BUILD A BETTER PATH TO MORE EFFICIENT INCOME

The search for income is getting harder, and there's no shortage of suggestions on where to get a little bit more. But what about the cost? We think that focusing on creating a better return sequence can help investors access more efficient income.

The baby boomer generation continues to move from its peak earning years into the retirement phase. As it does, it's become much more income hungry. And this appetite is having a big impact on the demand for income-generating allocations. In target-date solutions, for instance, bond allocations for peak earners are typically in single-digit percentages; for retirement-age investors, bonds can make up as much as half of their overall portfolio.

LOOKING FOR INCOME IN AN INCOMELESS WORLD

But the search for income is a challenge today, and isn't getting any easier. More and more baby boomers will be demanding income-generating bonds, and the income from those bonds is now lower, thanks to years of Federal Reserve quantitative easing, which has shrunk the market and reduced yields. As a result, yields are very low today (*Display 1, page 2*)—and they're even lower after accounting for inflation and taxes.

At the same time, risks inside income-oriented indices are rising (*Display 2, page 3*). The duration, or interest-rate sensitivity, of bond indices has grown by 30% since 2008. And with the US late in the credit cycle, credit quality is declining. On the equity side, dividend-paying stocks, based on price-to-earnings ratios, are trading at a valuation of 24.8 times earnings.

There's no shortage of ideas and suggestions on where to squeeze out a little more income today, but there's not much talk about the cost of that extra income. Many of the areas that people point to for an income boost face large drawdowns if things go wrong. Preferred stocks are a good example: over the past 10 years, the average drawdown in Morningstar's Preferred Stock category was 8%, and the biggest was about 44% (*Display 3, page 4*).

It's clear that simply piling into higher-income trades isn't the answer.

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Senior Portfolio Manager

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Fixed Income Product Director

IMPROVING THE PATH OF RETURNS

We think there's a better way to build solutions that can address some of the pitfalls investors face in the search for income. It starts with recognizing what the market landscape is likely to be in the years ahead.

Returns are expected to be lower, so simply trying to maximize returns can lead to unintended risks. One of the biggest challenges for investors is navigating a major drawdown early in their retirement-spending years, which can blow a hole in their savings that can't be refilled. That's where building a better path comes in: designing strategies that improve the sequence of returns, generating more efficient income.

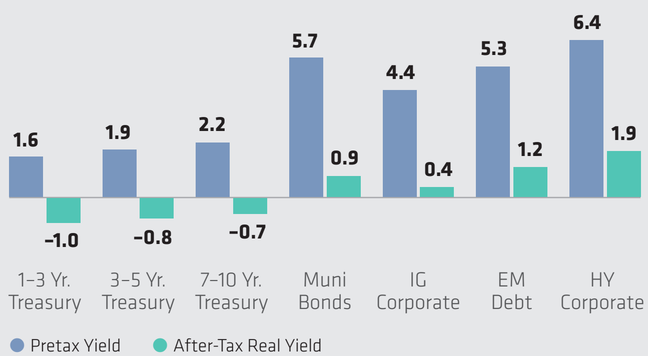
We can do that using the lens of up/down capture. How much participation in up markets do you want from your portfolio? And how much can you tolerate losing in a down market?

Here's a simple example using the S&P 500 Index that illustrates this point. Let's say your portfolio captures 50% of market returns in rising markets and only 20% in falling markets (*Display 4, page 5*). Over a long time period, that approach would stack up pretty well versus the S&P 500. However, in a big market rally like the one we've seen, it doesn't capture enough upside.

The good news is that making even a modest improvement in a portfolio's up/down capture can make a big difference in the return experience over time. For example, a portfolio with 90% up capture and 80% down capture doesn't seem radically different from the overall market. But it's able to largely keep pace with the S&P 500 in strong markets, and it actually outperforms the index over the long run.

DISPLAY 1: THE SEARCH FOR INCOME IS GROWING MORE CHALLENGING

Yields After Accounting for Inflation and Taxes (Percent)



Past performance and historical analysis do not guarantee future results.
As of October 27, 2017
Yield represented by yield to worst. HY Corporate represented by the Bloomberg Barclays US High-Yield 2% Issuer Capped Index; IG Corporate represented by the Bloomberg Barclays US Corporate Investment-Grade Index; Muni Bonds represented by the Bloomberg Barclays Municipal Bond Index; EM Debt represented by the Bloomberg Barclays Emerging Markets USD Aggregate Index shown in hard currency. Assumed inflation rate is 2%; assumed tax rate is 39.6%. Real Yield calculated by subtracting 2% (assumed inflation target) from nominal yields. The Muni Bonds yield is not reduced by tax due to the tax-exempt status of these securities at the federal level.
Source: Bloomberg Barclays and AB

BUILD A BETTER PATH: THREE PRINCIPLES

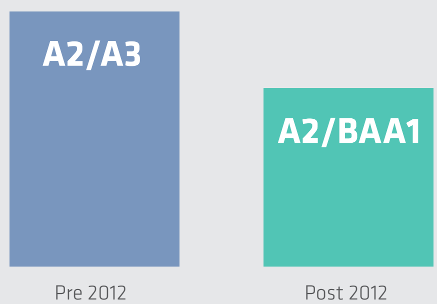
Through the lens of income generation, up/down capture translates to the level of income you want versus the level of potential principal loss you can tolerate. It's clear from the numbers that an income strategy with better up/down capture can generate more efficient income. But how specifically do you build a better path for an income portfolio?

We focus on three key principles:

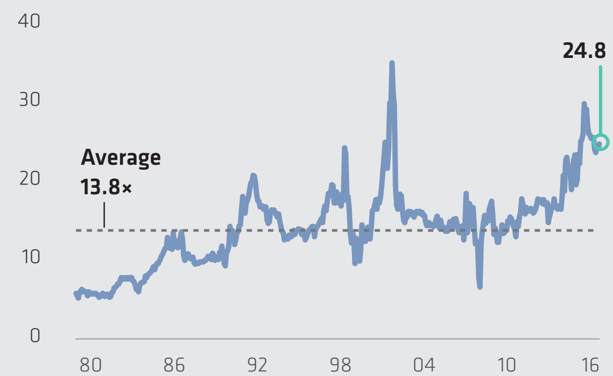
+ **Better beta.** Some markets and market factors have better up/down capture ratios than others. They're simply better betas. Global fixed income is an example. Over the past 10 years, a currency-hedged global bond index captured 91% of the US Aggregate Index's up markets and only 70% of its down markets. That translates to an up/down capture ratio of 1.30—a major improvement.

DISPLAY 2: YIELD CHASING IS GETTING RISKIER

Growing Credit Risk in Corporate Bonds
US Aggregate Corporate Credit Quality



Highest-Dividend Payers Trading Well Above Average
Price/Earnings Ratio (×)



Past performance and historical analysis do not guarantee future results.
As of September 30, 2017
Left display: Corporate credit quality deterioration represented by the average credit quality of Bloomberg Barclays US Aggregate Corporate Bond Index. Right display: Highest 20% of dividend payers among 1,500 US-listed stocks in the AB equity universe, excluding 33 companies that do not currently have a P/E ratio because they are not profitable
Source: Bloomberg Barclays, FactSet, Morningstar and AB

+ **Efficient structure.** In addition to choosing better betas for an income strategy, combining certain betas may also improve overall up/down capture. For example, a strategy that combines 50% high-yield bonds and 50% US Treasury bonds has historically demonstrated better up/down capture than either of those individual components on its own.
+ **Targeted alpha.** Outperformance from active management can further improve up/down capture, but it's important to focus on high-potential areas. We think one of these places is the opportunities created by post-financial-crisis market conditions. And there are structural opportunities to generate alpha: Inefficient indices such as high yield (where bigger debt issuers have a bigger index weight) also offer better alpha potential. Areas with a strong information advantage are another example—think emerging-market (EM) debt.

THE "PERFECT" INCOME SOLUTION

If following the three principles of building a better path can lead to better income outcomes, the next logical question is: What's the perfect income-generating solution?

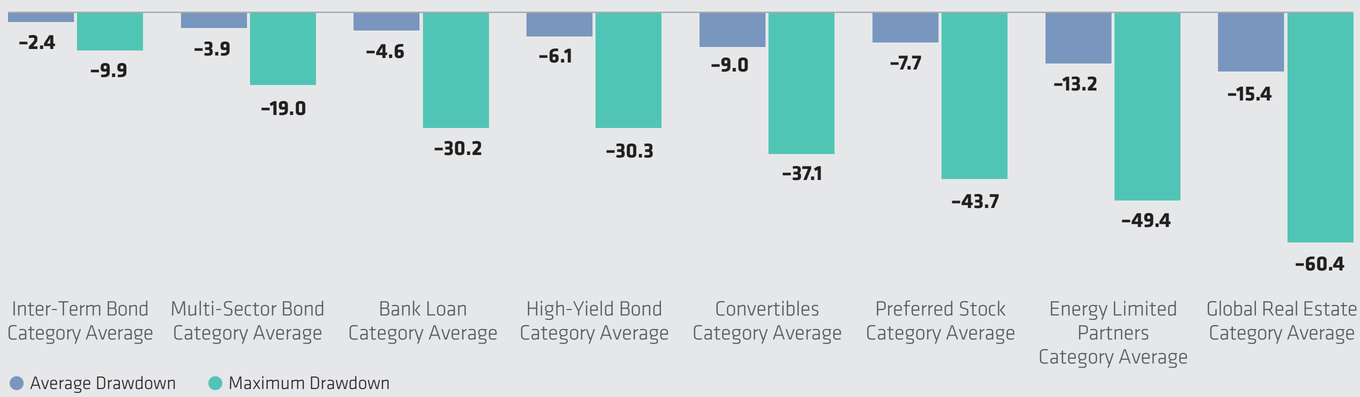
The answer is. . .it depends. First and foremost, to identify the best solution, every investor has to determine the appropriate trade-off between generating income and the potential principal cost from losses. That's because staying the course is by far the most important element.

Other factors matter, too. Taxes are often part of the equation, so you'll have to decide how important pretax income is versus after-tax income. Inflation is a consideration, and so is liquidity—how accessible do you want your savings to be as they generate income? And in today's world, the income/growth mix is key: do you want pure income or income with an option for capital growth?

DISPLAY 3: WHAT'S THE COST OF GETTING MORE INCOME?

10-Year Average Drawdowns (Percent)

Morningstar Category Averages: January 2008–December 2017



Past performance is not a guarantee of future results.

As of December 31, 2017

Source: Morningstar and AB

Together, the answers to these questions will help determine which betas—and which combination of betas—create a strategy and return experience that can deliver on your goals while helping you stay invested for the long run.

THE GREATEST HITS: FOUR KEY ROLES FOR INCOME

The "perfect" income solution doesn't live on an island—it has to be considered in the context of its role in a broader portfolio. We see four key roles for income: core, balanced income, high income and income with growth (*Display 5, page 6*). Here are our suggested "greatest hits" solutions for each:

+ **Core Income:** This role is the classic high-quality anchor for a diversified portfolio—the 60/40 stock/bond portfolio—where bonds offset equity volatility. Our greatest hit? A high-quality global bond portfolio that actively pursues income across the developed world. It's designed to provide solid income and relatively low volatility. The key is to hedge currency exposure—building a better beta. Currency hedging can reduce annualized volatility to about 4%, and it has historically produced better up/down capture than a US-only aggregate portfolio.
+ **Balanced Income:** For investors looking to squeeze a bit more income out of their allocation, a balanced strategy can be a good choice. In our view, the best way to do this is to combine allocations to both high-quality and high-yield bonds in a "barbell" strategy that balances interest-rate and credit exposure. Think back to the efficient-structure principle of building a better path—as we see it, this is one of the most efficient income structures in capital markets.

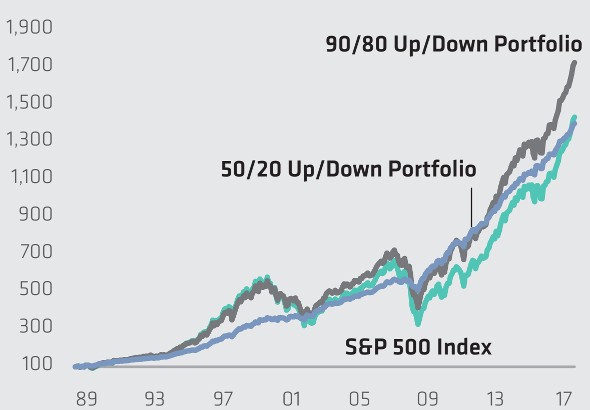
+ **High Income:** The next step outward on the income/risk spectrum is a pure high-income solution. In keeping with the building a better path concept, our "greatest hit" uses a straightforward, much more efficient structure that diversifies across regions and sectors. Instead of investing only in developed-market corporate high-yield bonds, this approach integrates EM bonds denominated in both local currencies and major developed-market currencies.

+ **Income with Growth:** In today's low-yield world, some investors want an option for growth along with income. To do this requires extending the universe to different betas beyond bonds, each of which has different balances of income and growth potential. Other income generators, such as dividend-paying stocks, inject some growth potential into the mix, and nontraditional sources of income for diversification. The high-income solution is mostly income-driven; the multi-asset solution tilts a bit more toward principal growth.

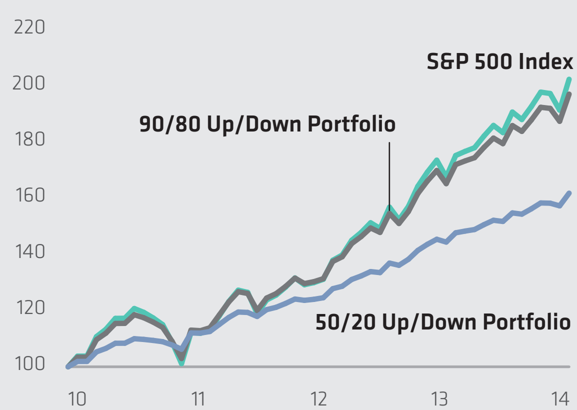
DISPLAY 4: BUILDING A BETTER RETURN PATH CAN IMPROVE UP/DOWN CAPTURE

Hypothetical Growth of $100

Effective Up/Down Capture Works over the Long Run...



...Although It Can Struggle in Beta-Driven Markets

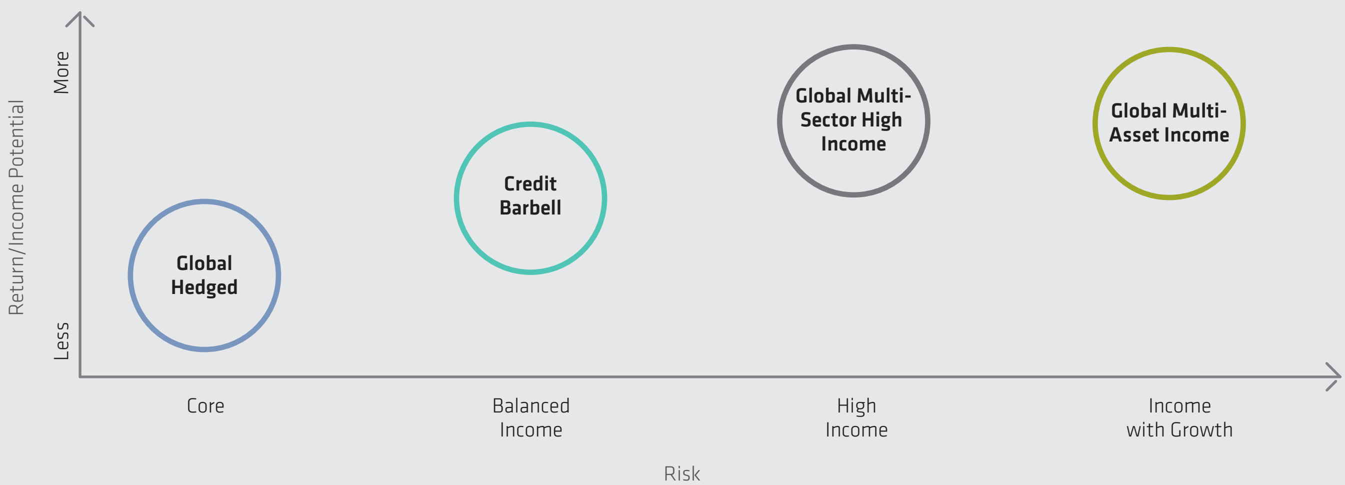


Through December 31, 2017

Index examples and up/down constructs are presented to illustrate the application of our investment philosophy and are used for comparison purposes only. An investor cannot invest directly in an index. Capture ratios are calculated on a month-to-month basis using the S&P 500 as the reference benchmark.

Source: S&P and AB

DISPLAY 5: GREATEST HITS OF INCOME: CHOICES ACROSS THE RISK/RETURN SPECTRUM



For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.
Source: AB

So there's a lot of flexibility in creating income solutions to fill diverse roles in investors' portfolios. But good design is critical. Simply investing in broad indices or bolting together different components is inefficient—and can leave portfolios vulnerable to unintended risks.

Well-designed income solutions should reflect the principles of building a better path, with a sequence of returns that aligns with investors' specific goals and risk tolerances. That requires accessing better beta sources and combining them in more efficient ways. It also means using active management to target higher-probability alpha opportunities and manage risk.

WELL-DESIGNED INCOME SOLUTIONS SHOULD REFLECT THE PRINCIPLES OF BUILDING A BETTER PATH.

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