



HIGH YIELD

EQUITY-LIKE RETURNS...WITH HALF THE RISK?

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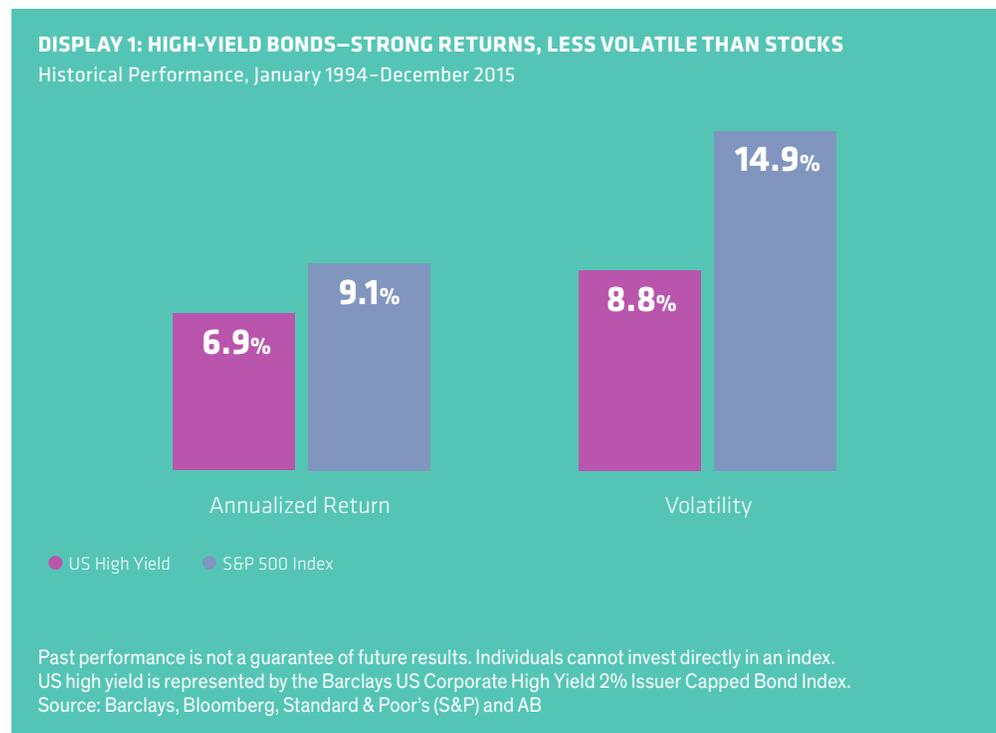
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IN THIS PAPER: Investors often think of high-yield bonds as just another part of their fixed-income allocation. And when investors seek to reduce equity volatility, they typically shift assets to areas of the fixed-income universe with more stability, such as investment-grade bonds. But they may not realize that high yield offers strong risk-adjusted return potential and a low correlation to interest-rate-sensitive investments. That may argue for giving high yield its own seat at the asset-allocation table.

THE CASE FOR HIGH YIELD

Today's fixed-income landscape features a dizzying array of securities—from US Treasury bills to corporate bonds, and from asset-backed securities to catastrophe-linked bonds. On the surface, high-yield bonds seem a lot like their fixed-income relatives: they represent loans from investors to an entity, they make regular coupon payments and they commit to repay investors in full on a specific maturity date.

So, it's not surprising that investors tend to think of high yield as part of their bond allocations. Because high yield is one of the riskiest fixed-income sectors, many investors adjust their high-yield allocations to raise or lower the overall risk in the fixed-income component of their portfolios.



LOOKS ARE DECEIVING

But even though high-yield bonds look like other bonds, they don't necessarily act like other bonds. This insight can have important implications for how investors consider high-yield bonds in an overall portfolio context.

High-yield performance patterns, for example, don't track those of other fixed-income sectors very closely over the long term. Looking back over 20 years, we've observed that US high-yield bonds have exhibited a correlation of only 0.22 to a broad universe of investment-grade bonds, and a correlation of -0.10 to US Treasury bonds, the traditional bellwethers of the US bond market. Of course, correlations aren't constant—they fluctuate substantially over time. Based on a rolling three-year average, high yield's correlation to US Treasuries has ranged from as low as -0.45 to as high as 0.78.

High yield's long-term correlation to US stocks, as measured by the S&P 500, has been 0.62; its correlation to global stocks, as measured by the MSCI World Index, has been about the same: 0.66.

Why is this? High-yield bonds, like equities, are strongly linked to the business results and fundamentals of the companies they represent. And credit spreads, the extra yield that high-yield bonds offer versus similar government bonds, tend to move in the opposite direction from interest rates. This scenario makes high-yield bonds generally insensitive to interest rates—the dominant risk for many investment-grade bond sectors.

But this sensitivity isn't constant over time. It's typically higher when high-yield spreads are lower. Correlation during these periods is positive, although modest. When yield spreads are wider, on the other hand, the correlation is often negative.

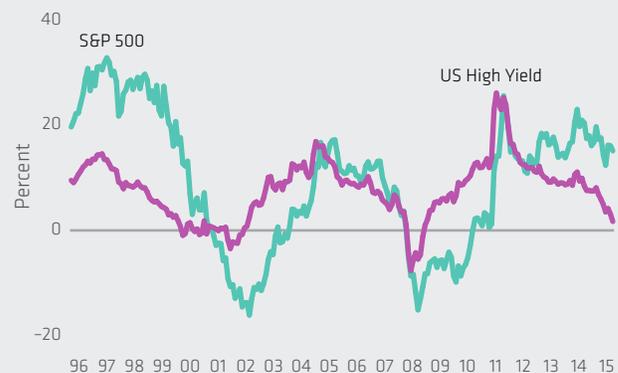
KEEPING PACE WITH EQUITY RETURNS OVER TIME

As for returns, high-yield bonds have stacked up well against equities. In fact, in over more than two decades of capital-market history, high-yield bonds have nearly matched equity performance—but with much lower volatility.

Since January 1994, stocks have produced an annualized return of 9.1%. High-yield bonds delivered a 6.9% return over that period.

DISPLAY 2: EQUITY RETURNS OUTPACE HIGH-YIELD BONDS AT TIMES

Rolling Three-Year Annualized Returns



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.

Data are from December 31, 1996, through December 31, 2015.

US high yield is represented by Barclays US Corporate High Yield Index.

Source: Barclays, Bloomberg, S&P and AB

That's lower than the return for equities, but still attractive, especially considering that this period spanned two full market cycles and countless rallies and sell-offs (*Display 1, previous page*).

These two asset classes can't be compared prior to 1983, because earlier high-yield index returns don't exist. But the 9.1% annualized return for stocks is roughly on par with performance dating back to 1927, so these performance patterns seem fairly consistent over time.

High-yield bonds haven't always kept up with stocks—they've been outpaced by a good margin over certain time frames, such as when the technology/media/telecom bubble was inflating in the second half of the 1990s (*Display 2*). But over the long haul, high yield has produced equity-like returns—with about half the risk of stocks, as measured by the standard deviation¹ of returns.

¹ Standard deviation is a measure of volatility, indicating the percentage by which an investment's performance has varied from its average; the higher the standard deviation, the greater the range of performance, indicating greater volatility.

High yield looks like other bonds, but doesn't necessarily act like other bonds.

DISPLAY 3: HIGH-YIELD BONDS HAVE HISTORICALLY HAD CONSISTENTLY LOWER VOLATILITY

Rolling Three-Year Annualized Standard Deviation



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.

Data are from December 31, 1996, through December 31, 2015.
US high yield is represented by Barclays US Corporate High Yield.
Source: Barclays, Bloomberg, S&P and AB

In fact, high yield's volatility has been lower than that of stocks (*Display 3*), even during some tumultuous periods for capital markets. These attributes, combined with relatively low correlations to stocks and very low correlations to other bonds—have made high-yield bonds effective in a diversified portfolio.

A PLACE AT THE ASSET-ALLOCATION TABLE

For investors seeking to control volatility in their equity portfolios while preserving return potential, high-yield bonds could be an effective solution.

A typical approach to moderating equity volatility is to shift assets into areas with more stability, including investment-grade bonds, passive equity funds or even cash. But this can mean sacrificing a good amount of return potential. High-yield bonds, on the other hand, can help investors reduce risk without giving up much return.

This outcome is partly because high-yield bonds provide investors with a consistent income stream that few other assets can match. This income—distributed semiannually as coupon payments—is constant. It gets paid in bull and bear markets alike. After accounting for maturities, tenders and callable bonds, the US high-yield market typically returns anywhere from 18% to 22% of its value every year in cash.

High-yield bonds also have a known terminal value that investors can count on. As long as the issuer doesn't go bankrupt, investors get their money back when the bond matures.

Doesn't this make the case that high-yield bonds deserve their own place at the table in portfolio discussions? And shouldn't investors think about a different asset-allocation question? Instead of asking, "How much of my bond exposure should be allocated to high yield?" perhaps they should ask, "How much equity exposure should I allocate to high yield?"

Historically, a significant allocation to high-yield bonds—rebalanced quarterly—would have been a highly productive answer to the second question. Investors would have been able to reduce their overall portfolio volatility in exchange for only a minimal reduction—if any—in annualized returns.

As mentioned earlier, from January 1994 through December 2015, the S&P 500 produced a 9.1% annualized return, with annualized risk of 14.9%. A portfolio mix of 75% equities and 25% high yield, on the other hand, would have lowered annualized risk to 12.7%, with nearly the same annualized return as the S&P (*Display 4*). And that’s with a sizable allocation to a high-yield asset class that returned slightly less than equities did over that time period.

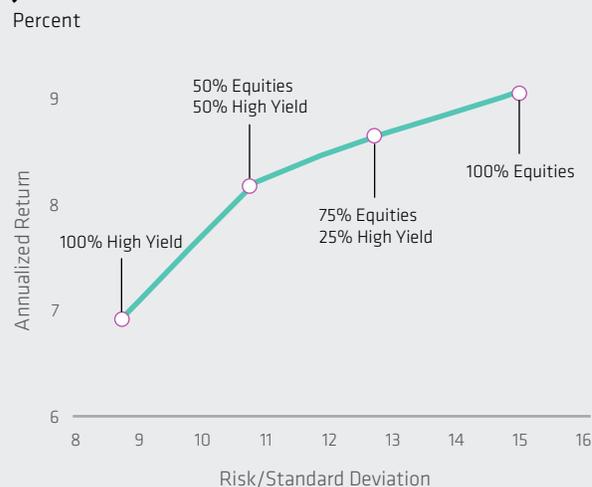
REBALANCING IN THE “TAILS”

How is this result possible? The answer has to do with rebalancing. Because stocks have been so much more volatile than high yield has, periodic portfolio rebalancing tends to happen during performance extremes—the “tails” in return distributions—when the gap between high-yield and equity returns is wide. This divide magnifies the “buy low, sell high” effect that rebalancing contributes to a portfolio’s performance.

Of course, the gap between returns on stocks and returns on investment-grade bonds would also be sizable during periods of performance extremes, if those two classes were paired in a portfolio. But investment-grade bonds wouldn’t contribute as much performance potential as high yield would.

Over the same time period referred to in the earlier example, investors could have split their portfolios 50/50 between stocks

DISPLAY 4: HYPOTHETICAL ANNUALIZED RISK AND RETURN, JANUARY 1994–DECEMBER 2015



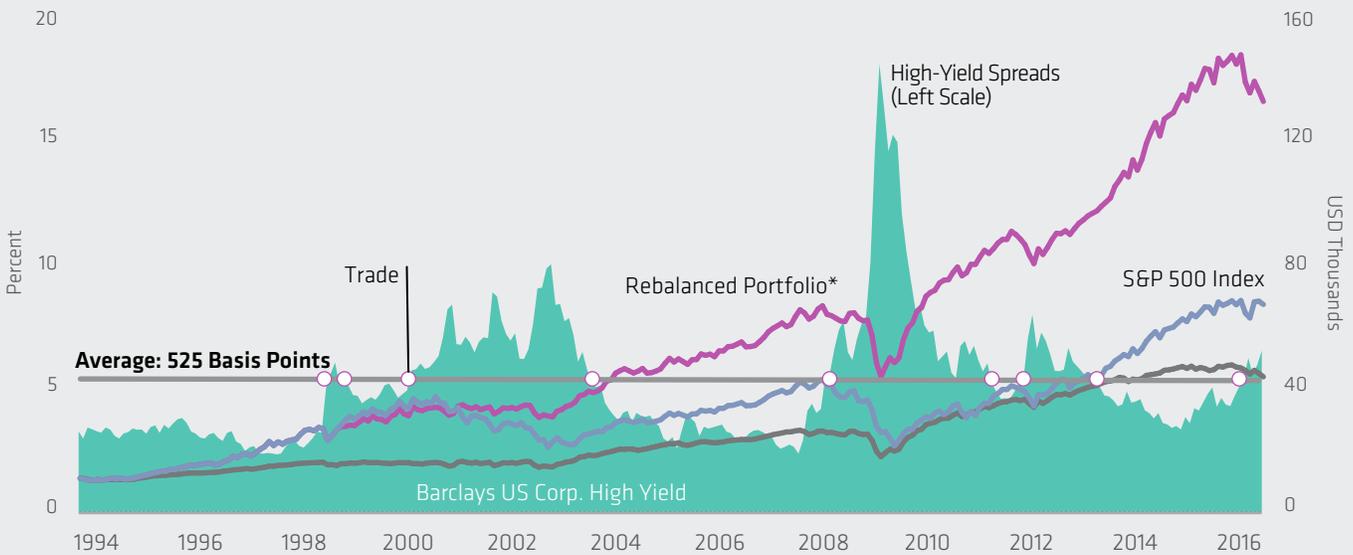
Diversification does not eliminate the risk of loss. Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
 Through December 31, 2015
 High yield is represented by Barclays US Corporate High Yield. Equities are represented by S&P 500.
 Source: Barclays, Bloomberg, S&P and AB

and high yield. This balancing would have slashed volatility from 14.9% to 10.8%—while still allowing investors to nearly match the 9.1% annualized hypothetical equity return.

Historically, high yield
has recovered most losses
in less than a year.

DISPLAY 5: TACTICAL APPROACH—RESULT OF “RISKING DOWN”

Hypothetical Growth of US\$10,000: January 1994–December 2015



Past performance is not a guarantee of future results. An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. The unmanaged index does not reflect the fees and expenses associated with the active management of a portfolio.

Through December 31, 2015; high-yield spreads are represented by option-adjusted spreads for Barclays US High Yield Corporate.

* Tactically alternates between US high yield and S&P 500, based on a 525 b.p. spread decision rule. Performance is based on spread levels and returns, and assumes an investor began the period (January 1, 1994) invested in the S&P 500 and made the following (nine) transactions: sold the S&P 500 and bought high yield on November 1, 1998; sold high yield and bought the S&P 500 on March 1, 1999; sold the S&P 500 and bought high yield on May 1, 2000; sold high yield and bought the S&P 500 on October 1, 2003; sold the S&P 500 and bought high yield on November 1, 2008; sold high yield and bought the S&P 500 on March 1, 2011; sold the S&P 500 and bought high yield on August 1, 2011; sold high yield and bought the S&P 500 on February 1, 2013; sold the S&P 500 and bought high yield on October 1, 2015.

Source: Barclays, S&P and AB

A TACTICAL APPROACH: WATCH CREDIT SPREADS

The strategy we've detailed so far amounts to a static allocation. Investors decide how much equity exposure they're comfortable allocating to high-yield bonds, and they rebalance their portfolios each quarter to maintain that allocation over time.

Our research, however, shows that a tactical approach can also be effective in reducing portfolio risk without surrendering too much return. This method involves rotating some equity exposure into high yield only when it's optimal. In other words, investors would only add high-yield bonds to their equity allocation when it's in their favor to do so.

How can investors tell when it's time for high yield? Our research suggests that average high-yield credit spreads² have been a reliable signal over time. When we measured 12-month rolling returns between 1994—the first year Barclays provided option-adjusted spread data for the Barclays US Corporate High Yield Index—and 2015, we found that high yield outperformed equities when spreads were wide.

At this point, investors may be wondering how wide is wide enough to justify adding high yield to an asset allocation. To find out, we conducted a hypothetical exercise to see what would have happened if an investor had shifted from equities to high-yield bonds at a number of different yield spread levels between 1994 and 2015. For the sake of simplicity, we assumed that the investor was shifting all of her portfolio out of equities and into high yield. In reality, investors would have only a certain percentage of their equity exposure allocated to high-yield bonds.

We looked at various spread levels and found that the way to optimize risk-adjusted returns over this period would have been to move into high-yield bonds when spreads were over 525 basis points for two straight months, and move back into equities after spreads had spent two months below that level.

An investor who put US\$10,000 in the S&P 500 on January 1, 1994, and stuck to the 525-basis-point approach would have made just nine trades over the past 22 years (*Display 5, previous page*)—and spent roughly 39% of the time in high-yield bonds. By the end of that period, she would have had returns of 12.5%, compared to 9.1% if her had invested 100% in the S&P 500. What's more, this tactical allocation would have slashed volatility to 12.0% from 14.9% for the all-equity portfolio. The hypothetical returns assume the assets were fully invested over the entire time period and don't include transaction costs or taxes.

Our research suggests that this tactical approach may help de-risk an equity portfolio when conditions are volatile—perhaps by substituting high-yield bonds for passive index strategies, which are especially vulnerable to drawdowns in down markets.

In both approaches—the static allocation, rebalanced periodically, and the tactical one—research suggests that rotating 25% to 50% of one's equity exposure into high yield can lower risk without sacrificing much return.

² Spread is the yield advantage over the risk-free rate.

HIGH YIELD IN THE PORTFOLIO FRAMEWORK

Of course, not all investors will be comfortable with 50%, or even 25%, of their equity exposure allocated to high-yield bonds. Investors must define a portfolio allocation that's appropriate for their specific goals and risk tolerances—and their allocations to equities, fixed income and other asset classes will vary.

Also, demonstrating that high-yield bonds are effective in a diversified portfolio doesn't imply that investment-grade bonds won't be effective too. Many investors rely on bonds to dampen the volatility of their equity portfolios, so they're naturally reluctant to give their investment managers too much flexibility in allocating to below-investment-grade bonds. That's because high-yield bonds are admittedly among the most volatile fixed-income asset classes—though they've been less volatile than stocks.

Given stocks' higher risk levels, we'd expect them to continue to beat high yield over the long run. However, high-yield bonds have clearly shown that they bring a lot to the table if investors combine them with stocks in a carefully designed and maintained portfolio.

ARE RISING RATES A RISK?

Some investors may ask if it's the right time to introduce high-yield bonds into their allocation. With interest rates in many countries still at or near historical lows, isn't there risk to high-yield bonds when rates start to rise again?

As we stated earlier, high-yield bonds have historically been fairly insensitive to interest-rate movements—especially when yield spreads were fairly wide. This insensitivity is because spreads often decline as rates rise, providing investors with a cushion against rate increases.

With yield spreads currently above average, we believe high yield should remain fairly insensitive to any increase in rates.

When spreads are narrow, that cushion isn't as thick, and high-yield bonds tend to be more sensitive to rising rates. During these periods, it's important to be selective about which high-yield bonds you add to an asset allocation. This process means conducting extensive credit analysis before investing, and focusing on high-quality issuers.

A gradual increase in interest rates is usually supportive of most of the high-yield market, because rising rates usually come with improving economic conditions and better profit potential for many corporations. Of course, it's certainly possible that a rapid increase in rates could lead high-yield bonds to be more sensitive to rising interest rates than our historical analysis indicates. In that scenario, we'd expect high-yield bonds to underperform equities.

Meaningful corrections—defined as a decline of 5% or more—aren't unusual in US high yield. But historically, the market has recovered most losses of that magnitude in less than a year. This decline is largely because prices revert to par over time, and the income that high-yield bonds produce provides an ongoing benefit to investors.

For instance, worries about the end of the Federal Reserve's bond-buying program and fear of rising rates in 2013 sparked a 5.2% decline in the US high-yield market over a period of about two months. But over the next four months, the market rose by 5.4%.

Most important, we think the decision to add high yield to an asset allocation should be based on a long-term portfolio-construction perspective. On that score, high yield retains the ability to dampen portfolio volatility without sacrificing much in the way of returns.

IS THIS A GLOBAL STORY?

In our view, designing a high-yield allocation today should involve a global perspective.

Our analysis focuses on US high-yield bonds, in large part because this market provides a lengthier historical data set than other high-yield markets do. But the global market for high-yield bonds continues to expand and evolve: European high yield, for instance, is a growing market that's been aided by the launch of the euro.

We believe that investors can access even greater diversification and flexibility in a high-yield allocation by investing across borders and incorporating not only high-yield bonds, but also sectors such as emerging-market debt—sovereign and corporate—and other fixed-income securities that offer potential for high income. This multi-sector approach provides greater flexibility in optimizing a high-yield allocation.

IN SUMMARY

High-yield bonds present an alternative for investors at a crossroads. Equity valuations appear high based on some measures, and volatility has led many investors to search for ways to temper the risk in their portfolios. At the same time, investment-grade bonds—a popular risk reducer—are less attractive than normal because of extremely low yields.

High yield's strong risk-adjusted return potential and complementary nature to both stocks and investment-grade bonds argue for a different perspective. Instead of stereotyping high-yield bonds because they “look like bonds,” our research suggests that investors should consider high-yield bonds as a worthy replacement for part of a portfolio's equity exposure—or even as a stand-alone allocation distinct from stocks and bonds.

Standard & Poor's (S&P) 500 Index includes 500 US stocks and is a common representation of the performance of the overall US stock market. **Barclays US Corporate High Yield Index** represents the performance of fixed-income securities having a maximum quality rating of Ba1, a minimum amount outstanding of \$150 million and at least 1 year to maturity. **Barclays High Yield 2% Issuer Constrained Index** is the 2% Issuer Cap component of the US Corporate High Yield Index, which represents the performance of fixed-income securities having a maximum quality rating of Ba1, a minimum amount outstanding of \$150 million and at least one year to maturity.

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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:** As interest rates rise, bond prices fall and vice versa—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:** Non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. Fluctuations in currency exchange rates may negatively affect the value of the investment or reduce returns. These risks are magnified in emerging or developing markets. **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:** Investments 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 may magnify 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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