AllianceBernstein

Investing in an Era of Uncertainty

AllianceBernstein Global Dynamic Duration Strategy Aims to Help Portfolios Defend Against Volatile Markets

The 2008–2009 global recession, in our view, marked a shift from an era of moderate economic growth and inflation to an age of higher volatility. In this landscape, we believe that being benchmark-agnostic is a better approach and that the Global Dynamic Duration Strategy is right for the times: defensive, while targeting a competitive return above cash.

Developments in financial markets, the policy arena and the real economy lead us to believe that investors are facing a long-term trend of growing—and more persistent—economic and market volatility. In this type of environment, we believe that the best strategy for generating sustainable returns is to take a more active stance in managing portfolios.

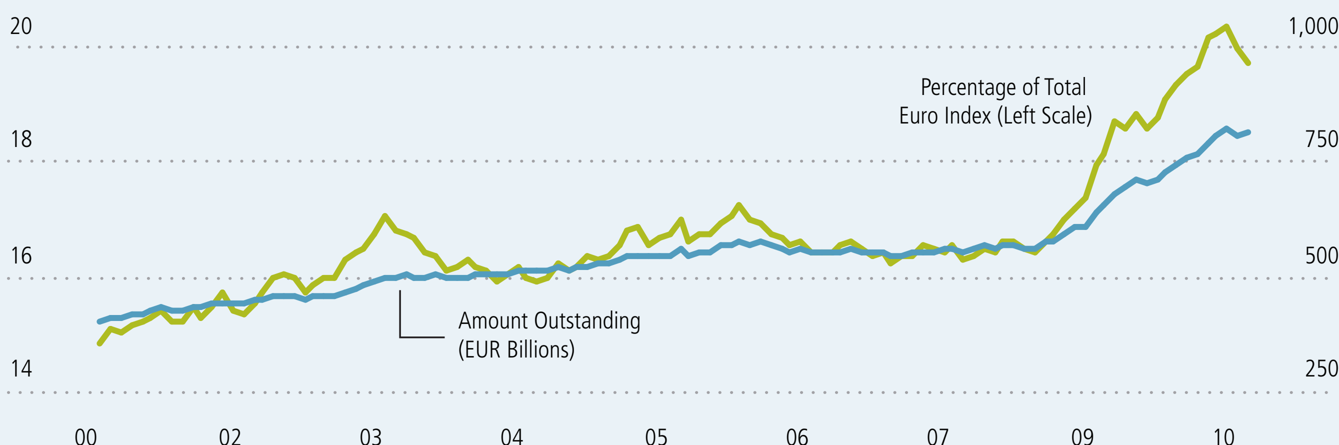
For a fixed-income portfolio, this could mean shifting assets from credit sectors to government bonds. And within a government-bond allocation, it could mean choosing long-duration bonds, with greater interest-rate sensitivity, or cash—depending on whether an investor expects bond yields to fall or rise.

If investors choose instead to follow benchmarks closely in times of market upheaval and economic stress, they might end up with more exposure to the worst performers. One example: if a country with weakening fundamentals issues more bonds to cover its growing deficits, the country can actually become a larger share of a government bond index (*Display 1*), forcing benchmark-driven investors to increase their exposure.

Highlights

- It's likely that a new era of higher volatility has begun—and that the days of moderate economic growth and inflation have passed
- AllianceBernstein believes that an active, benchmark-agnostic approach that focuses on individual return opportunities may be the most effective path
- Our Global Dynamic Duration Strategy seeks to deliver competitive returns while providing a defensive profile with limited downside interest-rate volatility

Display 1
Heavy Debt Issuance Caused Weaker Euro Countries to Become a Bigger Part of Bond Indices*



*Data through May 31, 2010. Based on the Barclays Capital Euro Aggregate Treasuries Index. Peripheral countries are Portugal, Ireland, Greece and Spain.
Source: Barclays Capital, European Commission and AllianceBernstein

Index or Insights?

The Search for Opportunities Shouldn't Be Benchmark-Driven

Downgrades Can Lead to a Forced-Selling Frenzy

When countries' credit ratings are downgraded to below-investment-grade status, it triggers another problem with benchmark-based investing. Many managers are forced by guidelines to sell along with the rest of the market, as downgraded countries drop out of the index they're following.

Selling with the herd can result in large capital losses, because when a downgrade triggers a sell-off, yield spreads often widen sharply. In 1997, for example, spreads on South Korean bonds grew from nearly 300 basis points to almost 750 in less than a week—the time between its downgrade to a B rating by Moody's Investors Service and its departure from the index.

In our view, the best approach—particularly in the current environment—is to be benchmark-unaware or benchmark-agnostic. Historically, there have been significant rewards for focusing instead on separating winners from losers: there's been a consistent gap between the best-and worst-performing countries globally (*Display 2*).

The Advantages of Staying Nimble

It's important for portfolio allocations to be nimble enough to exploit changing opportunities—particularly in volatile markets. One example: Australian government bonds outperformed Japanese bonds by 8.7% in 2008, but went on to underperform them by 7.1% in 2009.

The past six months have brought the benefits of active country selection into focus. By avoiding the peripheral euro countries so far in 2010, investors would have outperformed a broad euro benchmark significantly (*Display 3*).

By the same token, the time may come when it no longer makes sense to be underweight these countries and overweight German Bonds. We expect to see a shifting euro opportunity set over the balance of this year: in that environment, a well-diversified strategy of active country selection again has the potential to pay off.

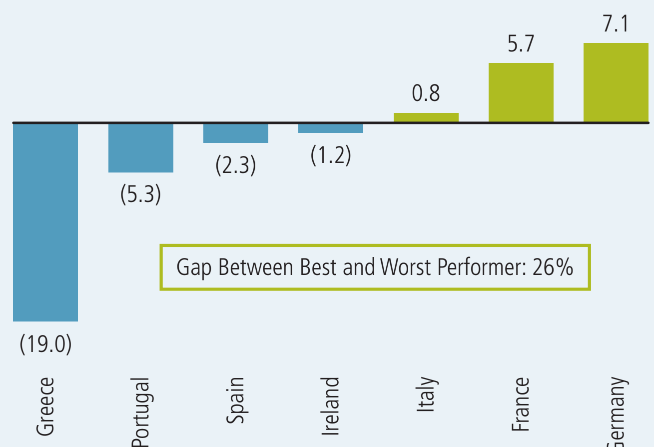
Display 2

Opportunity: Government Bond Returns Fluctuate over Time…*

	2004	2005	2006	2007	2008	2009
	Euro 7.6	Canada 6.4	Japan 3.1	US 7.5	Aus. 16.1	Euro 4.3
	Canada 6.9	Euro 5.4	Canada 2.4	Japan 6.4	US 14.2	Japan 1.6
	US 4.2	UK 5.2	US 0.9	Canada 4.2	Canada 12.1	Canada (1.9)
	UK 4.0	Japan 3.0	Euro (0.2)	UK 3.2	UK 10.9	UK (2.0)
	Aus. 3.7	Aus. 2.2	Aus. (0.9)	Euro 1.7	Euro 9.3	US (3.8)
	Japan 3.3	US 1.6	UK (1.2)	Aus. 0.6	Japan 7.4	Aus. (5.5)
Gap	4.3	4.8	4.3	6.9	8.7	9.8

Display 3

…and Today's Losers May Be Tomorrow's Winners**



*Returns are hedged to euros. Returns are represented by various Barclays Capital government bond indices.

**Year-to-date returns as of June 30, 2010 and in euros. Not all countries are shown.

Source: Barclays Capital, European Commission and AllianceBernstein

Global Dynamic Duration Strategy

Meeting Fixed-Income Investors' Needs in a Volatile Environment

What's the best way for a fixed-income portfolio to generate and measure a sustained return premium in an unsettled environment where even market indices—the traditional performance benchmarks—are more volatile?

That's the key question for investors, and AllianceBernstein's research has identified a strategy, Global Dynamic Duration, that we believe is particularly appropriate in the new, higher-volatility environment taking shape. But we also believe that the following attributes make it effective throughout the market cycle—in both high- and low-volatility environments:

- **Competitive return objective:** seeks to generate a premium above cash over the full market cycle
- **Liquidity:** aims to maintain a portfolio with a high degree of liquidity
- **Limited downside interest-rate volatility:** seeks to outperform bonds when bonds beat cash and to outperform cash when bonds fall behind
- **Defensive nature:** an emphasis on capital preservation, acting as an anchor to windward by providing some protection when equity and credit markets are weak.

Actively Managing Interest-Rate Risk in Sovereign Bonds

The strategy is benchmark-agnostic, seeking to deliver the performance profile above without being driven by the vagaries of index construction. It follows this disciplined, three-step process:

Step One: Set the Strategic Target Duration

The team identifies the "sweet spot" of the yield curve—the most effective bond durations to own throughout the cycle in order to capture a sustained risk-adjusted premium over cash rates. Today, our research points to the five-year portion of the yield curve.

Step Two: Determine Active Duration Position

Based on the shape of the yield curve and how we believe it's likely to change, we use fundamental and quantitative research to adjust the strategy's duration away from the sweet spot (*Display 4*). The potential duration range is wide and skewed toward lower interest-rate sensitivity, in keeping with the strategy's defensive characteristics.

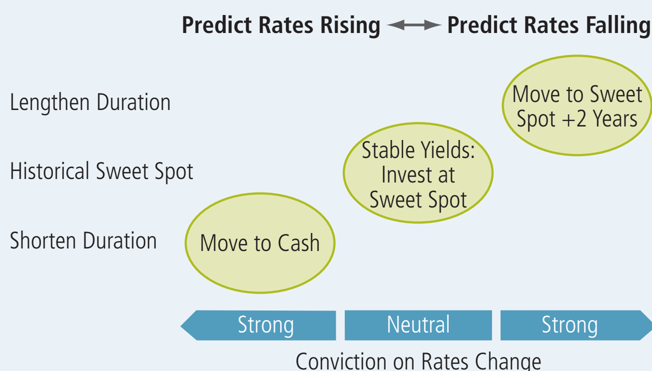
Step Three: Optimize Global Opportunities

Once we've defined the active target duration, we determine the best way to allocate that interest-rate risk across the yield curves of different countries around the world, based on our assessment of opportunities (*Display 3, previous page*).

Simulated returns from 1992 to 2009 suggest that the strategy possesses the broad defensive characteristics of a sovereign bond portfolio. It displayed a negative correlation to credit for most of the simulated period—particularly when credit underperformed. As a performance objective, we will combine the product's three return sources—term premium, active target duration and global government bonds—in an effort to generate a premium of 200 basis points over cash over a full market cycle (*Display 5*).

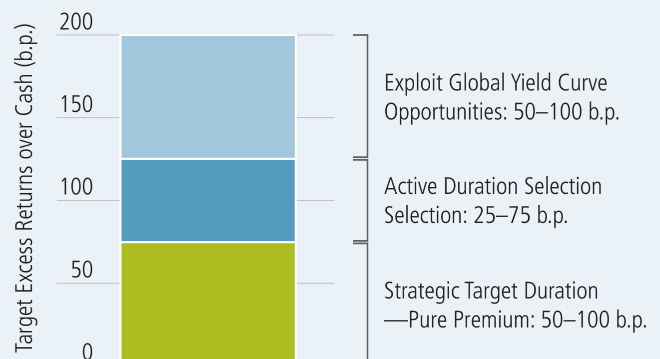
Display 4

Research Informs the Strategy's Duration Positioning



Display 5

Our Target: A Full-Cycle Premium of 200 Basis Points over Cash



Source: AllianceBernstein

AllianceBernstein Global Dynamic Duration Strategy

Investment Objective:	**Primary:** To outperform bank bill index by 200 basis points over a full market cycle **Secondary:** To outperform fixed-income when fixed-income outperforms cash
Target Investments:	Cash securities Global government futures Global government bonds (rated A or better)
Duration Management:	Dynamically adjust duration at cash, five-year (sweet spot) or seven-year Global exposures on a per-country basis limited to +/- one year
Currency Exposure:	Fully hedged to clients' local currency
Management Team:	AllianceBernstein Global Fixed-Income Team Averaging 19 years of investment experience Supported by depth of our Fixed-Income Quantitative and Fundamental Economic Research Teams

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Simulation Methodology and Notes
The simulations were conducted using AllianceBernstein's Global Yield Curve Model combined with a global government risk model used in a mean-variance optimization setting. The set of investable sovereign bonds are of up to ten year's maturity and come from Australia, Canada, Germany, Italy, Japan, Sweden, the US and the UK. The optimal portfolio is rebalanced on a monthly basis. Both long and short positions are allowed, but are limited to one year of duration per country. Duration relative to the benchmark was rebalanced on a monthly basis. The results are based on data from 1992 through 2009.

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