

Just as homeowners buy insurance well in advance of signs of fire or flood, investors should protect their portfolios long before signs of deflation or inflation emerge.

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Why You Need Inflation Protection Now

Although inflation remains subdued today (*Display 1*), unprecedented monetary policy makes it harder to forecast future developments, and we think it's well worth protecting your portfolio from inflation surprises.

Inflation has been low...so why worry?

Display 1

Personal Consumption Expenditures Excluding Food and Energy
 Chain-Type Price Index



Through April 1, 2013
 Source: US Department of Commerce—Bureau of Economic Analysis

Inflation—a persistent increase in the price level—hurts investors because it continually erodes the purchasing power of a portfolio. And inflation surprises can drive down both bond and stock prices, compounding the damage.

What's more, while rare, inflationary periods are notoriously difficult to predict. History shows that major bouts of inflation often strike suddenly and without warning, which is what makes inflation particularly dangerous. History also suggests we should expect a few inflation cycles per century—we just can't pinpoint when. And if one can't foresee the exact moment when a mishap will occur, guarding against it is essential.

That's why we think most investors should protect their portfolios against the potential damage from an unanticipated increase in the inflation rate. Just as homeowners buy fire insurance while hoping that their house never burns down, investors should add inflation protection to their asset mix: An inflation-protected portfolio should do fine if inflation stays in check, and it can better withstand an inflation shock.

Bonds: A Deflation Hedge

Ironically, investors already embrace the insurance approach when it comes to protecting their portfolio from *falling* price levels, or deflation. When economic growth is increasing, equities tend to deliver high real returns (*Display 2, right side*). But during difficult economic times, equities generally perform less well. Most portfolios include bonds, which generally do best in a weak economy with slowing inflation (*Display 2, bottom left*). Investors have experienced the benefits of this strategy in recent years, as economic weakness led the Federal Reserve to lower interest rates, which in turn boosted bond returns at the very times when stocks tended to be weak.

In our view, continued deflation seems relatively unlikely. The Federal Reserve has implemented unprecedented quantitative easing measures to avoid a Japan-style deflationary spiral. Nonetheless, most investors continue to hold bonds...just in case.

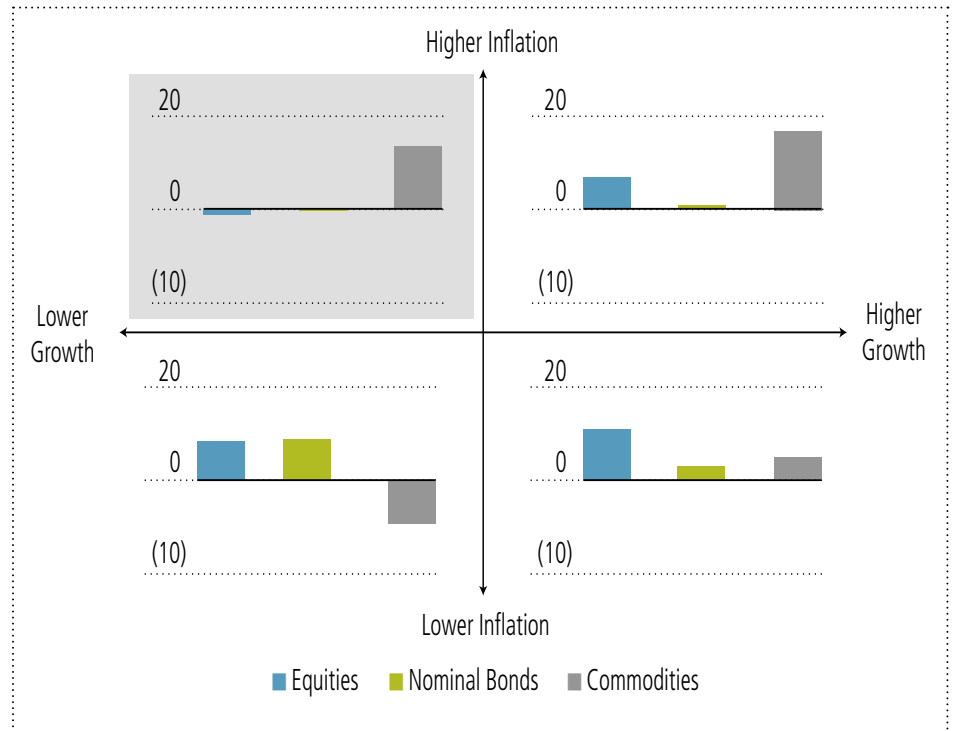
Like most hedges, deflation protection comes at a price. In today's environment, the price of deflation protection is quite steep.

Consider that the expected return advantage for investing in stocks instead of bonds (called the equity risk premium) is now almost twice what we'd expect under normal conditions. In other words, bond investors are willing to forgo nearly double the amount of extra return they'd typically receive in exchange for holding their "safe" assets.

Display 2

Higher Inflation and Lower Growth Hurts Both Stocks and Bonds

Annualized Real Returns (Percent)



Historical analysis does not guarantee future results.

Individuals cannot invest directly in an index. Diversification does not eliminate the risk of loss. January 1970 through June 24, 2013

Data reflect averages of rolling one-year total returns measured quarterly. Higher (Lower) Inflation represents periods where the trailing one-year inflation rate was increasing (decreasing) from its value the previous year. Higher (Lower) Growth represents periods where real GDP growth was higher (lower) than its value the previous year.

Inflation is measured by the US Consumer Price Index, US City Average, all items, not seasonally adjusted. Growth is represented by the US Real Gross Domestic Product, seasonally adjusted.

Equities are represented by the S&P 500 Index, bonds by the Barclays US Treasury Index, and commodities by the Dow Jones-UBS Commodity Index.

Source: Barclays, Bloomberg, Federal Reserve Bank of St. Louis, S&P Dow Jones Indices, and AllianceBernstein

Given that deflation seems unlikely—and that hedging against it appears relatively expensive—why bother? The reason is that deflation can wreak havoc on other parts of investors' portfolios. If deflation occurs, stocks and high-yield bonds could decline sharply because deflation usually coincides with a significant deterioration in corporate profits and creditworthiness. That's an environment where government and

investment-grade corporate bonds stand to gain, so holding them can protect the overall portfolio. While deflation may be a remote contingency in the coming years, protecting against it seems prudent, even when factoring in the associated cost.

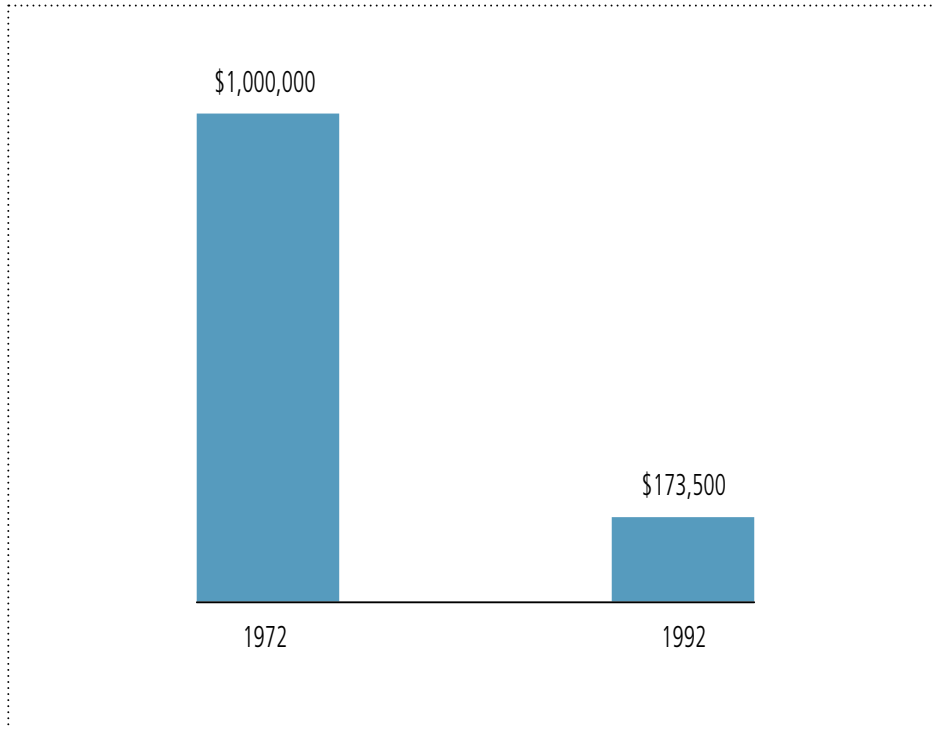
Two Sides of the Same Coin

We think investors need to apply the same approach to address the risk of inflation.

Display 3

Inflation Can Ravage an Unprotected Portfolio

Value Remaining in a US \$1 Million Portfolio After 20 Years of Inflation-Adjusted Spending



Historical analysis is not a guarantee of future results.

This is a hypothetical example and is not representative of any AllianceBernstein product. Individuals cannot invest directly in an index. 20-year period, June 1972 through December 1992

Traditional 60/40: 60% stocks, 40% bonds. Real spending rate of 5%

Source: AllianceBernstein

While inflation currently seems well anchored, that might change. Although it is not our base case, central banks may discover that the massive expansion of their balance sheets in recent years is hard to unwind. And interpreting macro data in a period of unprecedented liquidity is difficult, which may lead to monetary policy mistakes. Japan, for example, is now trying to create inflationary expectations, and it's possible they might succeed more than they would like.

Ironically, many will initially welcome the first burst of inflation: Workers like higher wages, and companies like

higher prices. The problems will only become apparent later, as companies grapple with the impact of paying higher wages and workers struggle to pay higher prices.

For investors, even modest amounts of inflation can be harmful—in some ways, even more so than deflation. To illustrate, consider the simultaneous impact of economic growth and inflation on different asset classes over the long term. Historically, we've seen an equal number of periods of strong and weak growth, coupled with high and low inflation—with each combination occurring about 25% of the time (*Display 2*).

In periods of declining inflation, equities and bonds tend to generate solid real returns (*Display 2, bottom half*). However, when inflation is rising, bonds do poorly because the value of future fixed income streams drops—and when higher inflation coincides with slower growth, *both* bonds and stocks fall in real terms (*Display 2, upper left*). Over time, the cumulative effect of such negative real returns can greatly impair the ability to sustain one's spending and heightens the risk of outliving one's assets.

To illustrate, let's take the case of a hypothetical investor who retired with \$1 million in retirement savings, in a traditional 60/40 stock/bond portfolio. To show an adverse scenario, we chose a period beginning in 1972, at the start of the Great Inflation of the 1970s. We also assumed that the investor withdrew 5% annually for the next 20 years, adjusting the withdrawal amount to keep up with inflation.

After 20 years of spending during this trying period, the value of an "unprotected" portfolio supporting a fast-growing stream of cash outlays declined significantly—from \$1 million to just over \$170,000 (*Display 3*). In other words, the portfolio's value dropped by over 80% after inflation-adjusted spending.

Protection Is Even More Compelling Today

Because inflation is so difficult to forecast, we believe inflation-protected assets always have a place in investors' portfolios. But we see three key reasons why an allocation to inflation protection is even more compelling today: heightened

uncertainty, the availability of better inflation hedges, and reasonable costs for inflation protection. Let's explore each reason in more detail.

More Uncertainty

Even in the best of times, there's no reliable forecast of the future path of inflation. Today, however, uncertainty about economic policy and its impact on the price level has become especially high, mainly because no one can confidently predict exactly what will happen as the enormous monetary expansion since the global financial crisis is ultimately unwound.

On the one hand, some view inflation as inevitable, given the pervasive climate of supportive monetary policy across developed economies. On the other hand, mixed economic data have kept the specter of deflation alive.

Given the experimental and opportunistic nature of central bank policy measures, economists' outlook for the breadth of possible inflation outcomes is highly divergent today. This heightens the risk of surprises, and makes inflation protection all the more vital.

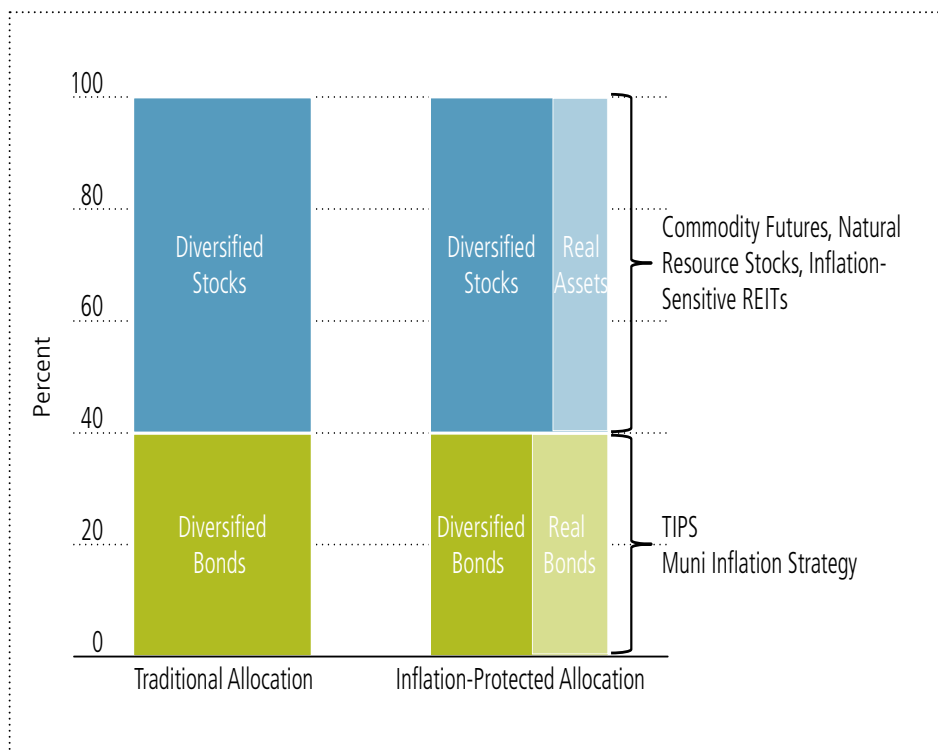
Better Hedges

Fortunately, better inflation hedges are available today than existed in past inflationary periods. From a portfolio construction standpoint, inflation hedges can be divided into two categories that complement a traditional portfolio: real bonds that protect risk-mitigating assets such as traditional bonds, and real assets that

Display 4

"Traditional" vs. Inflation-Protected Allocation

Real Investments Complement Traditional Counterparts



For illustrative purposes only
Source: AllianceBernstein

protect return-seeking assets such as stocks (Display 4).

Inflation-linked bonds such as Treasury Inflation-Protected Securities (TIPS) can provide very effective inflation protection for the bond portion of the asset mix. TIPS tend to rise almost as much as inflation because they move in tandem with changes in the price index by design. The inflation sensitivity afforded by TIPS, or "real bonds," should also be thought of as relative to nominal bonds. In periods when inflation expectations rise, like 2009, real bonds will outperform nominal bonds, and in periods when inflation expectations fall, like the

second quarter of 2013, real bonds will underperform. Note, however, that TIPS are not tax-efficient instruments. So, for taxable accounts, we recommend a muni inflation strategy that layers inflation protection onto a municipal bond portfolio.

TIPS are, however, only a partial inflation hedge for a number of reasons. First, TIPS track the government-calculated Consumer Price Index (CPI), which fails to fully capture all of the inflation in the economy. As a result, many products like TIPS that are linked to the CPI are not offering adequate protection, making additional inflation insurance necessary.¹

¹In addition, TIPS deliver returns slightly less than inflation, because increases in inflation can coincide with higher real interest rates, which hurt the value of a fixed income instrument like TIPS.

Second, TIPS pass through the CPI and so protect themselves but not the rest of the portfolio. To offset the headwind to the non-TIPS allocations, another strategy is needed that can go up more than one-for-one with rising inflation.

For instance, to protect the equity portion of the asset mix from inflation, we recommend a real asset portfolio. Real assets, such as commodity futures, natural resource stocks, and inflation-sensitive REITs, generate cash flows tightly linked to important components of the overall price level. For example, commodity futures have high inflation sensitivity because commodities respond directly to overall supply and demand trends in the economy, which also fuel inflation. Shares in mining and other natural resource stocks, as well as some real estate companies, can also benefit from rising prices. Note that most individual real assets are quite volatile, and so it makes sense to diversify a real asset portfolio across a wide range of inflation-sensitive investments (see our blackbook “Deflating Inflation” for more details).

We also see real assets as a good investment. Admittedly, the commodity super-cycle—driven by a decade of underinvestment in the 1990s followed by a decade of commodity-intensive double-digit growth in China—is over. However, current valuations for commodity-related investments in the futures and equity markets embed a view of future supply and demand far more dire than our fundamental research deems appropriate. Absent a collapse in China or a resurfacing

of global deflation fears, these commodity-related investments should at least keep pace with equities. And if inflation fears do appear at some point in the future, then these assets should play their typical role of performing when both stocks and nominal bonds struggle.

Reasonable Costs

Reasonable costs represent the final rationale for adopting proactive inflation protection today. TIPS are fairly priced, with a breakeven rate—or the difference in yield between inflation-protected securities and nominal bonds of the same maturity—under 2% for 10-year maturities. That’s not much of a premium to purchase inflation protection, especially compared to a high of 2.6% last fall when the Fed’s third round of quantitative easing was announced.

Real assets are also sensibly priced relative to their fundamentals. In particular, while forward curves vary by commodity and fluctuate over time, commodity markets are once again backwardated for the first time in years. Backwardation occurs when the price of a futures contract for a commodity trades below the spot price. That is good news for real asset investors, because backwardation means they can earn potential roll gains while they hold commodity futures.

To put things in context, we can compare the current cost of the deflation protection provided by bonds with the cost of the inflation protection provided by TIPS and real assets. How does the amount of return investors have been willing to sacrifice to stay in “safe” assets

compare to what they might expect to pay for another type of safety—namely, inflation protection?

Based on our proprietary Capital Markets Engine—a robust, forward-looking tool that projects 10,000 plausible outcomes for the markets based on initial conditions and proprietary econometric models—moving from a 60/40 to a 30/70 stock/bond mix significantly cuts deflation risk, but now costs 1.7% in expected returns per year. By contrast, moving from a traditional 60/40 portfolio to a 60/40 mix with inflation protection (like the one illustrated in Display 4) now costs just 0.3% in annual expected returns. So the bonds that many investors have poured hundreds of billions of dollars into over the past few years are a far more expensive form of protection from deflation than the cost of inflation protection.

Avoiding Complacency Has Its Rewards

Given the uncertainty about future inflation, and the possibility of purchasing protection at a reasonable cost, it seems prudent to hedge portfolios from the ravages of inflation. Yet relatively few investors currently do. Perhaps investors worry that the hedges might not work in practice. But history suggests that inflation protection pays off handsomely if inflation rises, with modest downside if inflation remains subdued.

To explore this point, let’s revisit our earlier example of the investor who retired in the inflationary period beginning in 1972, but let’s allocate the portfolio quite differently. This time, while keeping the withdrawal

rate the same, we'll assume the investor took our advice and added inflation hedges to the asset allocation. Specifically, the investor decided to shift 10% from stocks into real assets, and move 10% from bonds into TIPS.²

How did the inflation-hedged investor fare? After 20 years of spending a fast-inflating stream of cash outlays over this trying period, the inflation-hedged portfolio (as illustrated by the blue line) ends up worth nearly five times more than the traditional portfolio (*Display 5*). Clearly, adding some exposure to real assets and real bonds can have a significant portfolio impact when inflation rears its head.

What's the Downside?

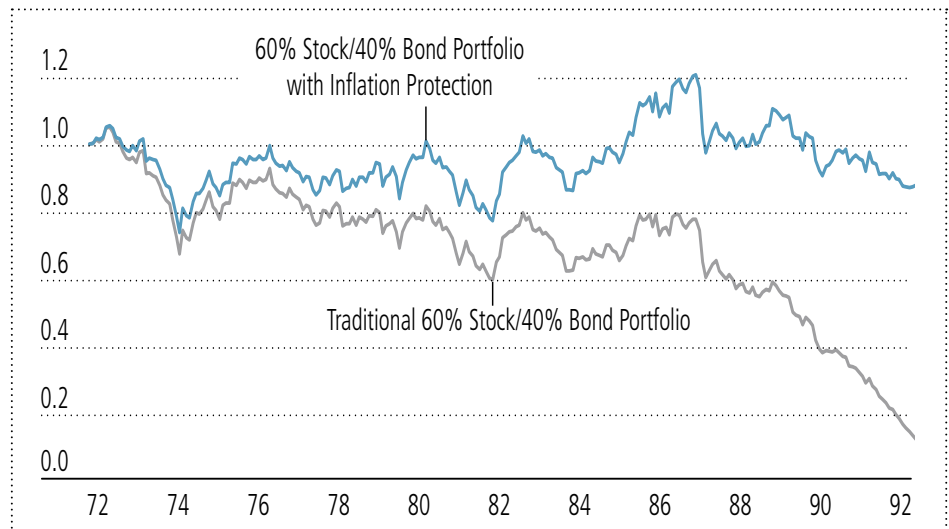
While the benefits of hedging inflation are clear in an inflationary environment, historically there's also been just a modest cost when inflation remains under wraps. To illustrate, let's return to the same retiree, but during a benign inflationary environment. This time, let's have our hypothetical investor retire in 1989, in order to benefit from two decades of well-contained consumer prices.

In this scenario, despite low inflation, the value of the inflation-hedged portfolio ends up nearly equal to the traditional portfolio after 20 years of spending (*Display 6*). In other words, while supporting a steady stream of spending, the cost of inflation protection detracted only slightly from overall wealth.

Display 5

Inflation Protection Helped When Inflation Spiked

Growth of US \$1 Million with 5% Inflation-Adjusted Spending



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This is a hypothetical example and is not representative of any AllianceBernstein product. Individuals cannot invest directly in an index. Chart shows nominal value after spending 5% grown with inflation over the 20-year period from June 1972 through December 1992. Traditional 60/40: 60% stocks, 40% bonds; 60/40 portfolio with inflation protection: 50% stocks, 10% real assets, 30% bonds, 10% Treasury Inflation-Protected Securities (TIPS). US stocks are represented by the S&P 500 Index, US bonds by 10-year US Treasuries, and real assets by a real asset portfolio comprising one-third US commodity stocks, one-third US REITs, and one-third commodity futures. REITs (Real Estate Investment Trusts) are sourced from the S&P 500 Index prior to 1972; they are represented by the FTSE NAREIT Equity REITs Index from 1972 through 1999 and the FTSE EPRA/NAREIT Index thereafter. Commodity futures are sourced from the S&P GSCI prior to February 1991; they are represented by the Dow Jones-UBS thereafter. Commodity stocks are sourced from the Ken French Data Library and AllianceBernstein prior to 1999, and the MSCI Commodity Producers Index thereafter. Inflation-linked bonds are represented by 10-year TIPS calculated from synthetic AllianceBernstein real yields estimated from actual inflation and nominal yield curve variables before 1999 and from Federal Reserve yields thereafter.
 Source: Federal Reserve, Ken French, MSCI, NAREIT, S&P Dow Jones Indices, and AllianceBernstein

An Ounce of Protection

Just as homeowners buy both fire and flood insurance on their residences well in advance of signs of fire or flood, investors should incorporate both deflation protection and inflation protection in their portfolios long before signs of deflation or inflation emerge.

In a core Bernstein portfolio, stocks provide exposure to growth, while nominal bonds provide protection

against bad economic environments including deflation. Because there will be times when stocks do well and other times when bonds outperform instead, investors need a mix of both.

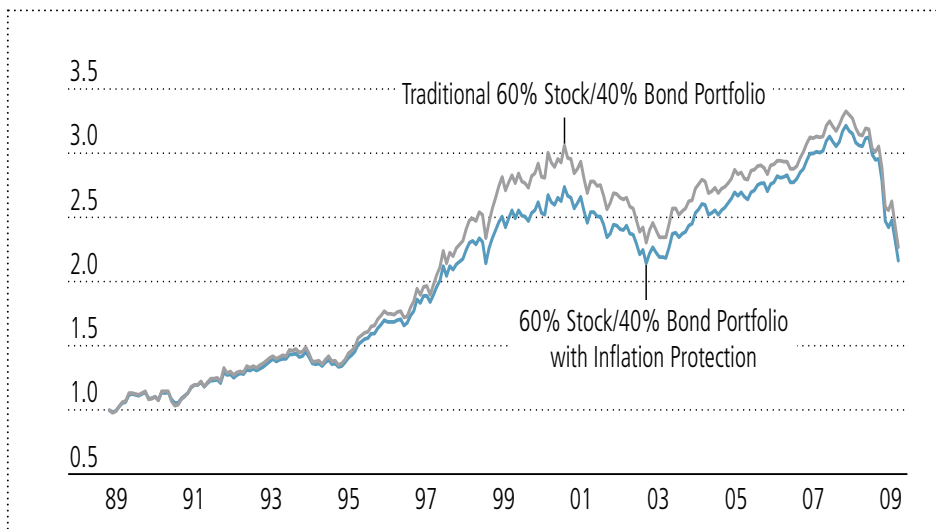
However, we also need to account for those periods when both stocks and bonds perform poorly—primarily due to an inflation surprise. During those times, investors need the added cushion of inflation protection, too. In those instances, exposure to real

²The TIPS market did not exist in the US until the late 1990s, so we undertook a research project that built a synthetic TIPS return series to determine how these bonds likely would have performed had they existed in the 1970s and other extreme historical periods (see our blackbook “Deflating Inflation” for more details). Our research suggests that TIPS would have dramatically outperformed nominal bonds in the 1970s and other periods of rising inflation, while the corollary also holds: TIPS underperform nominal bonds in periods of falling inflation/inflation expectations.

Display 6

Inflation Protection Didn't Detract Much When Inflation Was Subdued

Growth of US \$1 Million with 5% Inflation-Adjusted Spending



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Traditional 60/40: 60% stocks, 40% bonds; 60/40 portfolio with inflation protection: 50% stocks, 10% real assets, 30% bonds, 10% Treasury Inflation-Protected Securities (TIPS). US stocks are represented by the S&P 500 Index, US bonds by 10-year US Treasuries, and real assets by a real asset portfolio comprising one-third US commodity stocks, one-third US REITs, and one-third commodity futures. REITs (Real Estate Investment Trusts) are sourced from the S&P 500 Index prior to 1972; they are represented by the FTSE NAREIT Equity REITs Index from 1972 through 1999 and the FTSE EPRA/NAREIT Index thereafter. Commodity futures are sourced from the S&P GSCI prior to February 1991; they are represented by the Dow Jones-UBS thereafter. Commodity stocks are sourced from the Ken French Data Library and AllianceBernstein prior to 1999, and the MSCI Commodity Producers Index thereafter. Inflation-linked bonds are represented by 10-year TIPS calculated from synthetic AllianceBernstein real yields estimated from actual inflation and nominal yield curve variables before 1999 and from Federal Reserve yields thereafter.

Source: Federal Reserve, Ken French, MSCI, NAREIT, S&P Dow Jones Indices, and AllianceBernstein

assets can help protect traditional equities, while TIPS or our muni inflation strategy can help provide inflation protection for nominal bonds.

Protecting Your Portfolio

At Bernstein Global Wealth Management, the exposure to inflation-sensitive strategies is tailored to the client (see the sidebar). We work with each investor to determine whether inflation protection is appropriate, and then build a custom combination of inflation services to meet his or her needs.

Each of our inflation strategies provides inflation sensitivity in a different way based on our clients' best interests—factoring in market liquidity, risk, and taxation. At Bernstein, your Financial Advisor develops an asset allocation that considers the appropriate level of inflation protection for your portfolio depending on your age, wealth, tax circumstances, and spending goals. If you have concerns or questions about the inflation sensitivity of your portfolio, please contact your Bernstein Advisor.

Adjusting the Dial

Investors have different degrees of sensitivity to inflation based on their individual circumstances. For example, those who are still earning employment income have a natural "hedge" against inflation: As prices rise, their earnings will probably rise, too.

However, as these same investors approach retirement, their inflation sensitivity begins to rise. And for those who are spending from their portfolio, inflationary periods can be very harmful. So, for many retirees who don't have extra capital to fund their retirement spending, an allocation to inflation-sensitive strategies is advisable.

The decision to incorporate an inflation hedge is one of many trade-offs investors must make when constructing a well-diversified portfolio. It's hard to predict when inflation will occur, and by the time inflation is clearly rising, inflation-sensitive assets will already have appreciated significantly. This makes it difficult to time a move into inflation-related strategies—and is why we recommend inflation protection as part of investors' allocation decision.

The Capital Markets Engine is our proprietary model that uses our research and historical data to create a vast range of market returns, taking into account the linkages within and among the capital markets (based on indexes, not Bernstein portfolios), as well as their unpredictability.

Asset-class projections used in this paper reflect initial market conditions as of March 31, 2013. They include the following median forecasts of 10-year compound rates of return: global stocks (represented by the Morgan Stanley Capital International [MSCI] World Index), 7.3%; global bonds (represented by the Barclays Global Aggregate Bond Index), 1.8%.

An important assumption is that stocks will, over time, outperform long-term bonds by a reasonable amount, although this is by no means a certainty. Moreover, actual future results may not be consonant with Bernstein's estimates of the range of market returns, as these returns are subject to a variety of economic, market, and other variables. Accordingly, this analysis should not be construed as a promise of actual future results, the actual range of future results, or the actual probability that these results will be realized.

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