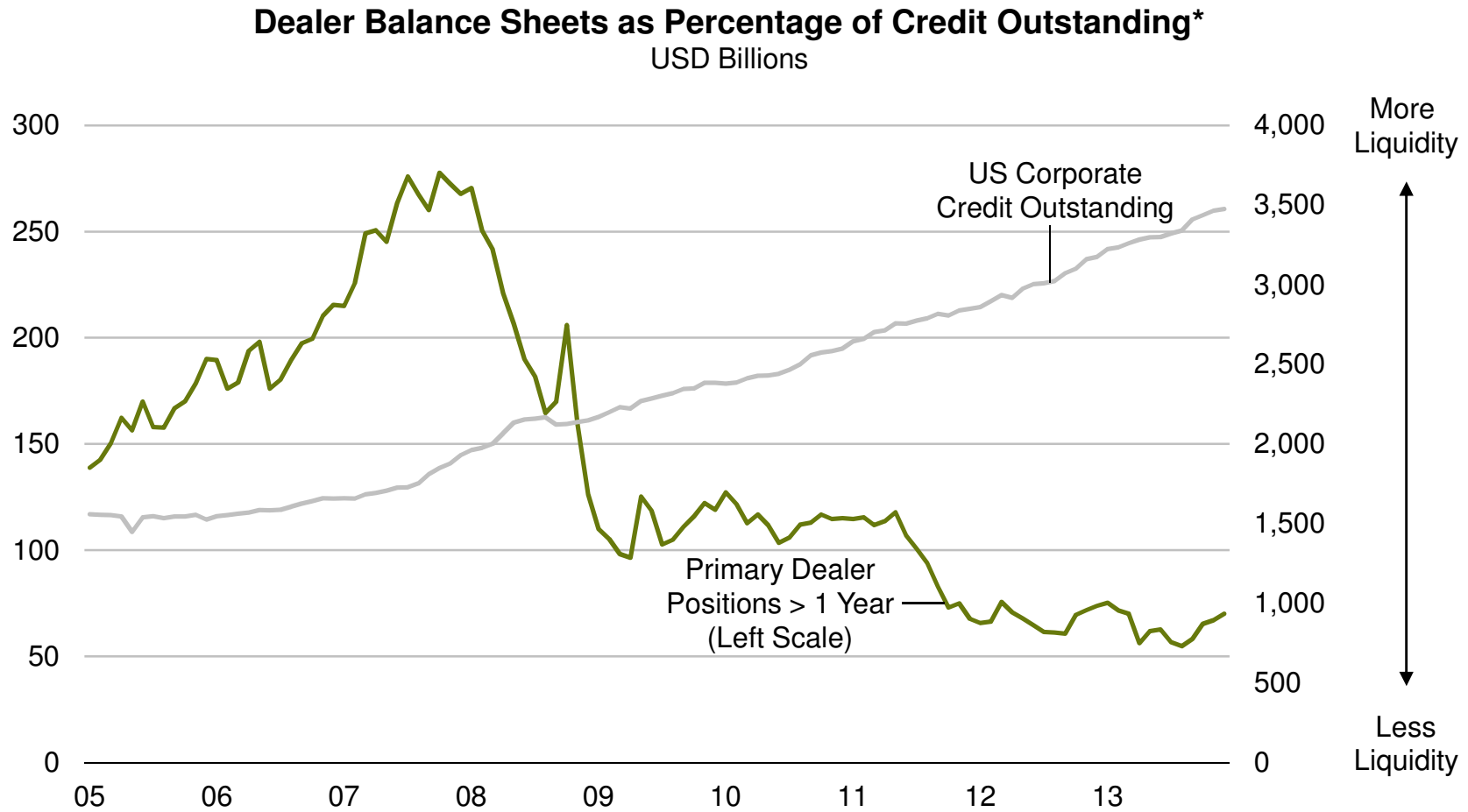


Historical analysis does not guarantee future results.

Government bond yields through April 30, 2014

Source: Bloomberg, Haver Analytics, Investment Company Institute, Morningstar and AllianceBernstein

# Challenges Abound for Bond Investors: Reduced Liquidity



As of December 31, 2013

Source: Barclays, Bloomberg, Federal Reserve Board, Haver Analytics, Investment Company Institute and AllianceBernstein

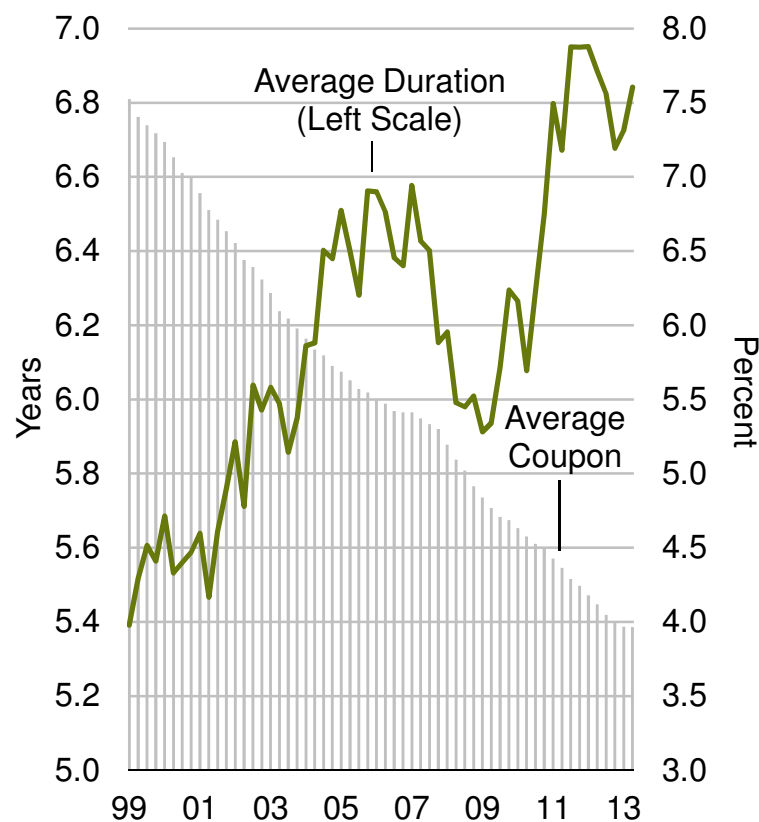
# What Can Investors Do?

- Begin with a better starting point
- Identify risk management strategies to buffer portfolios in times of stress
- Re-think alpha

**Begin with Better Beta**

# Traditional Benchmarks Offer Potentially Unwanted Risks

## Bond Market Duration is Climbing While Coupon Declines\*



## DEX Canadian Bond Overall Index: December 2000 vs. December 2013



**Yield:**  
Declined from 6.3% to 2.8%



**Credit:**  
AAA exposure declined from 56% to 44%



**Duration:**  
Extended from 5.7 years to 6.7 years



**Coupon:**  
Decreased from 7.2% to 4.0%

\*December 2000 through March 2014. Modified adjusted duration and average coupon of DEX Universe Index measured quarterly  
Source: Barclays and AllianceBernstein

# Consider Expanding the Bond Universe By Sector and Geography

January 1, 2008–December 31, 2013

**Fixed Income Sector Returns**  
Percent

	2008	2009	2010	2011	2012	2013
Best	Gov't 9.7	High Yield 55.2	CMBS 21.0	Global TIPS 11.7	Emerging 18.5	High Yield 8.2
	DEX 6.4	CMBS 26.7	High Yield 15.0	DEX 9.7	High Yield 16.5	CMBS 0.9
	Global TIPS 0.0	Emerging 26.2	Emerging 12.6	Emerging 9.2	IG Corp. 11.7	Gov't 0.8
	IG Corp. -5.2	IG Corp. 15.8	IG Corp. 7.7	CMBS 7.2	CMBS 10.8	IG Corp. 0.7
	Emerging -12.6	Global TIPS 9.0	DEX 6.7	Gov't 6.5	Global TIPS 7.6	DEX -1.2
	CMBS -24.3	DEX 5.4	Global TIPS 5.2	IG Corp. 5.4	Gov't 5.4	Emerging -3.6
Worst	High Yield -28.6	Gov't 1.0	Gov't 4.1	High Yield 5.1	DEX 3.6	Global TIPS -3.6
Difference	38.3	54.2	16.9	6.6	14.9	11.8

**Past performance does not guarantee future results. Returns are hedged in Canadian dollars.**

Government and Corporate indices are Global; Emerging is US dollar denominated emerging market debt; High Yield is US High Yield, CMBS is US CMBS

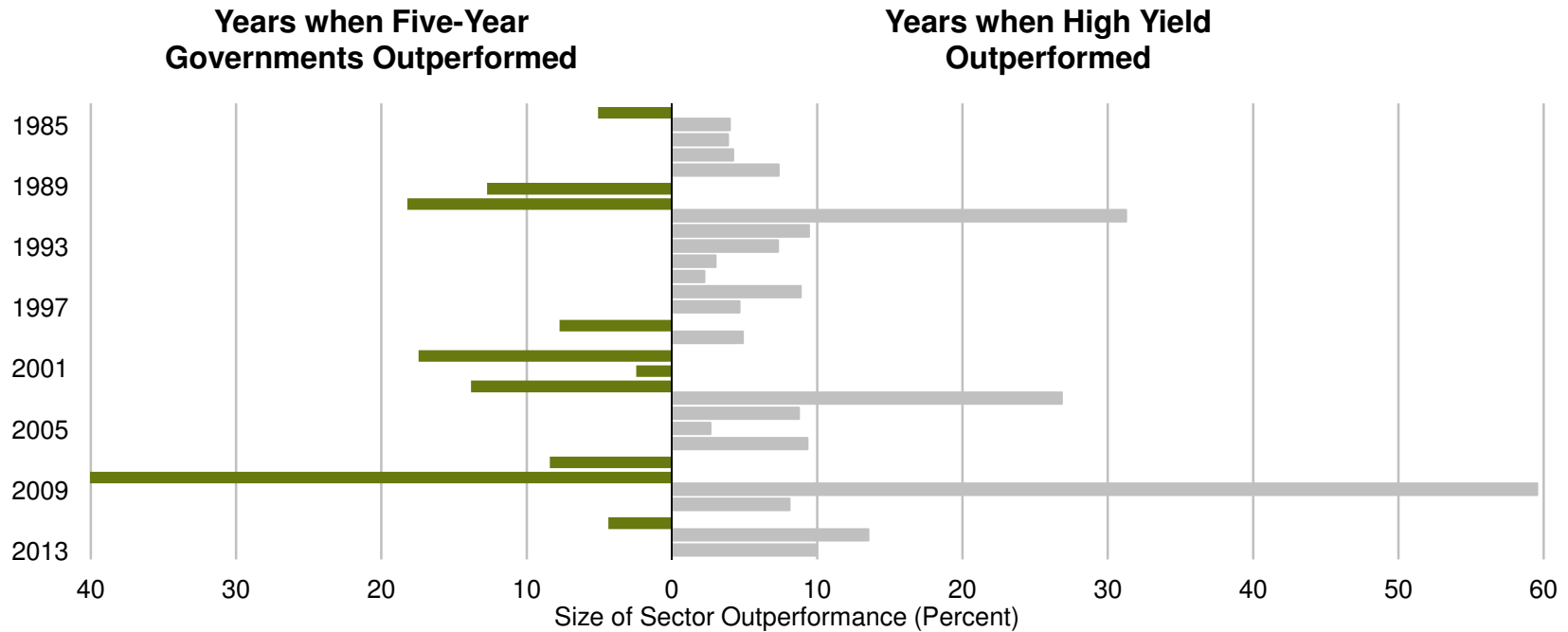
Returns represented by various Barclays and Merrill Lynch bond indices.

Source: Barclays, Merrill Lynch, Scotiabank and AllianceBernstein



# Rates and Credit Rotate Leadership, Making a Barbell Strategy Attractive

January 1, 1984–December 31, 2013



	Five-Year Govts.	High Yield	50/50
Average Return	7.3%	10.8%	8.7%
Annualized Volatility	4.9%	8.6%	5.0%
Sharpe Ratio	0.6	0.7	0.9

**Past performance does not guarantee future results. These returns are for illustrative purposes only and do not reflect the performance of any fund. Diversification does not eliminate the risk of loss.**

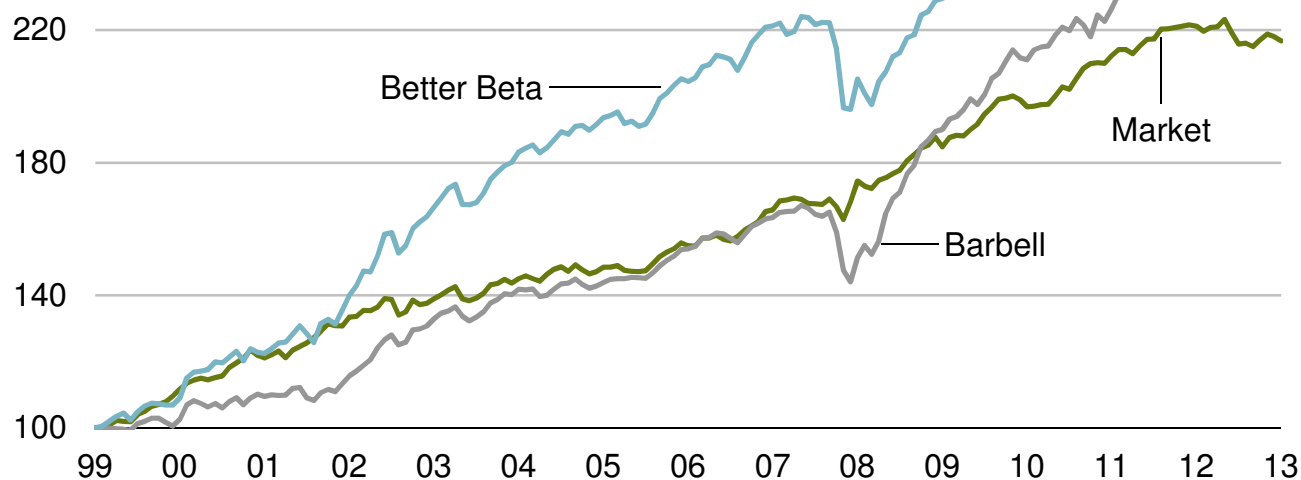
Governments as represented by Barclays 5-year US Treasury Bellwether Index. High Yield—Barclays US Corporate High Yield Index.

Source: Barclays and AllianceBernstein

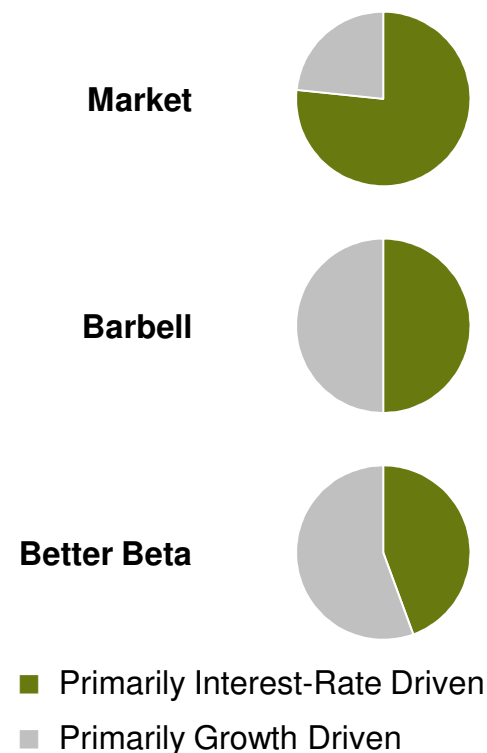
# Better Beta Compared with Barbell and Market Portfolios

Total return, December 31, 1999 to December 31, 2013 – SIMULATED

	Market	Barbell	Better Beta
Cumulative Return	117.0%	153.0%	185.0%
Annualized Return	6.1%	7.4%	8.4%
Annualized Volatility	3.6%	5.1%	5.8%
Sharpe Ratio	1.0x	0.9x	1.0x
Worst One-month Loss	-3.8%	-13.8%	-12.5%



## Portfolio Composition December 31, 2013



**For illustrative purposes only. Historical analysis does not guarantee future results.**

Through December 31, 2013

**Better Beta:** Simulated performance of multisector portfolio, composed of: CDX High Yield Credit Index; CDX Investment Grade Credit Index; CDX Emerging Market Credit Index; Deutsche Bank G10 Currency Futures Harvest Index (all primarily growth driven) and Barclays US Inflation Linked Bond Index; Barclays US Aggregate Treasury Index (both primarily interest-rate driven).

**Market:** Historical performance of Barclays US Aggregate Index, composed of: US Treasuries; US agencies/government related; mortgage-backed securities; CMBS/ABS (all primarily interest-rate driven) and investment-grade corporates (primarily growth-driven). These results are based on simulated or hypothetical performance results that have certain inherent limitations. Unlike the results shown in an actual performance record, these results do not represent actual trading. Also, because these trades have not actually been executed, these results may have under- or over-compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated or hypothetical trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. No representation is being made that any account will or is likely to achieve profits or losses similar to these being shown.

**Barbell:** Simulated performance of portfolio composed of 50% Barclays US Corporate High Yield Index and 50% Barclays Five-Year Bellwether Treasury Index.

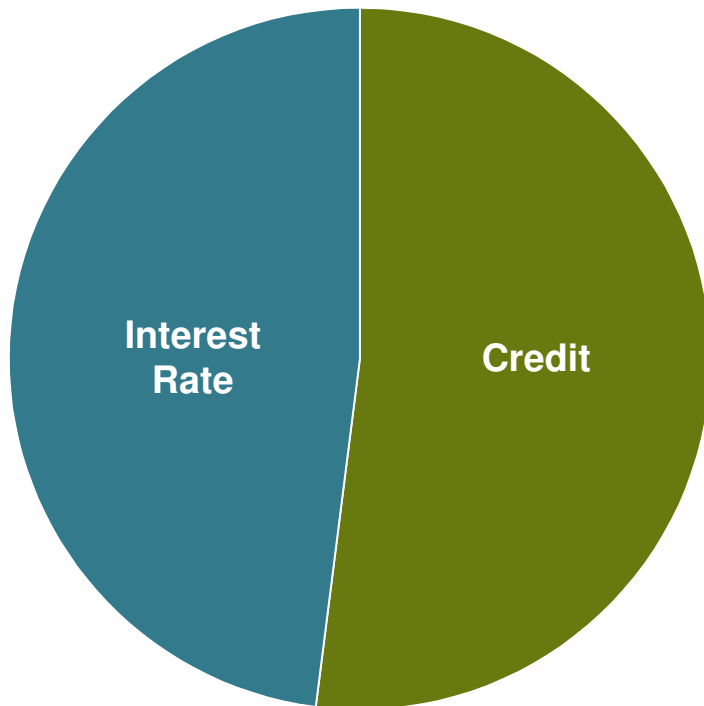
Source: Barclays, CDX, Deutsche Bank and AllianceBernstein

# Dynamically Adjust Beta Balance Based on Market Environment

As markets change, risk allocations shift to pursue sectors with attractive risk/return profiles

## Balanced Allocation\*

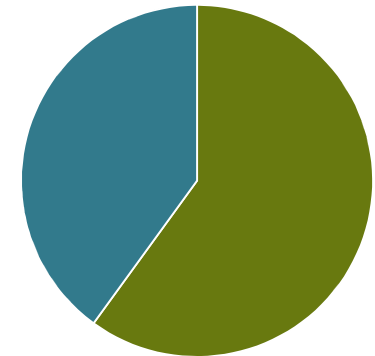
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## Credit Focus: Sample Scenario

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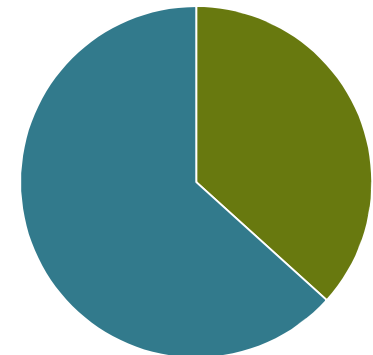
- Improving economic growth
- Rising interest rates



## Interest Rate Focus: Sample Scenario

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- Deteriorating economic growth, rising default risk
- Falling interest rates

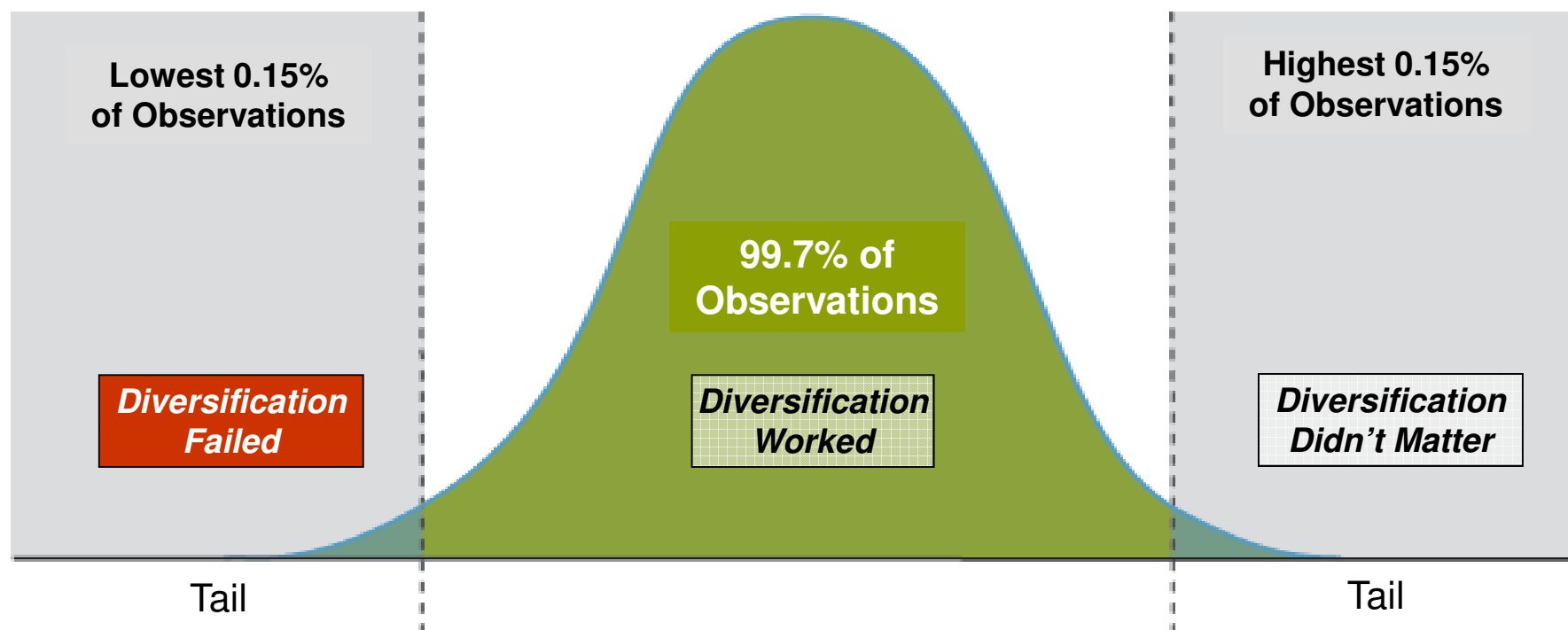


For illustrative purposes only.  
As of December 31, 2013  
\*For illustrative purposes only  
Source: AllianceBernstein

# Hedge Tail Risk

# What is a Tail Hedge? (Technical Definition)

A Tail Hedge strategy is designed to buffer a portfolio during extreme market events



For illustrative purposes only.  
As of 30 September 2013  
Source: Bloomberg and AllianceBernstein

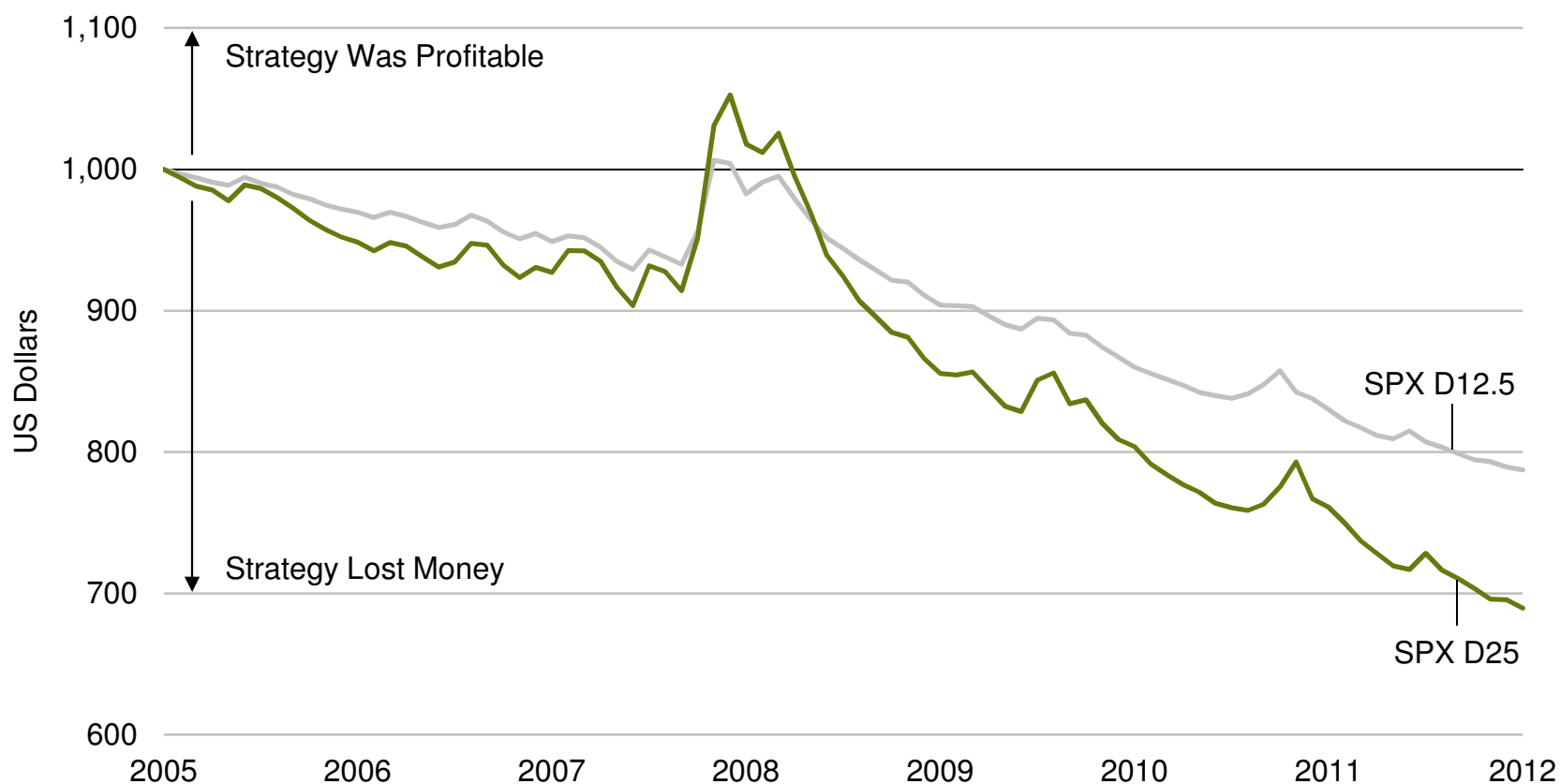
## What is a Tail Hedge? (Practical Definition)

A Tail Hedge strategy is like an umbrella...you want to own one before it rains



# Implementing Tail Hedges: Buy-and-Hold Strategies Can Be Expensive

## Value of \$1,000 in Three-Month S&P Put Options



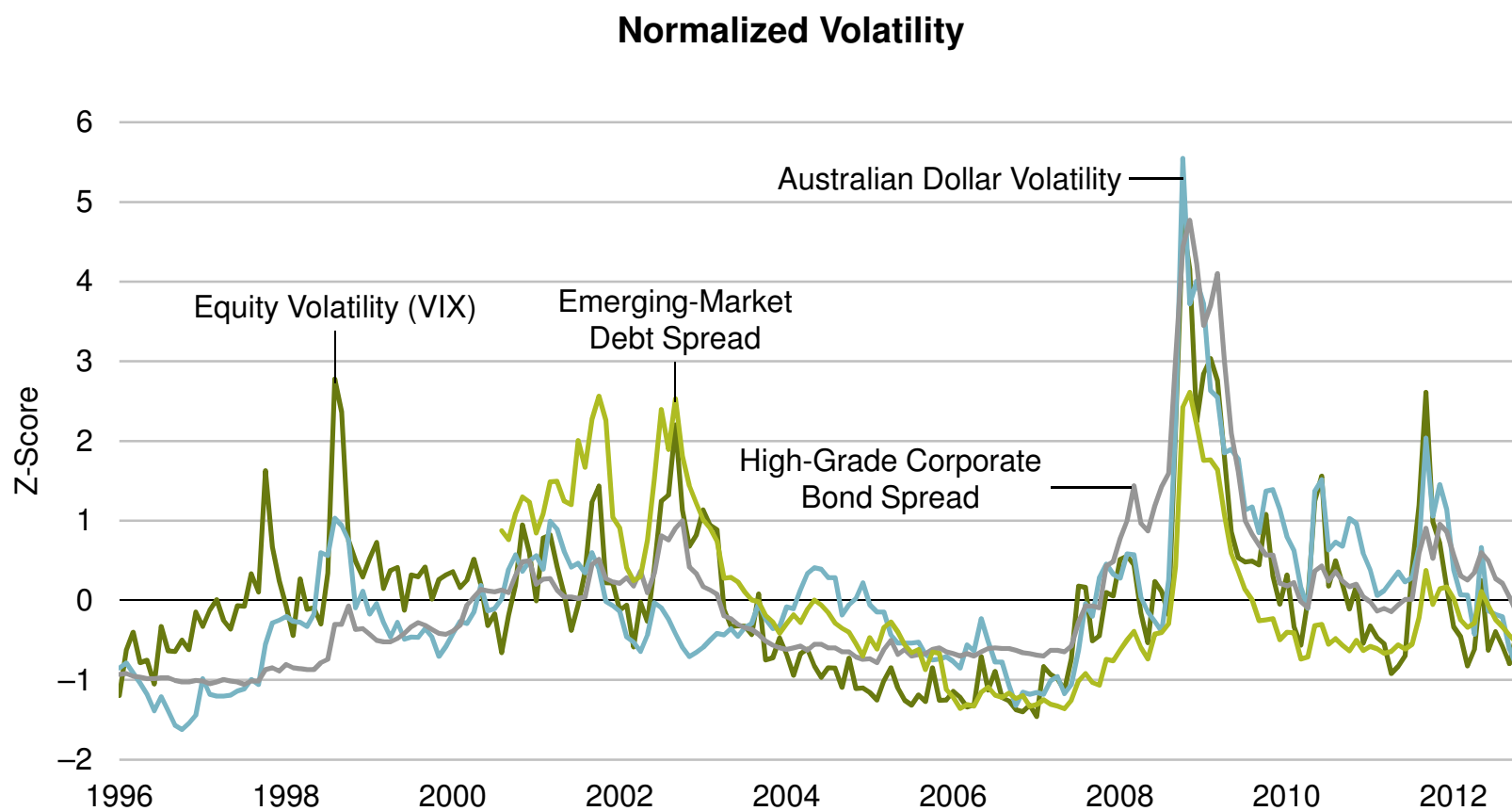
For illustrative purposes only.

February 2006–December 2012

SPX D25 represents a passive strategy where an investor buys and holds a three-month 25 Delta put option on the S&P 500, holding until maturity and enters a new transaction on each consecutive expiration date. SPX D12.5 represents a passive strategy where an investor buys and holds a three-month 12.5 Delta put option on the S&P 500, holding until maturity and enters a new transaction on each consecutive expiration date.

Source: Bloomberg, S&P and AllianceBernstein

# Volatilities Are Highly Correlated...



**Historical analysis is not a guarantee of future results.**

Through December 31, 2012

All time series are shown in Z-score units, standardized for the period of January 1996–August 2011. A Z-score is a measure of the distance from the mean of a distribution normalized by the standard deviation of the distribution.

Z-scores help quantify how different from normal a recorded value is.

Equity volatility is represented by the CBOE Volatility Index (VIX), Australian dollar volatility by one-month implied volatility on AUD/USD, and debt volatilities by option-adjusted spreads on the Barclays US Corporate Index and Barclays Emerging Markets Index.

Source: Bank of America Merrill Lynch, Barclays, Bloomberg and Chicago Board Options Exchange



# ...So Consider a Dynamic Diverse Range of Tail Hedge Strategies

## Equities

Option strategies in global equity markets are just one way to hedge tail risk.

## Volatility

The market has evolved to allow investors to implement strategies based on market volatility, such as options on the VIX.

## Rates

Duration and exposure to “risk-free” assets may serve investors well in periods of market stress. Yield-curve strategies (i.e., curve flatteners) may also help.

## Sovereign

Relative-value opportunities in sovereign credit risk can offer attractive, cost-efficient tail hedging.

## Credit

Credit and credit derivatives can offer compelling payout profiles in tail hedging. Credit strategies can span CDS to default protection on credit tranches.

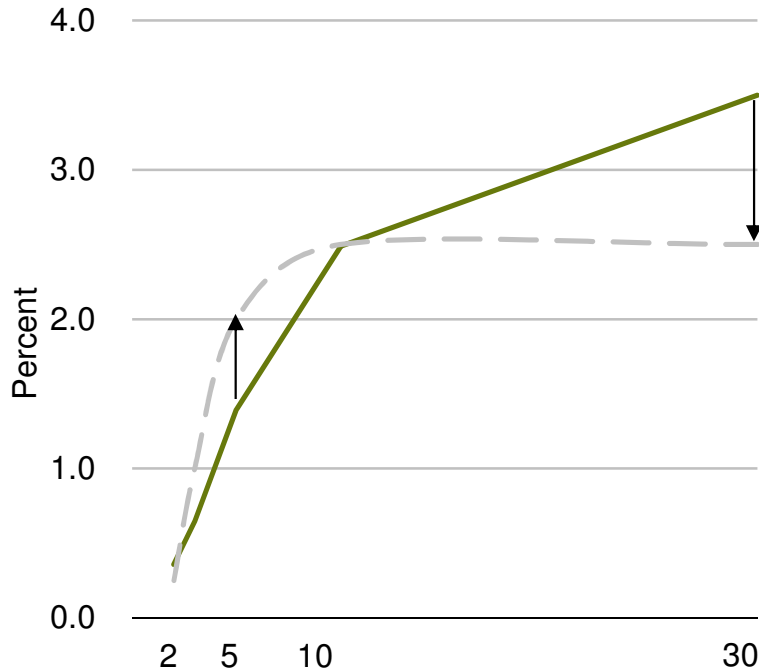
## Currency

As one of the most liquid markets in the world, currency strategies can provide effective/efficient tail-hedge strategies, including “anti-carry” trades.

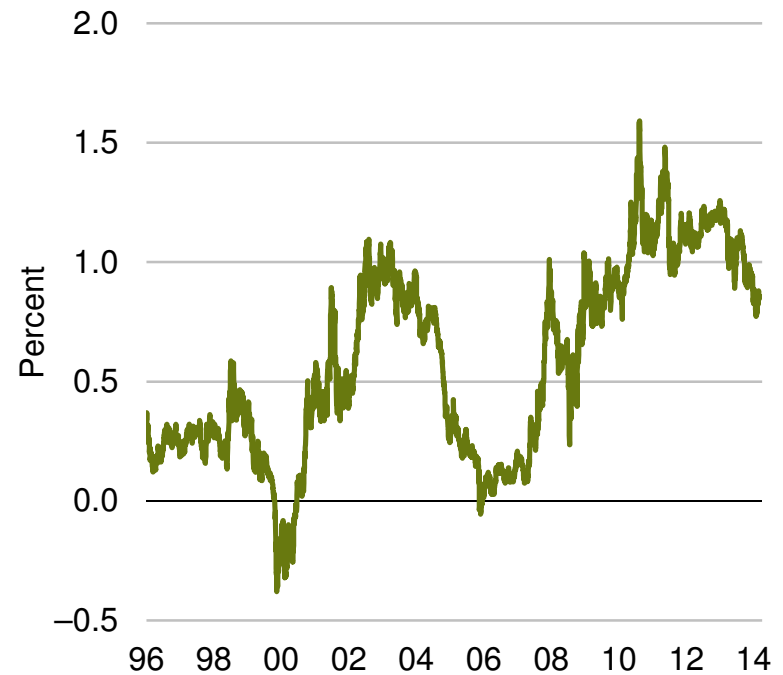
As of March 31, 2014  
Source: AllianceBernstein

# Long/Short Strategies May Reduce Hedging Costs

US Treasury Yield Curve



30-Year US Treasury vs. 10-Year US Treasury



- Yield curves typically “flatten” in a crisis as investors rush to add duration to their portfolios

- An effective hedge can be a long position in 30-year governments and short position in duration-equivalent 10-year governments

**Current and historical results does not guarantee future results.**

Left display as of June 30, 2013. Right display as of May 30, 2014

The graph and data are presented solely for the purpose of helping to illustrate the degree to which recent market dislocations have created attractive investment opportunities in the portfolio management process. There are always investment risks (e.g., counterparty risk) and it should therefore not be assumed that an investment in the security identified was or will be profitable. For more information regarding how AB attempts to manage counterparty risk, see “Protecting Against Counterparty Risk”

Please see “A Word About Risk” in the Appendix

Source: Bloomberg and AllianceBernstein

# Long/Short Strategies May Reduce Hedging Costs: Credit Default Swaps

## 5-Year CDS: Mexico vs. US Investment Grade CDX

- The Mexican economy's ties to the US make it an attractive hedge in times of crisis
- Mexican sovereign CDS typically widen almost 2x more than US IG Corp Index CDS
- An effective hedge can be a short position in 5-year Mexican sovereign CDS, offset by a long position in US IG CDX



**Historical analysis does not guarantee future results.**

As of March 31, 2014

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Source: Bloomberg and AllianceBernstein

# Important Considerations

## ■ Risk Management

- Counterparty Risk
- Basis Risk (using oranges to hedge apples) — diversify!

## ■ Rebalancing:

- Monetize gains
- Reallocate to more cost-effective instruments
- Maintain desired hedge level

# Rethink Alpha

## Rethinking Alpha in Today's Market

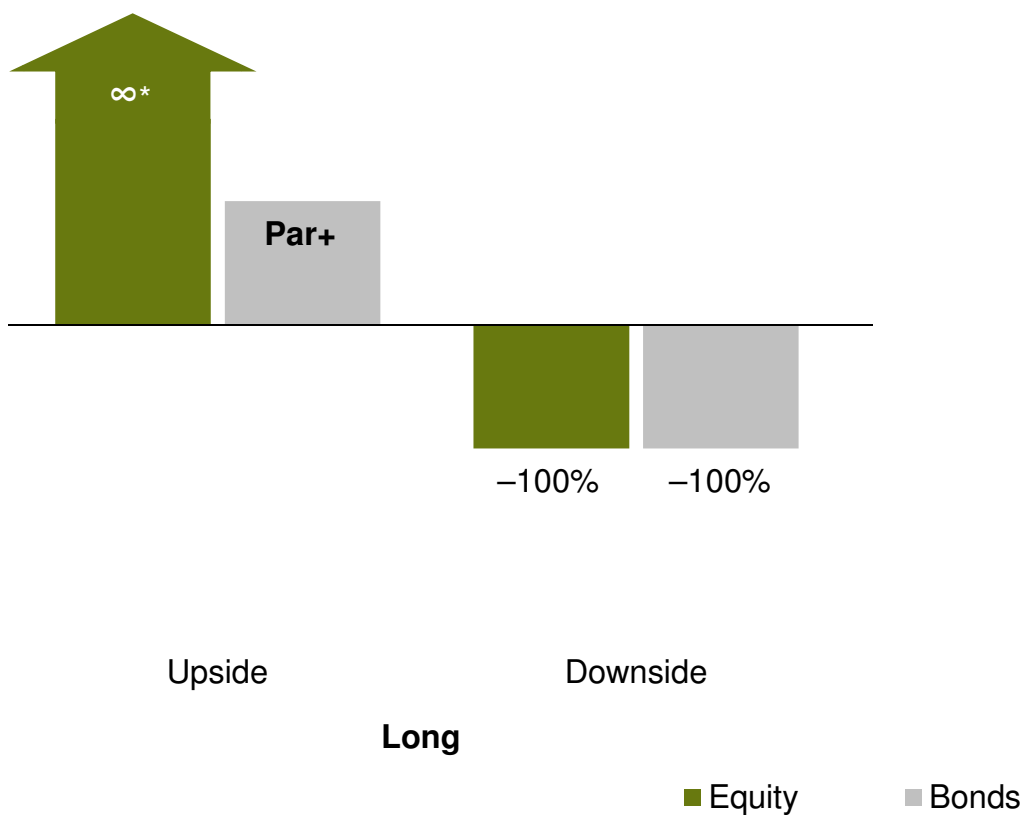
### **“Old” Alpha:**

*The value created from active investment management, associated with the weighting of securities against an index*

### **“New” Alpha**

*The value created from constructing investment strategies that add positive convexity to portfolios*

# Improving Convexity Requires Enhanced Investment Techniques



**Portfolio characteristics are subject to change. Current analysis does not guarantee future results.**

As of December 31, 2013

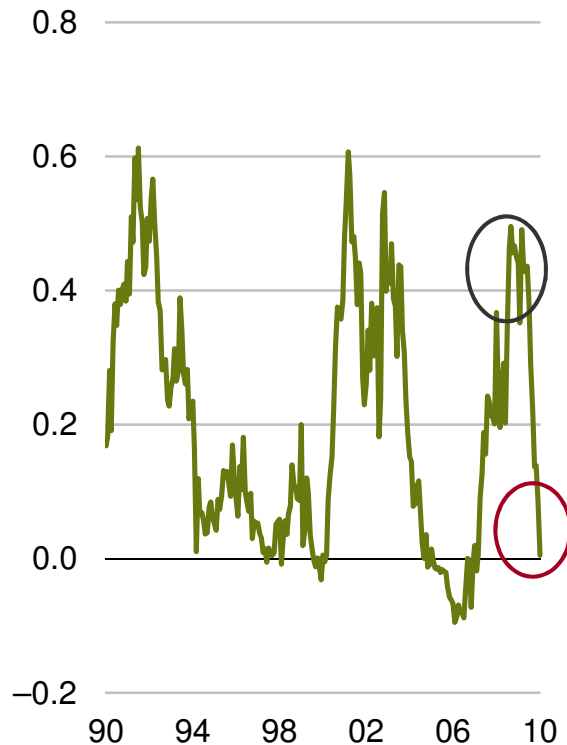
Additional return for high-yield bonds may come from call premiums, change-of-control puts, tender offers, etc.

\*Represents the infinite earning upside potential of equity ownership

Source: Barclays and AllianceBernstein

# Yield Curve Alpha Opportunities

## 5-Year US Treasury vs. 2-Year US Treasury and 10-Year US Treasury\*



## Traditional Long Only

- Overweight or underweight 5 year bond exposure
  - Overweight 5-year bond
  - Underweight 5-year bonds

## “New Alpha”

- Buy a spread trade
  - Long 5-year bond
  - Short 2 and 10-year bonds
 or
  - Short 5-year bond
  - Long 2 and 10-year bonds
- Portfolio position is duration neutral

Portfolio characteristics are subject to change. Current analysis does not guarantee future results.

As of December 31, 2012

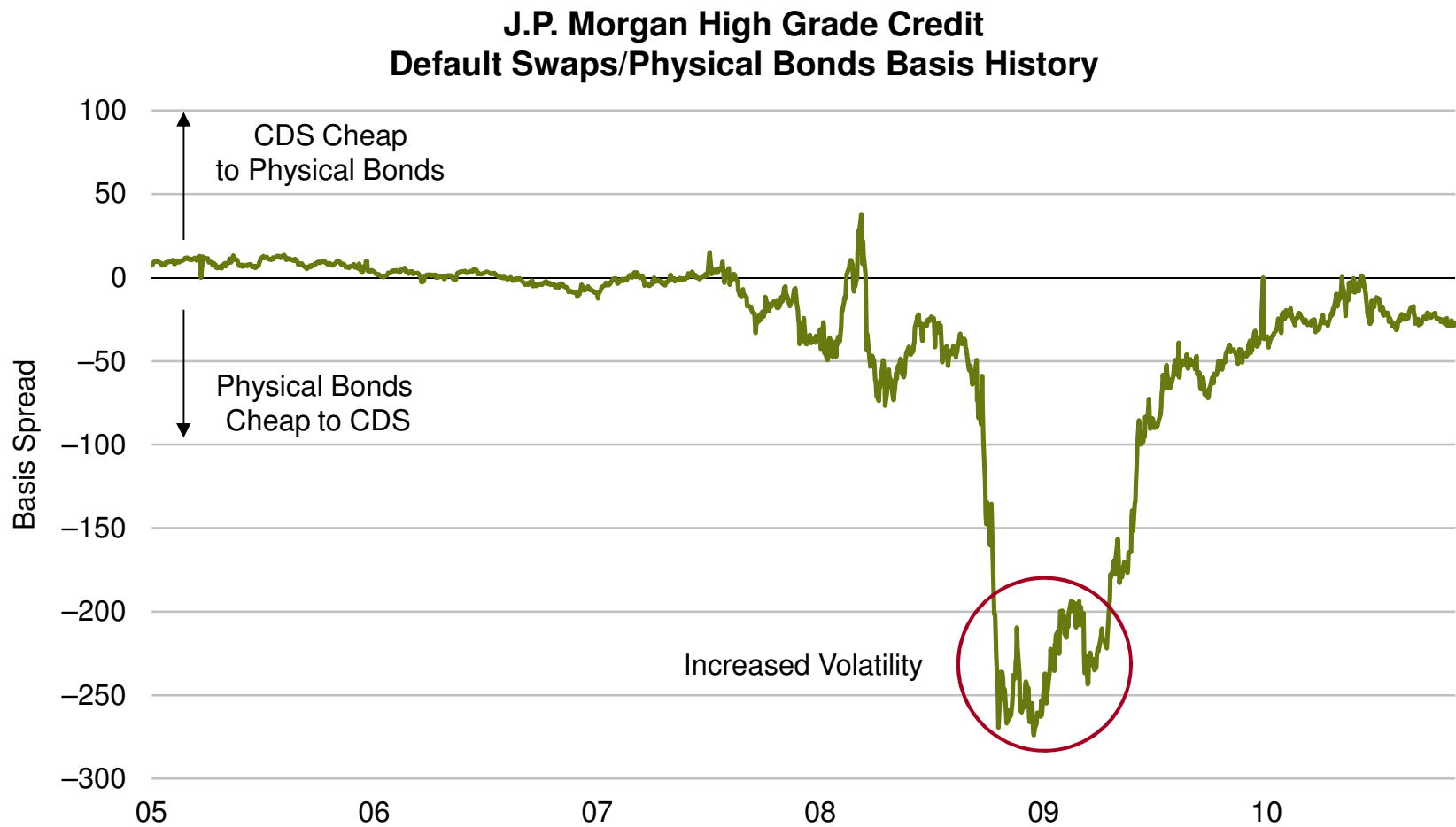
The illustrative investment opportunity above is intended to demonstrate a type of investment strategy employed by the Unconstrained Bond Fund. The illustrative opportunity was not specifically executed for any client account and you should not assume that similar opportunities will present themselves in the future nor that such an opportunity will achieve positive results. The illustration was constructed with the benefit of hindsight and does not reflect the impact that certain economic and market factors might have had on an investment decision-making process.

\*5-Year US Treasury Yield – [(2-Year US Treasury Yield + 10-year US Treasury Yield)/2]

Source: Barclays, Bloomberg and AllianceBernstein



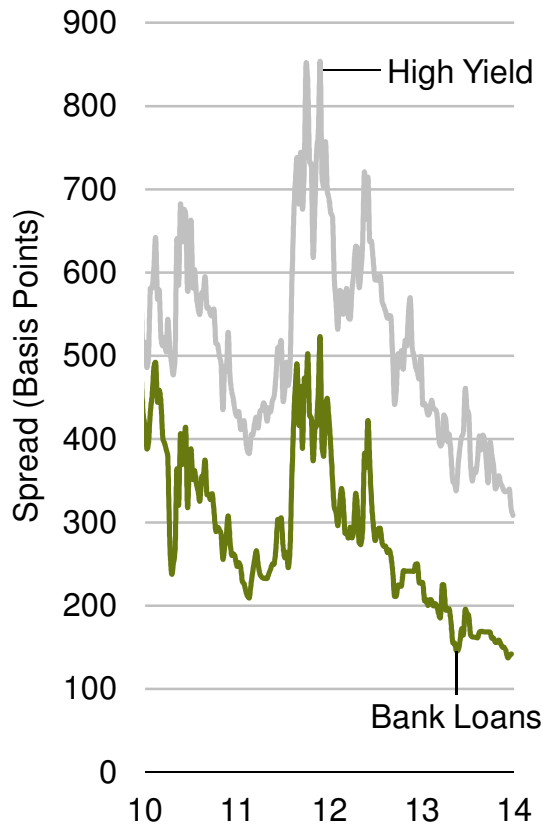
# Basis Spread Opportunities



For illustrative purposes only.  
Source: J.P. Morgan

# Credit Sector Alpha Opportunities

## High Yield Bonds vs. Bank Loans



## Traditional Long Only

- Buy bonds
- Overweight high yield
- Portfolio gains credit beta

## “New Alpha”

- Create a long/short trade using derivatives and/or ETFs, while remaining beta neutral

**Past performance does not guarantee future results.**

As of December 31, 2013

Bank Loans are represented using the LCDX CDSI Gen five year Spread Index; High Yield is represented by the CDX HY CDSI Gen five year Spread Index.

Source: Bloomberg, J.P. Morgan, Morningstar and AllianceBernstein

# Conclusions: Today's Environment Warrants Different Bond Strategies

## Techniques

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- Absolute return oriented
- Dynamic global approach
- Long/Short
- Tail-risk hedging

## Potential Benefits to Investors

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- Avoid unwanted risk
- Navigate today's environment
- Profit from relative-value opportunities
- Buffer the portfolio in periods of market stress

■ Better Beta

■ Tail Hedging

■ Improved Alpha

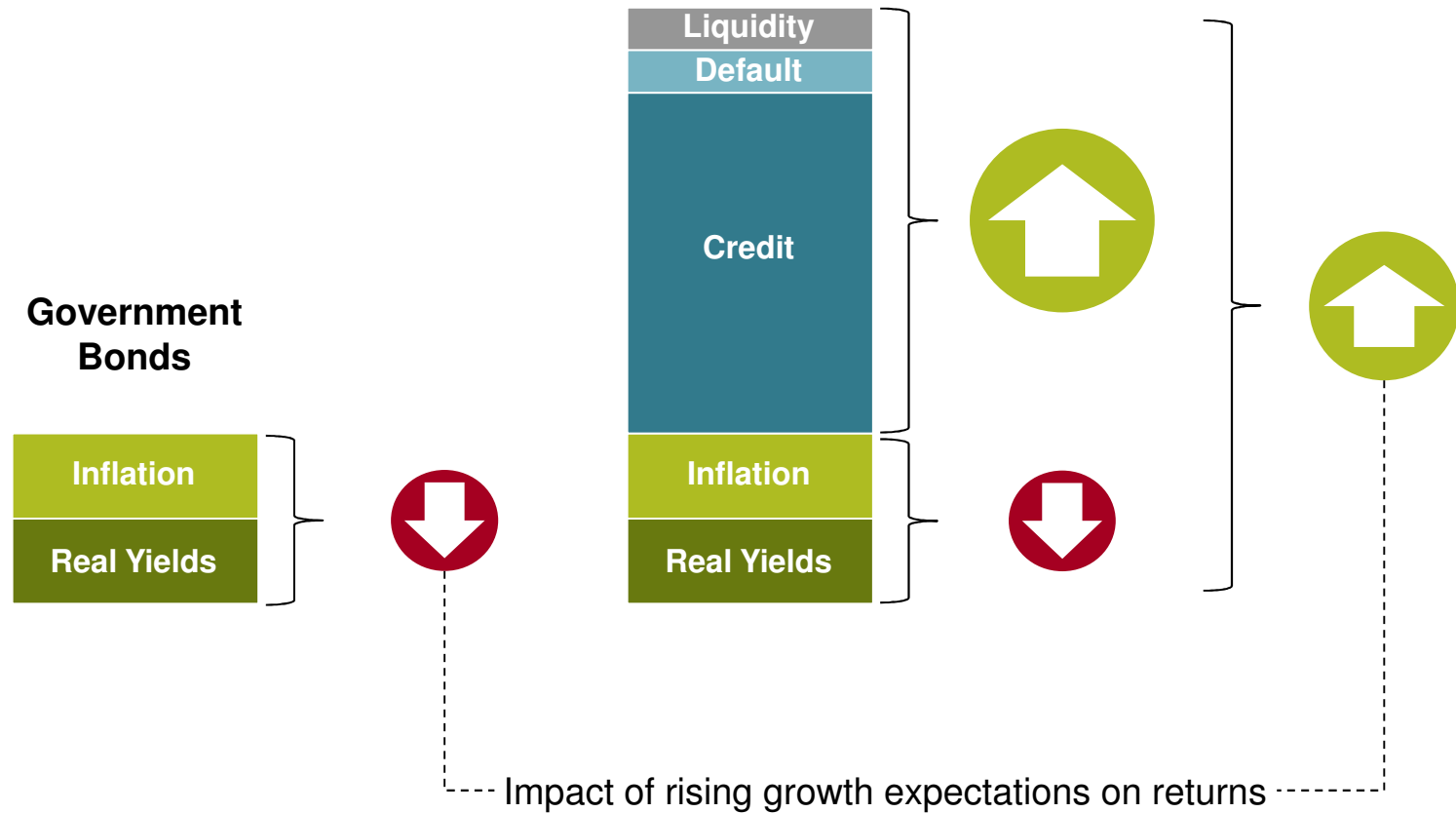
# Q & A

# Appendix

# Focus on Risk Premiums as Drivers of Sector Returns

Example: Rising GDP drives rate- and growth-related risk premiums in opposite directions

## High-Yield Corporate Bonds

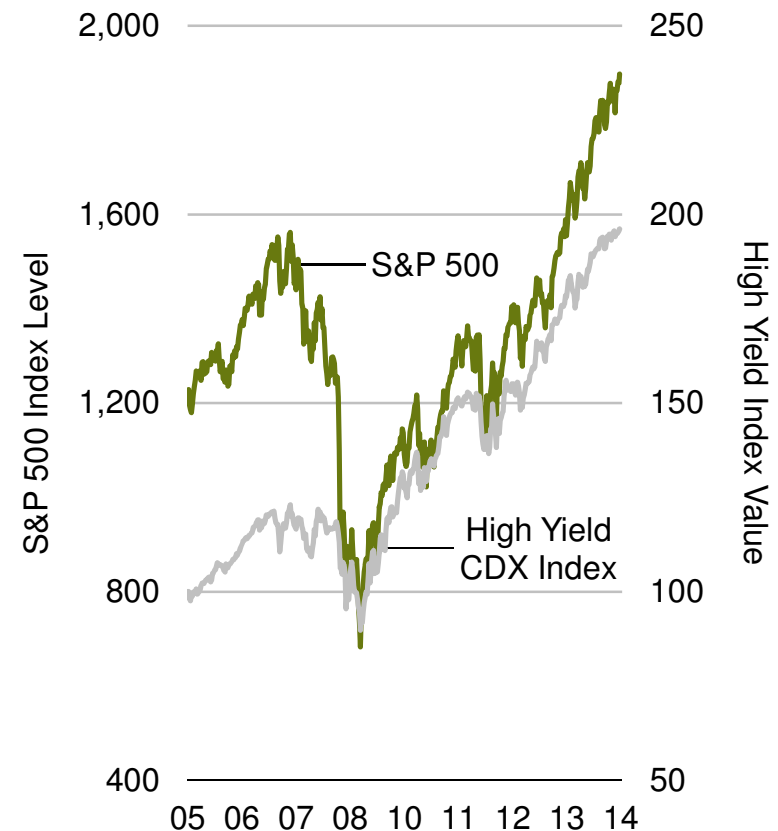


For illustrative purposes only.  
Source: AllianceBernstein

# Long/Short Strategies May Reduce Hedging Costs: Put Spread

- While buying out-of-the-money equity put options are often expensive...
- ...costs can sometimes be defrayed by selling out-of-the-money put options on US High Yield CDX
- In a market sell-off, equities typically underperform high yield bonds, so the net effect can help mitigate other losses

Long S&P Puts Short HY Puts



Historical information provided for illustrative purposes only. Historical analysis does not guarantee future results.

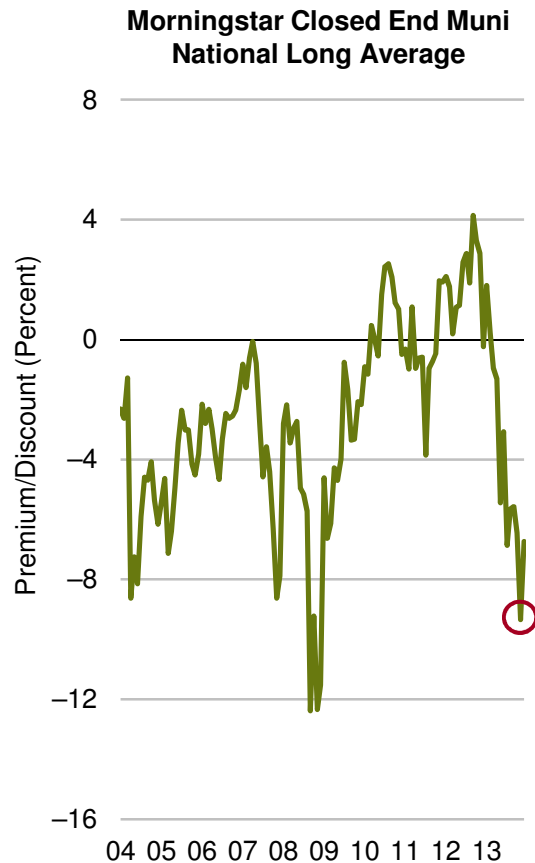
As of May 13, 2014.

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Source: Bloomberg and AllianceBernstein

# Capitalizing on Market Dislocations

## Long Muni Closed-End Funds Selling at Discounts



## Traditional Long Only

- Buy municipal bond funds
- Portfolio gains duration exposure

## “New Alpha”

- Create a long/short trade using closed end municipal funds, hedging duration risk with short futures or interest rate swaps

Past performance does not guarantee future results.

As of December 31, 2013

Source: Morningstar and AllianceBernstein



# 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.

**Interest Rate Risk:** Fixed-income securities may lose value if interest rates rise or fall—long-term securities tend to rise and fall more than short-term securities.

**Credit Risk:** A bond's credit rating reflects the issuer's ability to make timely payments of interest or principal—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.

**Inflation Risk:** Prices for goods and services tend to rise over time, which may erode the purchasing power of investments.

**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.

**Currency Risk:** If a non-US security's trading currency weakens versus the US dollar, its value may be negatively affected when translated back into US dollar terms.

**Diversification Risk:** Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since gains or losses from each security will have a greater impact on the portfolio's overall value.

**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.

**Leverage Risk:** Trying to enhance investment returns by borrowing money or using other leverage tools—magnifying both gains and losses, resulting in greater volatility.

**Below Investment Grade Securities Risk:** Investments in fixed-income securities with lower ratings (commonly known as “junk bonds”) tend to have a higher probability that an issuer will default or fail to meet its payment obligations



  
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