AllianceBernstein

Designing a flexible go anywhere multi-asset income strategy

Income Unleashed

There are a lot of suggestions these days about where to get extra income, but less discussion about the cost attached to it. A diversified multi-asset approach can help—and provide additional growth potential. But how it's designed matters.

The Easy Ride Is Over

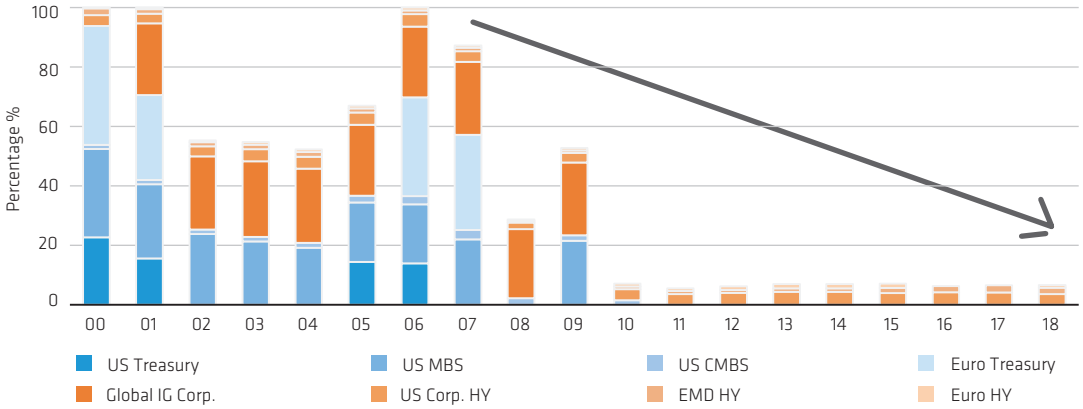
Earning investment income today is a challenge, and it's not getting any easier. Years of central bank quantitative easing have reduced the supply of income-generating bonds. As a result, yields are very low—and even lower after taxes and inflation. Over the next 10 years, traditional stock-and-bond portfolios are expected to earn less than half what they did over the previous five. Investors who have been able to achieve hefty returns by relying on bonds for income and riding along with equity indices need to turn off autopilot, expand their horizons to include a wider range of assets and manage their portfolios more actively to stay on top of rapidly changing markets.

Our forecasts suggest that a portfolio comprised of 60% equities and 40% bonds will earn just 4% in euro terms over the next 10 years compared with the 8.5% return of the last five years.

Furthermore, the universe for yield has shrunk, and earning yield today requires substantially more risk (Display below).

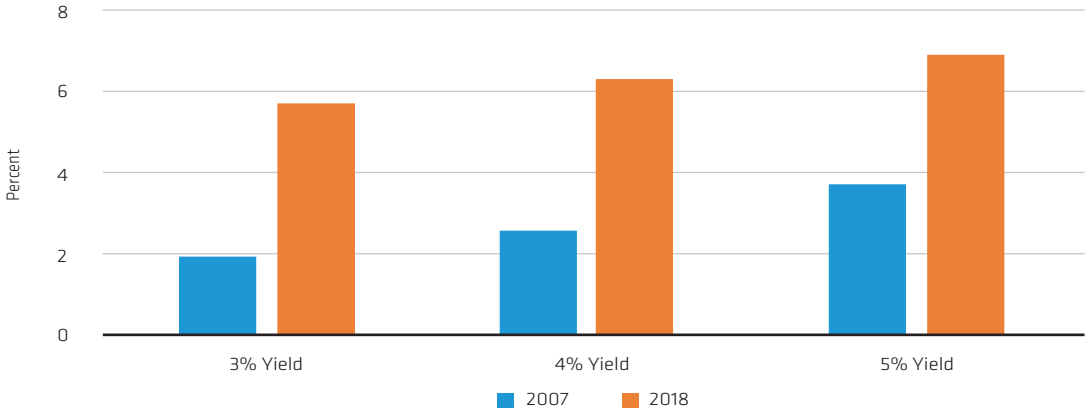
The Universe for Yield Is Shrinking

Asset Classes Yielding More than 4%*



Earning Yield Today Requires Substantially More Risk †

Standard Deviation of Blended Portfolio Needed to Achieve Desired Yield Target



As of 31 December 2018

Past performance does not guarantee future results.

*The asset classes listed in the top chart were sourced from Barclay's according to their weight in the Bloomberg Barclays Multi-Verse Index for each of the years shown.

†Risk is defined as trailing 10-year standard deviation.

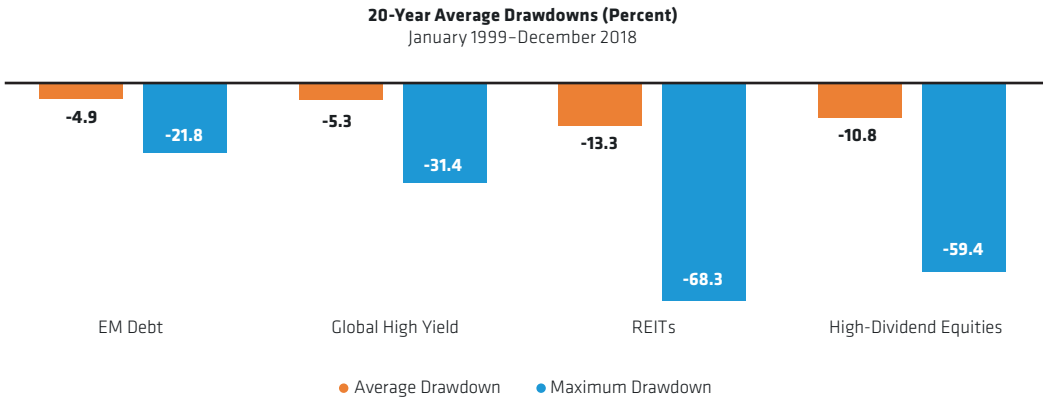
Bottom chart assumes investment into high-yield bonds, as represented by Bloomberg Barclay's Global High Yield Index; core bonds by Bloomberg Barclay's Global Aggregate. The hypothetical 3% portfolio in 2007 assumes a 71.6% allocation to core bonds and 28.4% in cash. In 2018, that allocation has 82.8% in core bonds and 17.2% in high-yield bonds. The hypothetical 4% portfolio in 2007 assumes a 95.5% allocation to core bonds and 4.5% in cash. In 2018, that allocation has 65.0% in core bonds and 35.0% in high-yield bonds. The hypothetical 5% portfolio in 2007 assumes a 83.3% allocation to core bonds and 16.7% in high-yield bonds. In 2018, that allocation has 47.2% in core bonds and 52.8% in high-yield bonds.

Source: Bloomberg Barclays, Morningstar and AB

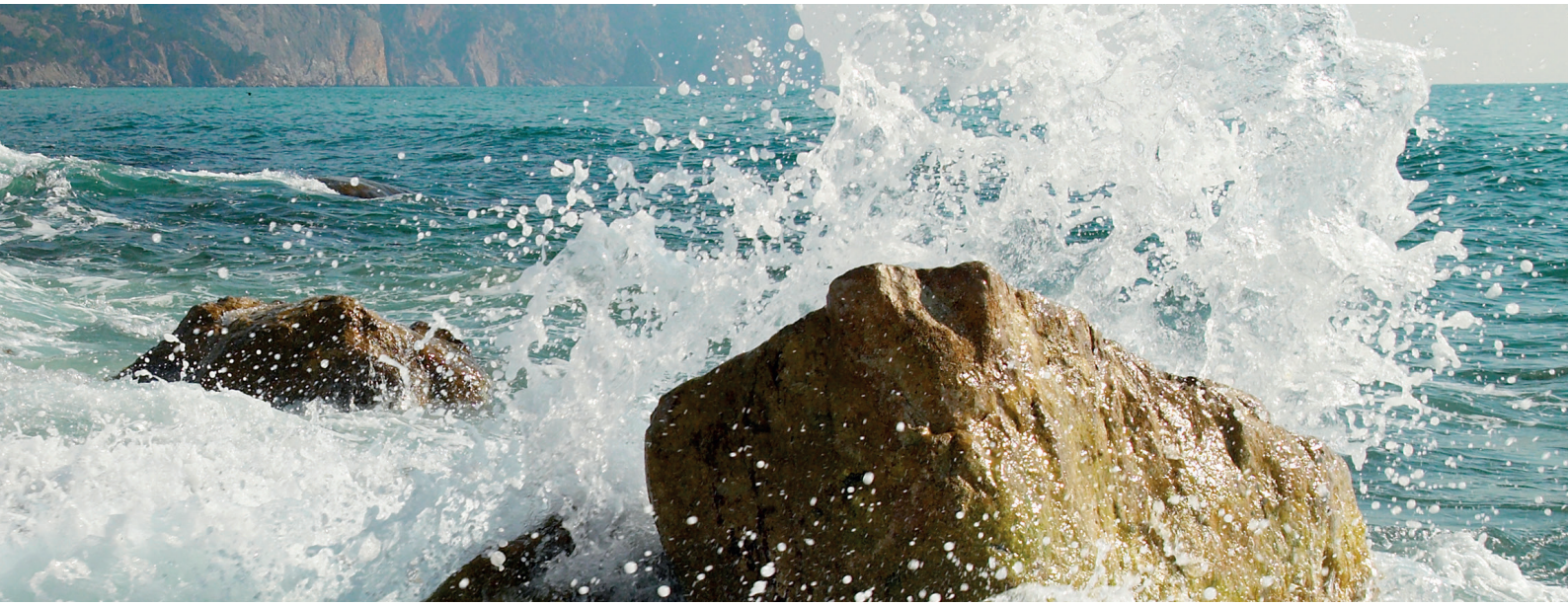
At the same time, the risks inside income-oriented indices are rising. Many companies have high levels of borrowings, which help to increase their earnings when the economy is healthy, but make them vulnerable when economic slowdown and trade wars hurt revenues. These risks are often not reflected in current valuations. For instance, higher-yielding bonds offer a relatively low level of extra income compared to safe government bonds – below the average of the last five years and well below longer-term levels. And many higher-yielding equities have abnormally low levels of earnings to cover their dividend payouts to investors. So it takes skilled analysis to capture the rewards of higher-yielding investments while navigating their risks.

In fact, many of the areas people turn to for an income boost run the risk of large drawdowns if things go wrong. Real estate is a good example. Over the last 20 years, the average drawdown in the FTSE NAREIT Globa Real Estate Investment Trust category was 13% and the biggest was about 68% (Display below).

What's the Cost of Getting More Income?



As of December 31, 2018
Past performance does not guarantee future results.
EM Debt: JPM EMBI Global Diversified, Global High Yield: Blomberg Barclays Global High Yield (Hdg USD), REITs: FTSE NAREIT All Equity REITs, High-Dividend Equities: MSCI World High Dividend Yield (Net).
Source: JPM, Bloomberg Barclays, FTSE, MSCI, AB, Morningstar



What Gives?

After a brief period when central banks seemed likely to normalize policy and return to familiar levels of interest rates, markets are instead now facing a new era of shrinking yields. Economic growth has started to trend lower, with trade wars adding to the downward pressure. In the US, the Federal Reserve has already cut interest rates, and in Europe the European Central Bank (ECB) is resuming its quantitative easing (QE) policies. Meanwhile, governments and central banks around the world are starting to respond with their own rate cuts and policy changes, anxious to keep their currencies competitive and their economies ready for possible further setbacks to economic growth.

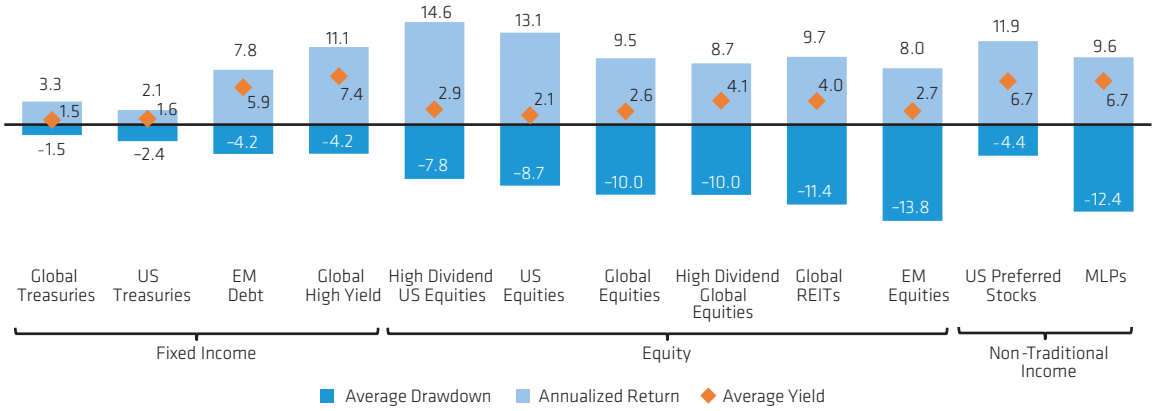
Before the global financial crisis, nearly all fixed-income assets—even US Treasuries—yielded more than 4%. Now, investors can only find such rates in much riskier assets, namely high-yield bonds in emerging markets and the US. In the late stages of a credit cycle, that's an uncomfortable position to be in.

Getting a Handle on Risk

Is there a way to generate high and stable income in today's environment with less risk? We think there is. Of course, "less" risk doesn't mean "none." In investing, as in life, nothing is free. That's why investors must decide how much income they need—and at what cost. There are lots of ways to generate income across different sectors, but at what cost? (Display below). In other words, how much can you tolerate losing in a down market? And with further rate cuts in prospect, the challenge for income investors is likely to get even tougher.

Sector Average 10-Year Yield, Annualized Return and Drawdown Attributes

Sectors Represented by Index Returns (January 2009–December 2018)



Past performance does not guarantee future results.

Data are shown over a 10-year time period ending on 31 December 2018

Average yield is the yield to worst for fixed income indices and dividend yield for equity indices.

Global Treasuries are represented by the Bloomberg Barclay's Global Treasury Index (Hedged USD), US Treasuries by Bloomberg Barclay's US Treasury Index, EM Debt is represented by J.P. Morgan EMBI Global Diversified Index, Global High Yield Bonds are represented by Bloomberg Barclay's Global High-Yield Index, High Dividend US Equities are represented by S&P 500 Dividend Aristocrats, US Equities are represented by the S&P 500, Global Equities are represented by the MSCI ACWI Index, High Div Global Equities are represented by the MSCI ACWI High Dividend Yield Index; EM Equities are represented by the MSCI Emerging Markets Index, Global REITs are represented by FTSE/NAREIT Global Real Estate Index, Preferred Stocks are represented by S&P US Preferred Stock Index, MLPs are represented by the Alerian MLP Index.

Source: Bloomberg, Bloomberg Barclays, J.P. Morgan, Morningstar, S&P and AB

Designing a Multi-Asset Income Strategy: the Requirements

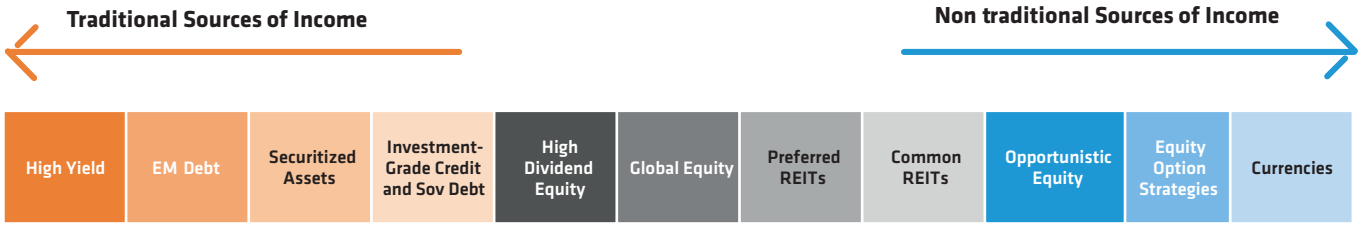
To generate attractive, sustainable income in today's low-yield environment, investors need to find alternative sources of income in addition to traditional bond investments. Using an unconstrained approach creates maximum opportunity to find those new sources of income. And as volatility returns to more normal levels investors will need to keep a careful eye on risk to protect their assets. We think an effective multi-asset income strategy can help, by bringing breadth, integration and dynamism.

An Effective Multi-Asset Strategy Should Be Broad and Unconstrained

What do we mean by that? Simply that managers shouldn't be shackled when it comes to sourcing income and returns. It's critically important that they can invest in a broad range of assets across the globe. For instance, managers should look across both traditional sources of income as well as using non traditional diversifiers (Display below).

Consequently, it's important that investors remain nimble. Breadth of exposure brings diversification of risk, too. For example, mixing in less traditional assets and strategies not highly correlated with global bonds and equities can help avoid large drawdowns and maintain a desired level of all-weather income. And tactical allocations to less traditional income generators beyond bonds and dividend-paying stocks can add growth potential to the mix.

It's also important seek to out new and uncorrelated sources of excess returns. That means expanding the investment universe to incorporate assets such as real estate investment trusts (REITs) and master limited partnerships (MLPs). Selective investment in these asset classes can provide an attractive source of income based on exposure to real assets, rather than the gyrations of the fixed-income or equity markets. Additionally, they can act as a potential inflation hedge. We're also seeing opportunities in select emerging-market bonds, which provide another attractive source of income and an opportunity to add some geographic diversity to portfolios. Finally, options overwriting strategies can help investors earn extra income even as they maintain some exposure to equities.



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

Managers Need a Deep Understanding of the Return Drivers of Every Portfolio Asset

Even a diversified portfolio can contain common risks. Too many multi-asset managers today use a bolt-on approach when building a portfolio: they toss many single-asset strategies into a single portfolio and manage them separately. This can overexpose investors to specific types of risk without their knowing it.

For example, dividend-paying stocks, real estate investment trusts and investment-grade corporate bonds are typical components of most income-oriented portfolios. What may not be clear to everyone is that all three also carry significant interest-rate risk. So they may all struggle simultaneously if government bond yields rise sharply. Managers who take a more integrated approach stand a better chance of identifying and hedging these common risks that can creep into portfolios.

Security selection plays an important role too. Effective multi-asset income strategies can improve diversification, for instance, by incorporating equities with more stable balance sheets, resilient profits and lower sensitivity to market moves. These types of stocks can be a good complement to high yield bond investments and a useful hedge to mitigate portfolio risk.

Multi-Asset Solutions Need to Be Dynamic and Flexible

The ability to adjust quickly is always important. But it's especially so today. As economic growth continues to slow and trade tensions continue to build, risks for bond and stock markets are rising. Meanwhile, investors can only find high yields in a narrowing range of markets and strategies. With no shortage of economic or geopolitical risks on the horizon investors will need to be nimble to navigate the rapidly changing investment landscape. Being able to pivot quickly as conditions change is important. Having a manager that keeps a close eye on the market and the positions underlying the fund each day is important to managing downside risk—particularly in periods of market stress.

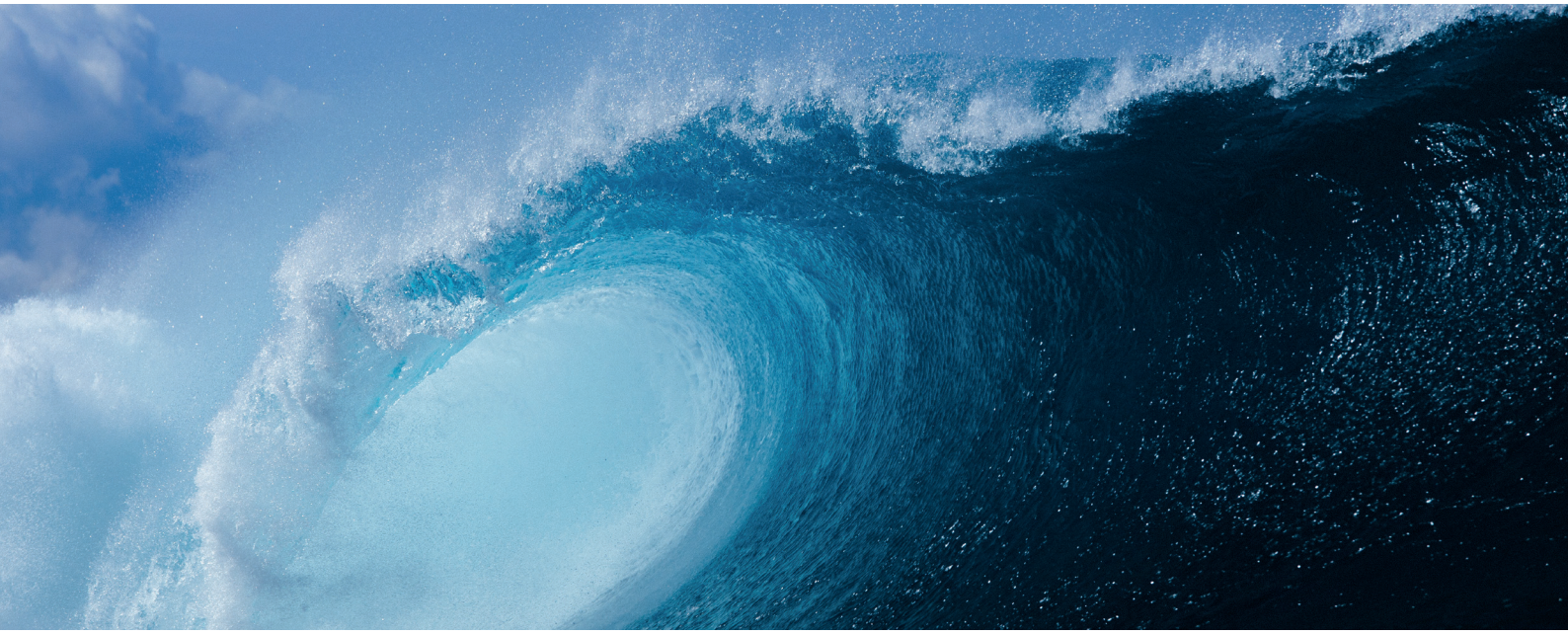
There are always going to be trade-offs between generating high and reliable income and the potential principal cost from losses. If investors select a strategy that is dynamically managed by experts, they can avoid the pitfalls of trying to time markets and pick winners themselves. That way, they can feel comfortable sticking with their choice and should be better-placed to achieve their objectives over the long haul.

How Does It All Come Together?

Depending on the investor's needs, a multi-asset income fund can make sense in several different ways. First, if investors use this type of strategy as the primary allocation in their portfolio, they have the reassurance that it will deliver a steady income stream and provide the opportunity for some capital growth, while keeping a careful eye on risk. These types of strategies can offer different types of distribution mechanisms, with some investors opting to receive the "natural yield" of this portfolio that distributes approximately 5% p.a., while others look to receive a higher, managed payout in the 7% range (this will be generated by income, but can also dip into capital growth). Particularly for those in retirement or approaching retirement, having a steady income while also putting their money to work is an attractive outcome.

This type of strategy is not just for everyday investors, but can also help smaller pension schemes that are looking to meet their liabilities with a more defined cash-flow stream, saving them the headache of working out how to tap existing investments for income. Even for larger discretionary managers, this type of solution can function as their diversified, enhanced, core allocation, around which satellite investments can be made opportunistically.

In a world where investing in bonds no longer offers so many opportunities for generating a high and reliable yield, a multi-asset income approach can provide greater diversification with potential for long-term capital growth. It can also offer dynamic management across asset classes to look for the best opportunities around the world, while keeping a close eye on risk.



IMPORTANT INFORMATION

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