HIGH YIELD

EQUITY-LIKE RETURNS...WITH HALF THE RISK? (AND CAN TACTICAL MOVES HELP, TOO?)

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IN THIS PAPER: Investors often think of high yield as just another part of their fixed-income allocation, typically de-risking equity volatility by shifting into fixed-income segments like investment-grade bonds. But high yield, despite enduring tough stretches, offers compelling attributes that may make the case for its own seat at the asset-allocation table. And tactical flexibility with high-yield exposure may offer investors a tool to further enhance risk-adjusted returns.

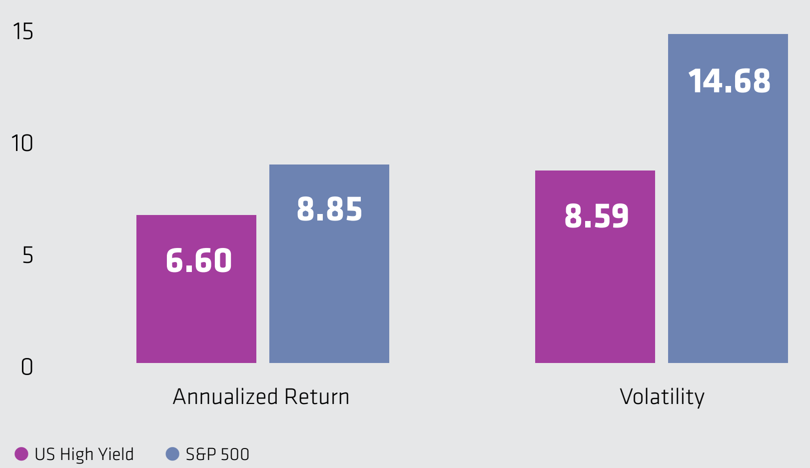
THE CASE FOR HIGH YIELD

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 the issuer, make regular coupon payments and 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.

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

DISPLAY 1: HIGH-YIELD BONDS—STRONG RETURNS, LESS VOLATILE THAN STOCKS
Historical Performance, January 1994–March 2020 (Percent)



Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
US high yield is represented by the Bloomberg Barclays US Corporate High Yield 2% Issuer Capped Bond.
As of March 31, 2020
Source: Bloomberg Barclays, S&P and AB

LOOKS ARE DECEIVING

High-yield performance patterns, for example, don't track those of other fixed-income sectors very closely over the long term.

Over roughly the past 25 years (*Display 2*), US high-yield bonds have exhibited a correlation of only 0.22 to a broad universe of investment-grade bonds and a correlation of –0.13 to US Treasury bonds, the traditional bellwethers of the US bond market. Of course, correlations aren't constant—they fluctuate quite a bit over time. Based on a rolling three-year average, high yield's correlation to US Treasuries has ranged from as low as –0.52 to as high as 0.73.

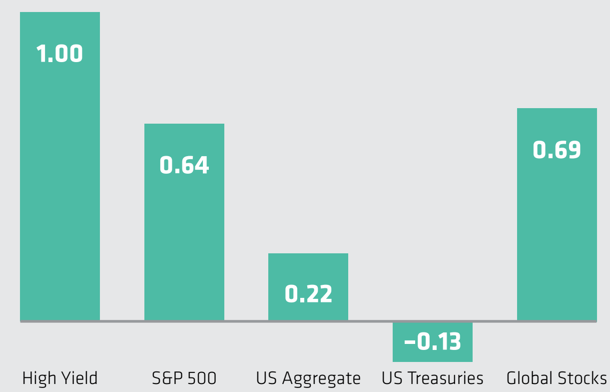
High yield's long-term correlation to US stocks, as measured by the S&P 500, has been 0.64; its correlation to global stocks, as measured by the MSCI World Index, has been about the same: 0.69.

So it's important to ask this question: Why do high-yield returns have more in common with stocks than with other bonds?

Like equities, high-yield bonds are strongly linked to the fundamentals of the companies that issue them. And credit spreads, the extra yield high-yield bonds offer versus similar government bonds, tend to move in the opposite direction from interest rates. So high-yield bonds are generally insensitive to interest rates—the dominant risk for many investment-grade bond sectors.

DISPLAY 2: HIGH YIELD DOESN'T ACT LIKE OTHER BONDS

Correlation to US High-Yield Bonds, 1994–2020



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

High yield represented by the Bloomberg Barclays US Corporate High-Yield; US aggregate represented by the Bloomberg Barclays US Aggregate Bond; US Treasuries represented by the Bloomberg Barclays US Treasury; global stocks represented by the MSCI World

As of March 31, 2020

Source: Bloomberg Barclays, Morningstar Direct, MSCI, S&P and AB

STACKING UP AGAINST EQUITY RETURNS OVER TIME

In more than two decades of capital-market history, high-yield bonds have stacked up fairly well against equity performance—but with much lower volatility.

Since January 1994, stocks have delivered an annualized return of 8.85%. High-yield bonds returned 6.60% over that period. 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*).

Of course, high-yield bonds haven't always kept up with stocks—they've been outpaced by a good margin over certain time frames, like when the technology/media/telecom bubble was inflating in the second half of the 1990s. But over the long haul, high yield has produced equity-like returns—with slightly more than half the risk of stocks, as measured by standard deviation.

Lower volatility has been a consistent theme: high yield has generally been less volatile than stocks based on rolling periods (*Display 3, page 2*), though high yield has endured its share of high-volatility episodes—including early 2020. Over the long run, however, a favorable risk/return profile, relatively low correlations to stocks and very low correlations to other bond types have made high-yield bonds effective within a diversified portfolio.

> Instead of asking, "How much of my bond exposure should be allocated to high yield?" perhaps investors should ask, "How much equity exposure should I allocate to high yield?"

A PLACE AT THE ASSET-ALLOCATION TABLE

So, for investors looking to pare down volatility in their equity portfolios while preserving attractive return potential, high-yield bonds could fit the bill.

Many investors looking to reduce risk shift assets into areas with more stability, including investment-grade bonds or even cash. But this can also mean sacrificing a good amount of return potential. High-yield bonds, on the other hand, can help investors reduce risk without giving up as much return.

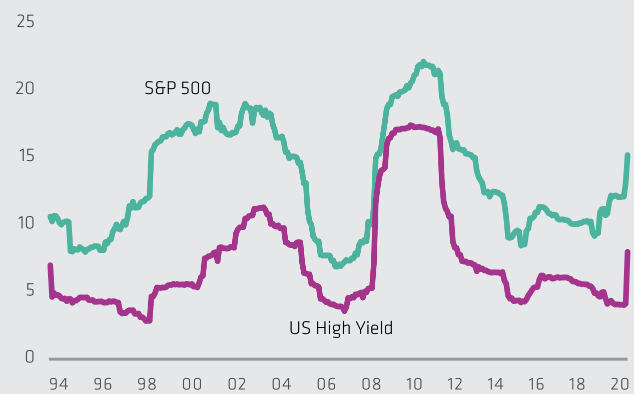
How does this work? In part, it's because high-yield bonds churn out a consistent income stream that few other assets can match. This income—distributed semiannually as coupon payments—is constant. It gets paid in both bull and bear markets. After accounting for maturities, tenders and callable bonds, 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 ending value investors can count on. As long as the issuer doesn't go bankrupt, investors get their money back when the bond matures. Identifying which issuers are in better financial shape and more able to endure hard times is critical in managing default risk, which can increase substantially in times of market and economic stress.

In the big picture, we think high yield has made the case for its own place at the table when investors think about portfolio allocations. Instead of asking, "How much of my bond exposure should be

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

Rolling Three-Year Annualized Standard Deviation (Percent)



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

US high yield is represented by the Bloomberg Barclays US Corporate High Yield.

From January 31, 1994, through March 31, 2020

Source: Bloomberg Barclays, S&P and AB

allocated to high yield?" perhaps investors should ask, "How much of my equity exposure should I allocate to high yield?"

Historically, a significant allocation to high-yield bonds—rebalanced monthly—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 a modest reduction in annualized returns.

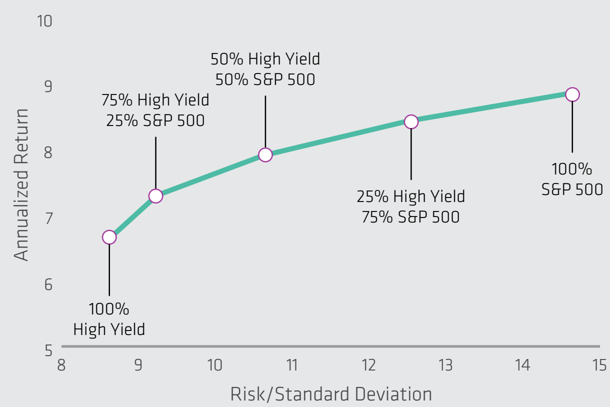
Let's look at the numbers. As mentioned earlier, the S&P 500 produced an 8.58% annualized return from January 1994 through March 2020, with annualized risk of 14.68%. A portfolio with a mix of 75% stocks and 25% high-yield bonds, on the other hand, would have lowered annualized risk to 12.50%, with a return of 8.42% (*Display 4*).

REBALANCING IN THE "TAILS"

How is this result possible? The answer has a lot to do with portfolio rebalancing. Because stocks have generally been so much more volatile than high yield has, periodic 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.

Over the same time period referred to in the earlier example, investors could have split their portfolios 50/50 between stocks and high yield. This mix—also rebalanced periodically—would have reduced volatility from 14.68% to 10.62%, while still delivering a strong return of 7.9%.

DISPLAY 4: HYPOTHETICAL ANNUALIZED RISK AND RETURN, JANUARY 1994–MARCH 2020 (PERCENT)



Diversification does not eliminate the risk of loss. Past performance is not a guarantee of future results. Individuals cannot invest directly in an index.
High yield is represented by the Bloomberg Barclays US Corporate High Yield.
Equities are represented by the S&P 500.
As of March 31, 2020
Source: Bloomberg Barclays, S&P and AB

IS THE HIGH-YIELD STORY 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, remains a growing market.

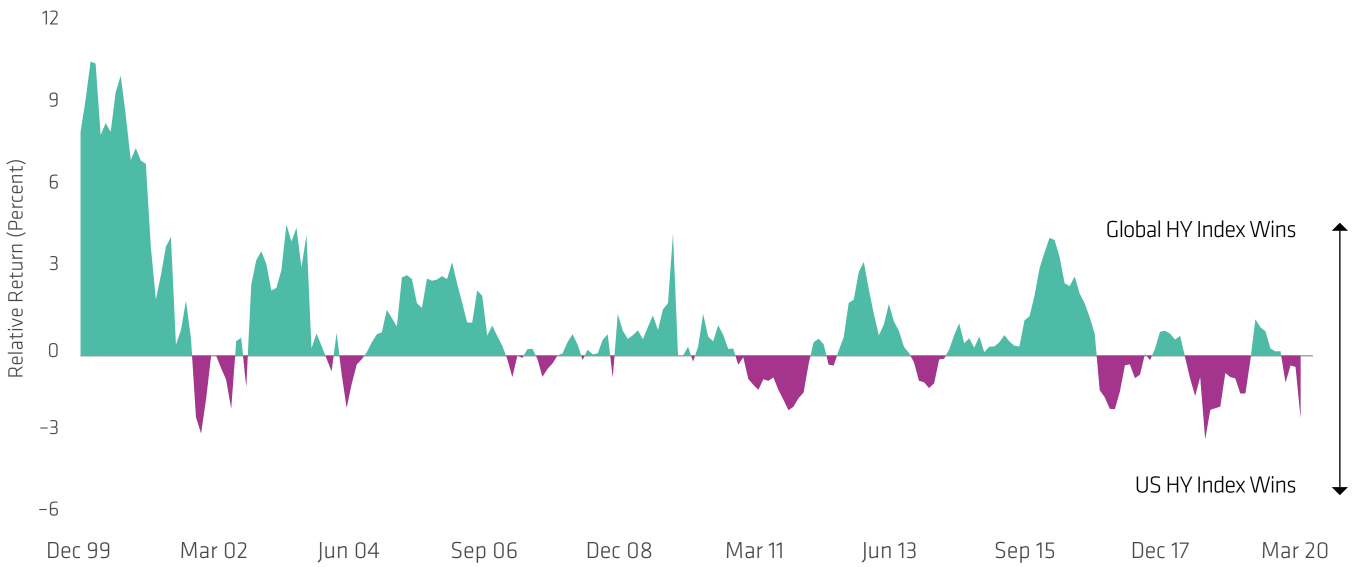
We believe that investors can access even greater diversification and flexibility in a high-yield allocation by investing across borders.

A global high-yield strategy including corporate bonds and emerging-market debt, with currency exposure hedged to the US dollar, has beaten a US corporate high-yield strategy more than 68% of the time (*Display*).

A global, multi-sector approach also provides greater flexibility in optimizing a high-yield allocation.

GLOBALIZING YOUR EXPOSURE CAN GENERATE ADDITIONAL ALPHA

Global High Yield (Hedged) Beats US High Yield ~68% of the Time (Using Trailing 12-Month Periods)



Past performance and current analysis do not guarantee future results.

Global high yield (hedged) is represented by the Bloomberg Barclays Global High Yield (USD hedged); US high yield is represented by the Bloomberg Barclays US Corporate High Yield.

Alpha, often considered the active return on an investment, gauges the performance of an investment against the market and is used as a measure of manager skill.

From December 1999 through March 2020

Source: Bloomberg Barclays, Morningstar Direct and AB

THE (INEVITABLE) BUMP IN THE ROAD

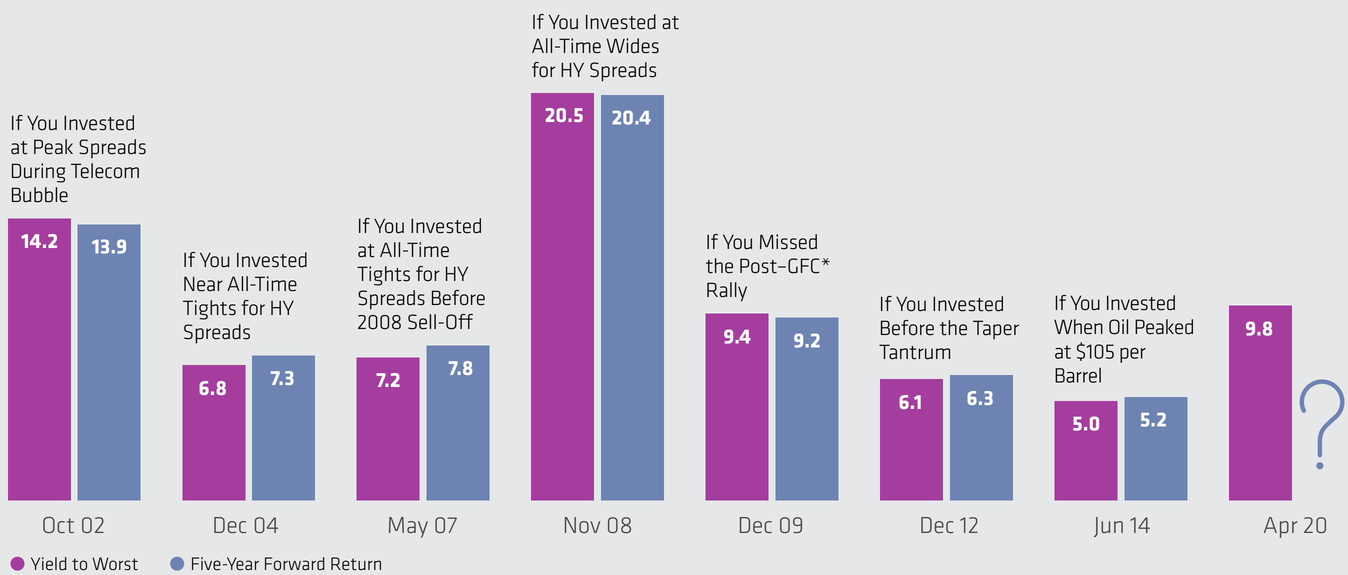
As with every investment, even an impressive long-run track record doesn't mean high-yield bonds are immune from hard times. Meaningful corrections aren't unusual in US high yield, and sometimes sell-offs cut much deeper, as we saw during the global financial crisis and the 2020 risk-asset sell-off driven by coronavirus-related shutdowns.

When the economy is weak, pressure on corporate bond issuers rises. The longer the economic downturn—or, as happened in early 2020, an outright shutdown—lasts, the deeper and more lasting the damage can be. As pressure on corporate bond issuers increases, downgrades and defaults rise, including fallen angels downgraded from BBB into the high-yield space.

Fallen angels can present buying opportunities: their prices tend to bounce back quickly after downgrades as new high-yield buyers step forward. But the key to prevailing through challenging markets is using fundamental research to identify issuers—whether fallen angels or original high-yield issuers—that are better positioned to endure times of stress.

Investors who do that successfully have the opportunity to capitalize on larger yield spreads, which in some cases may be more than enough to compensate for higher default and downgrade risk. As we've discussed, yields on high-yield bonds have historically been good indicators of subsequent returns (*Display 5*).

DISPLAY 5: YIELD HAS HISTORICALLY BEEN A STRONG PREDICTOR OF HIGH-YIELD RETURNS



Historical and current analyses and current forecasts do not guarantee future results.
US Corporate high yield is represented by the Bloomberg Barclays Global High Yield (USD hedged). Any benchmark or index cited herein is used for comparison purposes only. An investor cannot invest directly in an index. The unmanaged index performance does not reflect any fees and expenses associated with the active management of an AB portfolio. Yield to worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting.
*****Global financial crisis
As of April 3, 2020
Source: Bloomberg Barclays, Morningstar and AB

> A tactical approach to high-yield exposure may help de-risk an equity portfolio in volatile markets.

BEING TACTICAL: THE 525 RULE

The approach we've discussed so far is a static mix of stocks and bonds. Investors decide how much equity exposure they're comfortable shifting over to high-yield bonds, and they rebalance their portfolios each quarter to maintain that desired allocation over time.

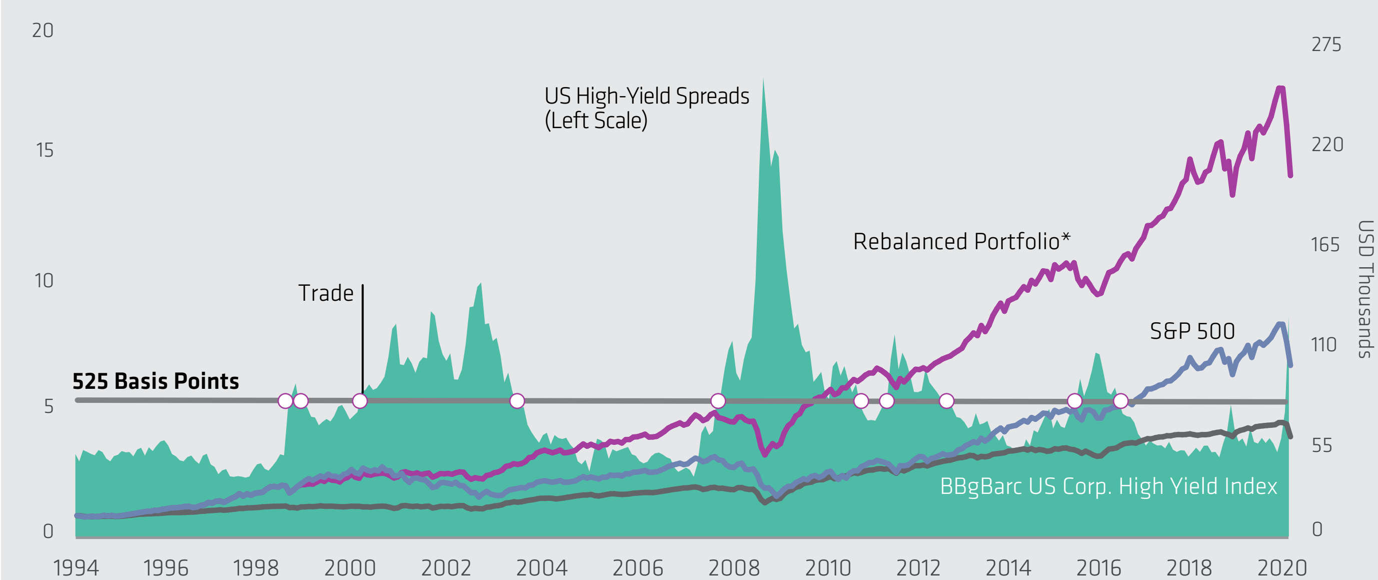
But our research suggests that a tactical approach to this mix may also help reduce portfolio risk without giving up too much return. The concept also involves shifting some equity exposure into high-yield bonds, but only when that decision is optimal based on how attractive high-yield valuations are. In other words, only when it's most worth the move.

Based on our analysis, average high-yield credit spreads have been a reliable signal over time. When we measured 12-month rolling returns between 1994—the first year Bloomberg Barclays provided option-adjusted spread data for the Bloomberg Barclays US Corporate High Yield Index—and the first quarter of 2020, we found that high yield beat equities when high-yield spreads were high.

How high should spreads be to consider adding high yield? To find out, we ran a hypothetical exercise to look at outcomes based on shifting from equities to high-yield bonds at different yield-spread levels between 1994 and March 2020. For simplicity's sake, we

DISPLAY 6: TACTICAL APPROACH—RESULT OF "RISKING DOWN"

Hypothetical Growth of US$10,000: January 1994–March 2020 (Percent)



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. The returns do not account for transaction fees, expenses or taxes.

US high-yield spreads are represented by option-adjusted spreads for the Bloomberg Barclays US High Yield Corporate.

* Tactically alternates between US high yield and S&P 500, based on a 525-basis-point 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 10 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 January 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; sold high yield and bought the S&P 500 on 10/1/2016.

Through March 31, 2020

Source: Bloomberg Barclays, S&P and AB

assumed an investor would shift the entire portfolio from equities into high yield when the time was right. In reality, investors would have only a certain percentage of their equity exposure shifted to high yield.

Of all the spread levels we looked at, 525 basis points seemed to be the best threshold for reallocation: the portfolio would move into high-yield bonds when yield spreads were over 525 basis points for two straight months, and then move back into stocks after spreads had spent two months below that level.

Investors 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 10 trades over the past 26 years or so (*Display 6, page 6*)—and spent roughly 35.9% of the time in high-yield bonds. By the end of that period, they would have seen returns of 12.02%, compared with 8.85% if they had stayed fully invested in the S&P 500 the entire time. The tactical allocation to high yield would have also reduced volatility to 12.21% from 14.68% for the all-equity portfolio. These 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 equity-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 equity exposure into high yield can lower risk without sacrificing much return.

THE BIG PICTURE

Whether it's a strategic asset allocation from equity to high yield or a tactical approach, investors' high-yield exposure should fit within a portfolio structure that makes sense based on their goals and risk tolerances. Allocations to equities, fixed income and other asset classes will vary.

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 fixed income to dampen the volatility of their equity portfolios, so they're reluctant to give their investment managers too much flexibility in allocating to below-investment-grade bonds. That's because high-yield bonds are among the most volatile fixed-income segments—though 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.

To sum things up, high-yield bonds are a compelling alternative for investors seeking to temper equity risk in their portfolios. They have strong risk-adjusted return potential and are complementary to both stocks and investment-grade bonds. Investors shouldn't stereotype high-yield bonds because they "look like bonds."

Our research suggests that high-yield bonds are a worthy replacement for part of a portfolio's equity exposure—or even as a standalone allocation distinct from stocks and bonds.

S&P 500 includes 500 US stocks and is a common representation of the performance of the overall US stock market. **Bloomberg Barclays US Corporate High Yield** 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. **Bloomberg Barclays High Yield 2% Issuer Constrained** 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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A WORD ABOUT RISK

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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