JUNE 2019

AllianceBernstein

Q&A – AB FINANCIAL CREDIT PORTFOLIO

CAPTURING EXCEPTIONAL INCOME OPPORTUNITIES

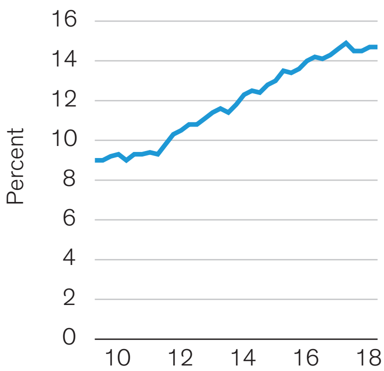
Investing in banks' subordinated debt such as Additional Tier 1 (also known as CoCos[1]) represents an attractive investment opportunity, but it comes with some specific risks. AllianceBernstein's (AB's) Financial Credit Portfolio (the Portfolio) gives investors access to this relatively complex asset class. Portfolio Manager **Jørgen Kjærsgaard**, Credit Research Analyst **Steve Hussey** and Quantitative Research Analyst **Sahil Khan** discuss the unique characteristics that have helped the Portfolio capture the upside risk whilst avoiding the pitfalls during its first full year.

Why do we think there is value in subordinated financials?

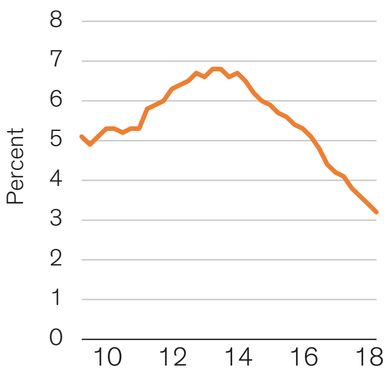
Steve: Since the Global Financial Crisis (GFC) banks have been forced by strict regulation to significantly build the quality and quantity of their equity capital bases, as well as cleaning up asset quality and improving the liquidity of their balance sheets (see display below). These improvements in credit fundamentals are the key reason supporting our positive view on subordinated bonds issued by financials. In essence, large equity capital bases provide a sizeable buffer between bondholders and potential loss absorption.

Strong Bank Fundamentals Following Multi-Years Of Deleveraging
Higher Capital, Lower Non-Performing Loans and Better Liquidity

Capital Adequacy Improving
Common Equity Tier 1 (CET1)



Asset Quality Improving
Non-Performing Loans (NPLs)



Liquidity Measure Improving
Liquidity Coverage Ratio (LCR: Minimum Requirement = 100%)

Historical analysis does not guarantee future results.
For Group 1 Banks. As defined by the European Banking Authority, Group 1 banks are those that have Tier 1 Capital in excess of 3€ billion and are internationally active.
As of 31 December 2018
Source: EBA Risk Dashboard

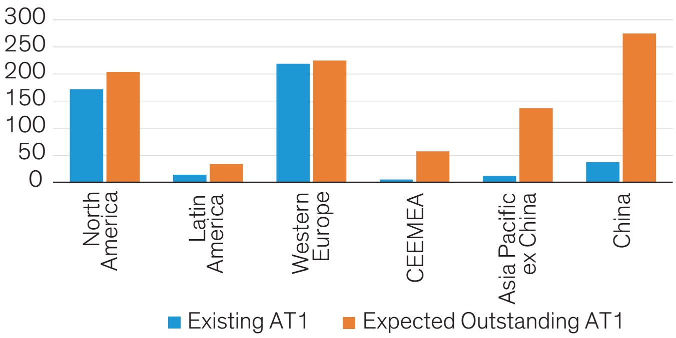
The Financial Credit Portfolio is a portfolio of AB SICAV I, an investment company with variable capital (société d'investissement à capital variable) incorporated with limited liability under the laws of the Grand Duchy of Luxembourg.

However, investing in banks' debt is not an easy task given the complexity of the capital structure, particularly in the most subordinated debt known as Additional Tier 1 (AT1), or in the jargon, "CoCos". We believe that this part of the capital structure is a particularly attractive opportunity, and it currently provides an average yield of around 5.5%*. But it needs to be considered carefully – it is important to review each issue's terms and conditions, as these can vary and are a key driver of how these bonds trade. This complexity provides an attractive opportunity to add value by specialist research and skilled security selection.

We have invested in Legacy Tier 1 (the fore-runner of the new AT1s) since 2000 and in AT1s since 2013 – the latter market has grown globally to over US$400bln in outstanding (see display below). In the current low-rate environment, there are very few relatively large and liquid markets that can provide comparable levels of income. In time, as the AT1 market matures, new issuance will reduce, repeat issuance will be commonplace, and these bonds will become more familiar to a wider investor base.

AT1 Market Size

USD Billions



Historical analysis does not guarantee future results.

N.B. Majority of Chinese bank requirement is expected to be met by domestic, local-currency issuance (on-shore)

As of 31 December 2017

Source: AB

How do we find the best relative value bonds to populate the Portfolio?

Jørgen: We consider a global opportunity set across all financials and across each issuer's capital structure, but our strategy is largely to stick to the higher quality issuers, where we can apply both in-depth fundamental and quantitative (quant) research—an approach we call 'dual advocacy'. We then apportion relatively higher weightings to what we consider the best structure and currency bond for each of these issuers.

We use a team approach in managing the Portfolio. Including a security in the portfolio is the result of extensive daily discussion between me and the broader PM team, Steve (and his global team of fundamental analysts) and Sahil, with input from our dedicated financial traders globally. Consistent with the AB investment approach, we combine fundamental and quant analysis. Given the complexity of AT1s, we have developed a dedicated quant AT1 model which allows us to determine relative value across and within AT1 issuers, and this gives us valuable insights into the overall tone of the AT1 market.

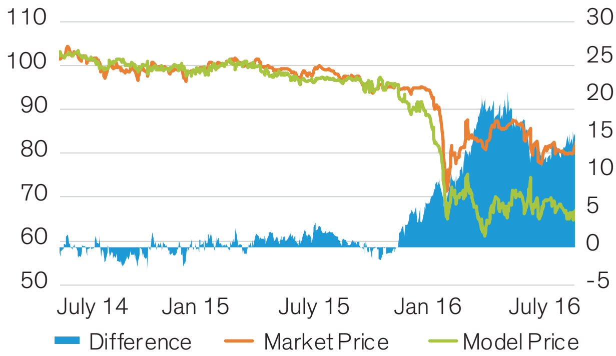
What is the role of quantitative research?

Sahil: AT1s are complex securities with credit, equity and volatility features that mean they can behave in very different ways depending on market conditions. It is therefore vital to understand how to appropriately price the different features and determine a fair value for these instruments and attribute what is driving their performance.

Our AT1 model went live in 2016 and predicted a steep fall in AT1 prices which had never occurred in this market before (display, below). We were able to identify the drivers of the sell-off, and so have an informed debate on which securities to select on any market rebound. We have continued to increase model coverage and look at innovative ways to leverage it further including better risk management.

Deutsche Bank USD 6.25% AT1 Bonds

Model predicted the price fall a month before it happened



Historical information provided for illustrative purpose only.

Past performance does not guarantee future results.

As of 4 October 2016

Source: Bloomberg and AB

Most risk models are not designed to tackle AT1s and do not correctly identify the risks inherent in these instruments. Our model allows us to create surfaces that price these instruments across moves in spreads, equity and volatility and therefore far better identify how the various types of negative convexity affect these assets.

***Past performance does not guarantee future results.**

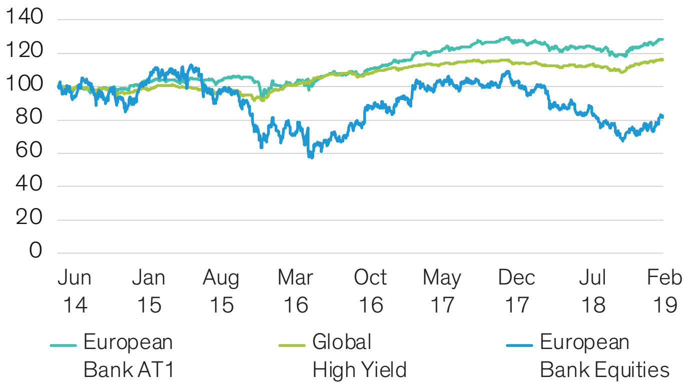
But even the best quant model has limitations. Each issuing bank is different, and each AT1 issue may have very specific features that can make a difference to its fair value. That's why we need our fundamental analysts to research the small print in the terms of each bond, and to understand the nuances of accounting and regulation across different countries. The dual advocacy approach is key to our fixed income process generally and is especially important in the financials' sector.

How does the fund fit within asset allocation?

Jørgen: We believe the Portfolio provides a compelling risk-return opportunity when viewed against both bank equities and corporate high-yield. We think AT1 securities have the return-generating properties of equity, but with a more stable return pattern. Within the financial sector, they can be a good diversifier from existing holdings in banks' stocks and a means of de-risking equity exposure. The benefits include lower volatility (6-8% versus 25% for AT1s and banks' stocks respectively), shallower drawdowns, steady cashflow and potentially higher returns. In fact, since the launch of the AT1 market, those securities have outperformed bank equity on a cumulative basis by almost 50%[2]—a startling difference—and have outperformed global high yield by almost 13% (Display, below).

Who Said Equities Always Provide Higher Returns Than Fixed Income?

European Bank AT1 vs. European Bank Equity (Euro returns)*



Past performance does not guarantee future results.
* Cumulative returns since the launch of Bloomberg Barclays European Banks AT1
As of 31 March 2019
Source: Bloomberg Barclays, Bloomberg, AB

We expect this trend to persist, as European banks continue to struggle to improve profitability given the low rates, flat yield curve and low growth environment in Europe. This is the main reason for the underperformance of banks' equity over the last few years. On the other hand, bank bonds, including AT1s, have performed well due to stronger and more liquid balance sheets with higher capital and better asset quality. AT1s also represent an alternative to high-yield corporates, without sacrificing yields. In fact, our portfolio is mainly split between BBB investment-grade and BB high-yield issues, but with yields that are more akin to lower-quality single-B and CCC type high-yield corporate issuers.

[1] AT1 securities are designed to provide an additional capital buffer to improve banks' solvency. These bonds are a category of Contingent Convertibles (CoCos)—a more complex type of bond which converts to equity or is written down should a pre-specified trigger event occur. The risk of investing in these types of instruments is that the holders of CoCos will suffer losses ahead of other equity investors and may not receive the return of their investment. The generic term 'AT1s' is generally used to refer to CoCos that are classified as Additional Tier 1 capital under the Basel III rules.

[2] Cumulative returns since the launch of Bloomberg Barclays European Banks AT1 Index through 30 April 2019

Jørgen Kjærsgaard

Jørgen Kjærsgaard is Senior Vice President, Co-Head of European Fixed Income and Director of European and Global Credit. Prior to joining AB in 2007, he was executive director for Structured Credit Solutions at Rabobank.

Steve Hussey

Steve Hussey is a Senior Vice President and Head of Financial Institutions Credit Research globally. He is also responsible for analyzing European banks and investment banks within this group. Before joining the firm in 2000, Hussey spent six years at credit rating agency Fitch IBCA, where he was a director, responsible for the Spanish and Latin American banking sectors.

Sahil Khan

Sahil Khan is a Quantitative Analyst on AB's Fixed Income Investments team. Prior to joining the firm in 2015, he ran the Quant team at ECM Asset Management, a boutique European credit manager. Khan started his career at Baring Asset Management, where he conducted quant analysis for the Fixed Income team and Emerging Market Equities.