



# BOND REBOOT

Remaking Your  
Fixed-Income Strategy

+ **IN FIXED-INCOME MARKETS,  
TIMES ARE CHANGING.**

Douglas J. Peebles

+ **YES TO GLOBAL. NO TO CURRENCY.**

Scott DiMaggio, CFA

+ **BREAKING DOWN HIGH-INCOME  
BORDERS**

Gershon M. Distenfeld, CFA

+ **MANAGE RISING RATES. BENCH  
YOUR BENCHMARK.**

Michael L. Mon, CFA



**WAITING—AND WAITING  
—FOR RISING RATES**

Paul DeNoon

**AFTER A LONG BULL  
MARKET FOR BONDS,  
HOW CAN FIXED-  
INCOME INVESTORS  
KEEP THEIR PORTFOLIOS  
AHEAD OF THE CURVE?**



# IN FIXED-INCOME MARKETS, TIMES ARE CHANGING.

Douglas J. Peebles | Chief Investment Officer and Head of AB Fixed Income

US interest rates are more likely to head up than down over the next few years. But nobody's quite sure what their path will be. How should fixed-income investors approach their bond exposure?

A 30-year decline in interest rates has driven strong bonds performance. Today, there simply aren't many broad areas of the market that are still cheap. Official short-term rates are expected to start rising in the US this year, and could go as high as 4% by the end of 2017. That's actually a "slow and steady" pace.

We expect to see some volatility as the US Federal Reserve engineers a path toward "normalization." Bond performance, particularly for high-quality bonds, is likely to be relatively modest. But we don't think this means a major bond sell-off like the ones investors saw back in 1981 and 1994.

In fact, rising rates can be beneficial for investors. The market learned that lesson in 2014, when what was feared to be a bond market sell-off ended up producing a solid year for core bond portfolios. But there are new risks to manage as well. Corporate bond markets are becoming less liquid, so market activity tends to dry up during times of stress.

The need to manage this "liquidity risk" has grown—but so has the opportunity to capitalize on it in stressed areas of the market. This has implications for the way portfolios are built—and run: enhanced trading capabilities, more flexible and diverse strategies, and risk/return assessments that consider the possibility of periods of illiquidity.

So what should investors consider to get their portfolios ready for a bond market reboot?

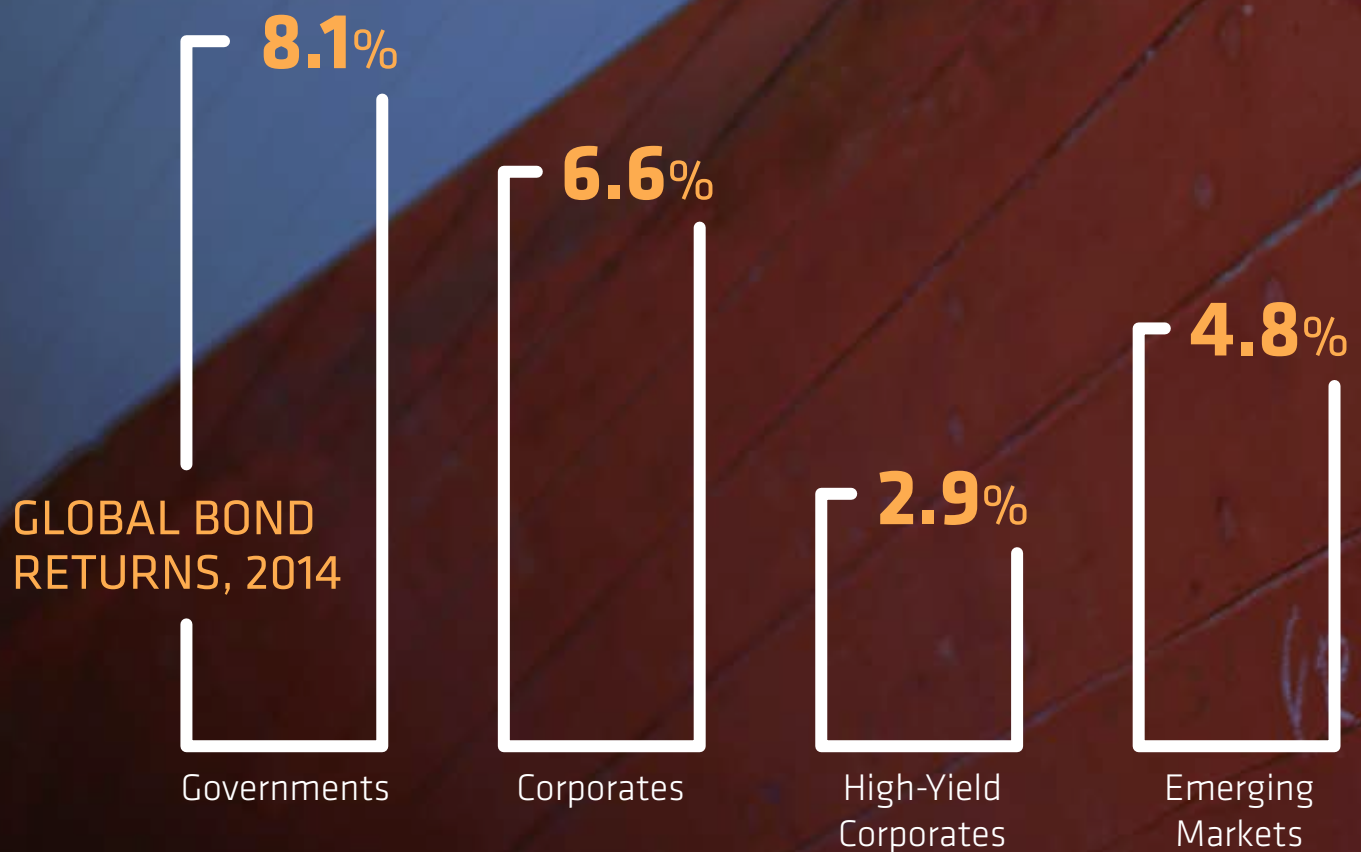
**Go Global.** The US isn't the only game in town: its economic and interest-rate cycles don't define what's happening in other countries. Because these patterns vary over time, we believe that including some global bond exposure can diversify interest-rate risk. It can also offer the opportunity to boost returns by picking winners and avoiding losers. But exposure to a variety of global currencies has increased the volatility of bond portfolios, so we think that hedging currency risk is the way to go.

**Diversify.** Credit exposure has historically provided insulation against rising rates. Rates are often driven higher by strong economic growth, and strong growth means better business conditions for corporate bond issuers. But some areas of the market are downright expensive, and periods of illiquidity can occur. We think it's best to diversify broadly across credit segments. This may improve diversification, and a little selectivity might capture attractive income-generating opportunities.

**Get Flexible.** An unconstrained bond strategy isn't bound by traditional broad-market benchmarks. This type of fixed-income strategy can be more nimble in accessing pockets of illiquidity opportunity in the market—and is flexible enough to dynamically balance different bond risks.



Panic about rising rates was misplaced in 2014, and investors who stayed on the sidelines missed out on a pretty good year for bonds. We think that rising rates can be an opportunity. They bring the potential for more income, and aspects like “roll” can potentially add to returns when long-term yields are much higher than short-term yields.



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

As of December 31, 2014

Governments: Barclays Global Treasury Index; Corporates: Barclays Global Credit-Corporate; High-Yield Corporates: Barclays Global High-Yield Corporate; Emerging Markets: Barclays EM USD Aggregate. An investor cannot invest directly in an index, and its performance does not reflect the performance of any AB portfolio. 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.

Source: Barclays and AB



# WAITING—AND WAITING— FOR RISING RATES

Paul DeNoon | Director, Emerging-Market Debt

Investors who feared rising rates in 2014 may have been out of position for what turned out to be a solid year for bonds. Even though rates will eventually go up, we don't think it's something to fear.

In late 2013, the 10-year US Treasury yield hit 3%, spooking investors who thought the bond bubble was on the verge of bursting. Prognosticators urged investors to abandon bonds. And then—they waited. Those who stayed underweight in bonds and waited it out in 2014 were left largely empty-handed, while core bond investors earned a respectable 4%.<sup>1</sup>

## **NOTHING TO FEAR—AND SOMETHING TO GAIN**

The lesson: bonds and rising rates shouldn't be feared, and investors who are thoughtful when it comes to their fixed-income allocation may be able to do just fine—even when bond yields do rise.

For most investors, especially those who need income, rising rates—and bond yields—can be a good thing. The value of higher yields is realized gradually—that's where investors make money in fixed income. Bond portfolios are unlikely to suffer the way some headlines would have us think, and investors will likely see positive returns over time even if rates do rise.

There are further advantages to rising rates. When the yield curve is steep—in other words, when long-term yields are quite a bit higher than short-term yields—yield-curve “roll” can cushion the impact of rising rates and falling bond prices. Roll is the tendency of a bond's price to increase as it moves closer to maturity, all other things being equal.

And as long as your portfolio's duration (interest-rate sensitivity, expressed in years) is shorter than your investing horizon, rising rates could boost your total return over time. Bondholders can especially benefit if rates rise by less than what's reflected in market expectations.

## **DOES IT PAY TO WAIT?**

No one knows for sure what path of future will take. Our advice is to stop paying attention to day-to-day movements in prices and waiting for rates to rise. Investors who do that will miss the big picture. Sticking to long-term asset-allocation goals is key. You may or may not know when you'll see higher yields or how quickly they'll go up, but it will not be such a bad thing if it happens.

<sup>1</sup> The Barclays US Aggregate Bond Index was up 0.8% year to date through May 27, 2015.

# YES TO GLOBAL. NO TO CURRENCY.

Scott DiMaggio, CFA | Director, Global Fixed Income

We think this is a good time for investors to reposition their core bond allocations into a global strategy. A currency-hedged approach may be a way to reduce unwanted currency exposure.

Bond investors tend to have a strong “home country bias”—a preference for owning domestic bonds over foreign bonds. This happens most often in core bond portfolios, which aim to provide stability and income by focusing on investment-grade bonds and holding a healthy share of government bonds.

But our research suggests that global bonds have delivered returns on par with domestic bonds—with less volatility. What’s more, global exposure allows investors to diversify interest-rate and economic risk. That’s important today, with business cycles, economic growth, monetary policies and yield curves around the world marching to their own drums.

Bonds typically provide two main sources of return: income (from coupon payments) and price changes (from capital gains or losses). Most of a bond’s return comes from income, which is relatively stable. Price changes provide a smaller contribution, because unlike equities, bonds have limited upside; eventually, they all mature at their face value.

Global bonds have a third return source: currency exposure. Many investors decide to keep their currency exposure, hoping it’ll boost returns over the long run. They also assume that the combination of multiple return sources—income, price and currency—will reduce their overall risk. Some investors simply assume that hedging to reduce or eliminate currency exposure is too costly.

As it turns out, none of these assumptions is correct.

Currency hedging can be done effectively and cheaply. And over long periods, the returns of hedged and unhedged bond portfolios have run virtually neck and neck. Between 1994 and 2014, a US dollar–hedged global bond portfolio, represented by the Barclays Global Aggregate, generated 6.3% annualized versus 5.7% annualized for its unhedged counterpart.

Most surprisingly, currency exposure didn’t reduce overall volatility. Currency-hedged global bonds have consistently been far less volatile than unhedged global bonds, and even less volatile than US bonds—thanks to the benefits of economic-cycle diversification. So, currency exposure has made no contribution to unhedged global bond returns over the past decade, but it has contributed an astonishing three-fifths of overall volatility.

Currency alone is about twice as risky as fixed income. It may make sense to opportunistically take on currency risk in some global bond strategies, but core investors looking to bonds as a source of stability will likely find a hedged global bond portfolio to be a better fit.

A global approach also offers protection when US bonds stumble. We reviewed quarterly returns between 1990 and 2014: when the Barclays US Aggregate Bond Index was positive, it returned 5.8% on average. The Barclays Global Aggregate Bond Index (Hedged) performed nearly as well, capturing 95% of those gains. We call this the “up capture.”

The “down capture” was a different story. When the Barclays US Aggregate was

negative, the hedged Global Aggregate was also negative. But the global “down capture” was just 67%. In other words, the hedged global strategy captured nearly all the returns of the Barclays US Aggregate during positive quarters, but suffered only about two-thirds of the average quarterly loss.

Over the years, investors who shifted away from the US and toward other countries where rates were rising more slowly, or falling, preserved more of their capital. That may be worth keeping in mind if, as expected, the US Fed is one of the first developed-market central banks to start raising policy rates this year. We think this is a great time to consider going global.



CONSIDER:

**AB GLOBAL BOND FUND**  
(ANAYX)

OVERALL MORNINGSTAR RATING™  
Advisor Shares

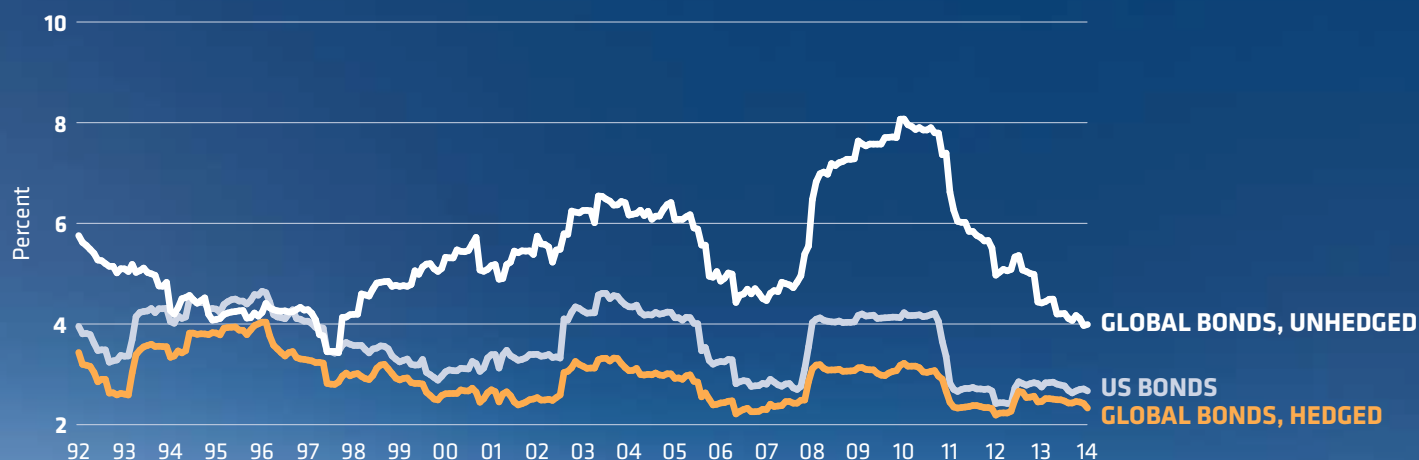


Rated Against 316 World Bond Funds  
Based on Risk-Adjusted Performance  
as of 9/30/15



## A HEDGED GLOBAL APPROACH HAS HISTORICALLY OFFERED BETTER RISK-ADJUSTED RETURNS

3 YEARS ENDING DECEMBER 31, 2014



**Historical analysis does not guarantee future results.**

Through December 31, 2014

Global bonds (unhedged) are represented by Barclays Global Aggregate USD Unhedged. US bonds are represented by Barclays US Aggregate. Global bonds (hedged) are represented by Barclays Global Aggregate USD Global Aggregate USD Hedged. 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.

Source: Barclays and AB



# BREAKING DOWN HIGH-INCOME BORDERS

Gershon M. Distenfeld, CFA | Director, High Yield

Many investors want new ways to get more income. We don't think diving into riskier credits is the answer. Instead, consider moving beyond traditional boundaries—both geographical and credit quality.

European and Asian high-yield investors are accustomed to taking a global view with their high-yield allocations. The fact that the US high-yield market developed first—and was for many years the dominant issuing region—explains some of this global perspective. In contrast, US high-yield investors tend to stick close to home.

But in recent years Asia, Europe and emerging regions have seen their high-yield issuance expand, diversify and become more liquid. The result? US investors may benefit from looking further afield than they have in the past.

Fifteen years ago, less than 1% of the corporate high-yield market was issued outside the US. Today, US-only investors are cutting themselves off from nearly a third of the high-yield market. Those willing to reach across borders (and able to do in-depth research in other regions) can often find opportunities in developed and emerging markets. These bonds can have credit ratings that are equal to or better than those of home-field issuers, with higher yields and higher

potential returns. What's not to like about that?

## CROSSING THE INVESTMENT-GRADE BORDER

We think some of the best ideas for high-yield investors in all regions right now may be outside the traditional high-yield credit-rating zone. The way we see it, there's no unbreachable wall between investment-grade and high-yield securities. It's a continuum, and in all three of the major issuing regions there are numerous BBB and split-rated issuers with yields comparable to their lower-rated cousins.

So, investors shouldn't fence in their high-yield allocation. One option is to invest part of a longer-maturity high-yield allocation in BBB-rated and split-rated bonds, and focus intermediate- and shorter-maturity exposures in issues rated BB and lower. In our view, this may make a portfolio better able to weather a downgrade along the way. It might also allow a portfolio to benefit from a rising star, because some split-rated bonds could be headed for a passport out of the high-yield universe.

## DON'T BE A YIELD HERO

By diversifying across regions and selectively moving up in credit, there's no need to pursue higher yields simply by chasing highly speculative credits.

Tight markets bait investors into taking bad risks, and we're beginning to see this occur as a stream of investors reach down into CCC-rated bonds and so-called covenant-lite bank loans. While opportunities do exist for investors who research and monitor these issuers carefully, overall we don't think these segments compensate investors for their risks.

With so many opportunities to diversify and find strong securities globally and to reach up and find value in investment-grade bonds, we don't think there's any need for high-yield investors to be yield heroes.



CONSIDER:

### AB HIGH INCOME FUND (AGDYX)

OVERALL MORNINGSTAR RATING™  
Advisor Shares

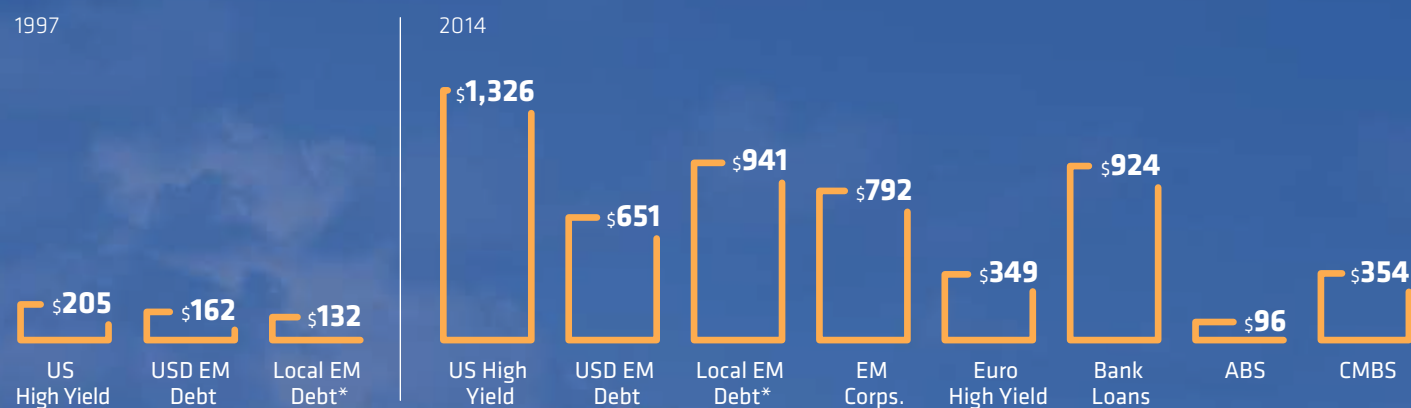


Rated Against 225 Multisector Bond Funds Based on Risk-Adjusted Performance as of 9/30/15



## HIGH-YIELD MARKETS EVOLVE

GLOBAL HIGH-YIELD MARKET (USD BILLIONS)



Historical information provided for illustrative purposes only.

As of December 31, 2014

\*1997 Local EM Debt is represented by J.P. Morgan ELMI Plus; In 2014 Local EM Debt is represented by J.P. Morgan GBI-EM Global

US High Yield is represented by Barclays US Corporate High Yield; USD EM Debt by J.P. Morgan EMBI Global; EM Corps. by J.P. Morgan CEMBI Broad; Euro High-Yield by Barclays Pan-European High Yield; Bank Loans by Credit Suisse Leveraged Loan; ABS by Barclays US ABS; CMBS by Barclays US CMBS. An investor cannot invest directly in an index or average, and neither includes the sales charges or operating expenses associated with an investment in a mutual fund, which would reduce total returns.

Source: Barclays, Credit Suisse, J.P. Morgan and AB





# MANAGE RISING RATES. BENCH YOUR BENCHMARK.

Michael L. Mon, CFA | Portfolio Manager, Fixed Income

The risks of benchmark-oriented bond portfolios are becoming more apparent today. It may be time to “bench” the benchmark and consider more flexible, unconstrained approaches.

Benchmarked investing worked well enough when interest rates were declining, providing a major tailwind to bond returns. But bond indices were never good model portfolios, and their flaws can pose a major risk today.

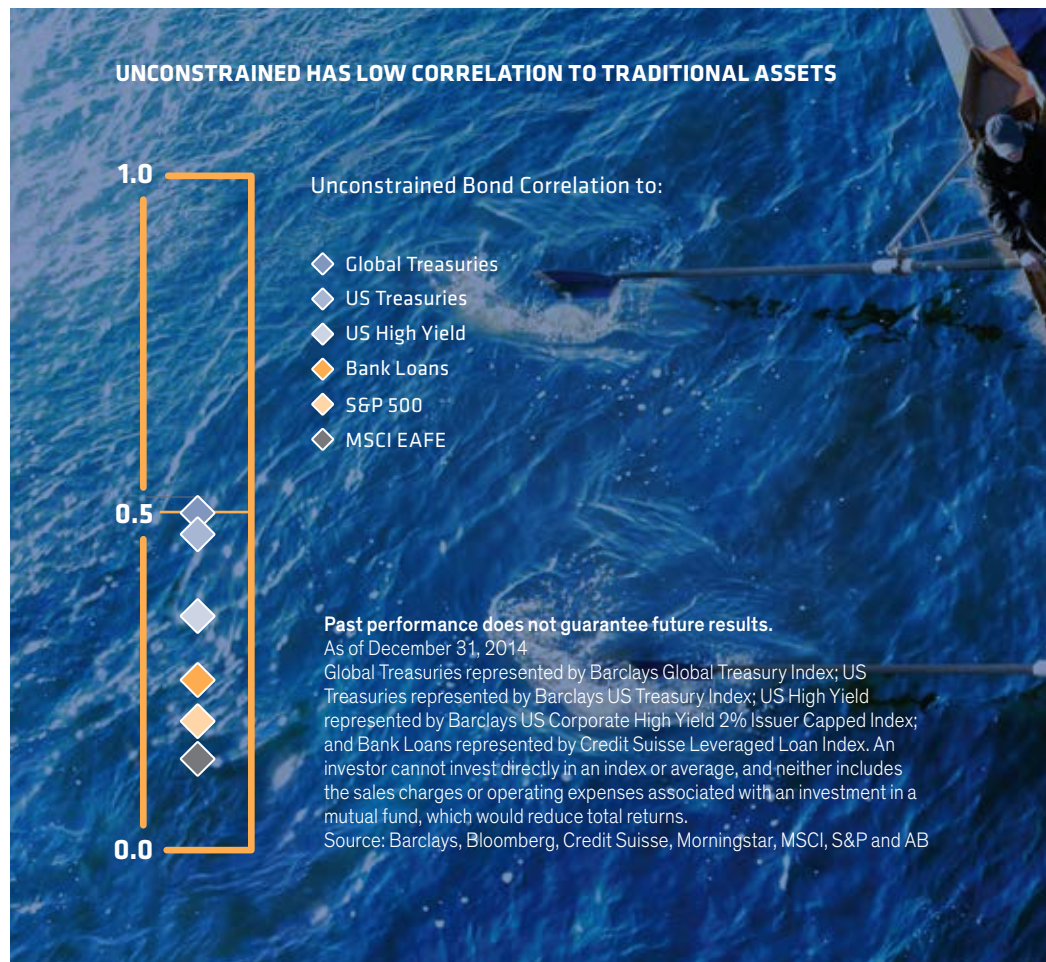
One challenge is rising interest-rate risk—the duration of the Barclays Global Aggregate Index has risen from 5.1 to 6.5 years in the past decade, and US bond indices have seen a similar climb. That's a big jump in interest-rate sensitivity, which may not be a good fit for bearish investors.

Another issue is that bond indices are weighted by market capitalization: if an issuer churns out more debt, it becomes a bigger part of the index. Benchmarked investors are obligated to buy more debt from an issuer that they should arguably be avoiding. Compounding these problems, many indices are bloated with government bonds, which have some of the lowest yields in the market.

Not surprisingly, many bond investors are moving to an unconstrained approach, which seeks to provide a positive return in a wide range of market conditions. There are a few ways that unconstrained portfolios can go where benchmark-driven investing can't, as discussed below.

## Toning Down Interest-Rate Risk:

Benchmark-based portfolios generally aren't very aggressive in managing duration to control interest-rate risk. This was clear in the mid-2014 bond sell-off. From May through July of that year, the Barclays US Aggregate Index lost 3.2%. Over the same period, only 26% of intermediate-term investment-grade managers beat that index.



Of course, intermediate-term bonds have historically gone on to rebound from rising rates, but unconstrained portfolios offer a different path that doesn't track an index. This can mean more room to manage duration risk. As a result, 83% of unconstrained bond managers beat the US Aggregate during that challenging period. (The categories measured were the Lipper Intermediate Investment-Grade Bond peer universe and members of the

Lipper Absolute Return peer universe that contain the words “Unconstrained Bond” in their names.)

**Improving Flexibility:** Benchmark-based investors can be limited in their ability to underweight certain investments, because the lowest they can go is zero. Take countries, for example. If a country has a large enough weighting, the ability to go to zero can make a difference. But for



countries with small weights, going to zero may not move the needle much.

Unconstrained strategies with a strong negative view on a small country can take a short position (sell a bond the portfolio does not own), which would benefit when the country's bonds do poorly. This flexibility is important: 15 out of the 22 local bond markets in the Barclay's Global Aggregate (as categorized by the currency

of issuance) each comprise less than 1% of the index. Shorting securities has risks if the price rises, of course, but the upward price movement of bonds has been somewhat restricted because of their structure.

#### **Unlocking Value in a Low-Value World:**

Making a call on the direction of interest rates is only one aspect of bond investing—and it's challenging to get it right. But what if you could express a strong view without adding duration to a portfolio? Suppose the price relationship between two countries becomes skewed. Unconstrained portfolios can exploit these discrepancies by buying one country and selling another at the same time—called a long/short trade. This has the potential to add value without bumping up interest-rate risk. This idea can be extended to sector and yield-curve opportunities, too.

There are many other strategies in unconstrained bond investing, but the common themes are flexibility and the effort to add value rather than look like the benchmark. However, unconstrained investing should still have responsible limits for managing portfolio risk. Among these are issuer concentration rules, limits on low-quality bonds and volatility targets.

With so many strikes against benchmarking, it's easy to see why investors are seeking more creative ways to invest in bonds. With the long-running bull market for bonds likely over and broad market indices showing their flaws, it may be time to consider having benchmarked investing to sit this period out.



CONSIDER:

#### **AB UNCONSTRAINED BOND FUND (AGSIX)**

Advisor Shares



Rated Against 240 Nontraditional Bond Funds Based on Risk-Adjusted Performance as of 9/30/15

#### **AB CREDIT LONG/SHORT PORTFOLIO (ALYSX)**



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The Overall Morningstar Rating for a fund is derived from a weighted average of the performance figures associated with its three-, five- and 10-year (if applicable) Morningstar Rating metrics. For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating™ based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) Morningstar Rating is for the Advisor share class only; other classes may have different performance characteristics.

Global Bond Fund was rated 4, 4 and 4 against 316, 236 and 137 funds in the category for the 3-, 5- and 10-year periods, respectively. High Income Fund was rated 5 and 5 against 225 and 169 funds in the category, for the 3- and 5-year periods, respectively. Unconstrained Bond Fund was rated 3, 4 and 4 against 240, 144 and 49 funds in the category, for the 3-, 5- and 10-year periods, respectively.

**Risks to Consider—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:** Fixed-income securities may lose value if interest rates rise or fall—long-term securities tend to rise and fall more than short-term securities. The values of mortgage-related and asset-backed securities are particularly sensitive to changes in interest rates due to prepayment risk. **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:** Investing in non-US securities may be more volatile because of political, regulatory, market and economic uncertainties associated with such securities. These risks are magnified in securities of emerging or developing markets. **Currency Risk:** If a non-US security's trading currency weakens versus the US dollar, its value may be negatively affected when translated back into US-dollar terms. **Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than investing in 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—magnifying both gains and losses, resulting in greater volatility. **Below-Investment-Grade 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.

**Investors should consider the investment objectives, risks, charges and expenses of the Fund/Portfolio carefully before investing. For copies of our prospectus or summary prospectus, which contain this and other information, visit us online at [www.abglobal.com](http://www.abglobal.com) or contact your AB representative. Please read the prospectus and/or summary prospectus carefully before investing.**

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