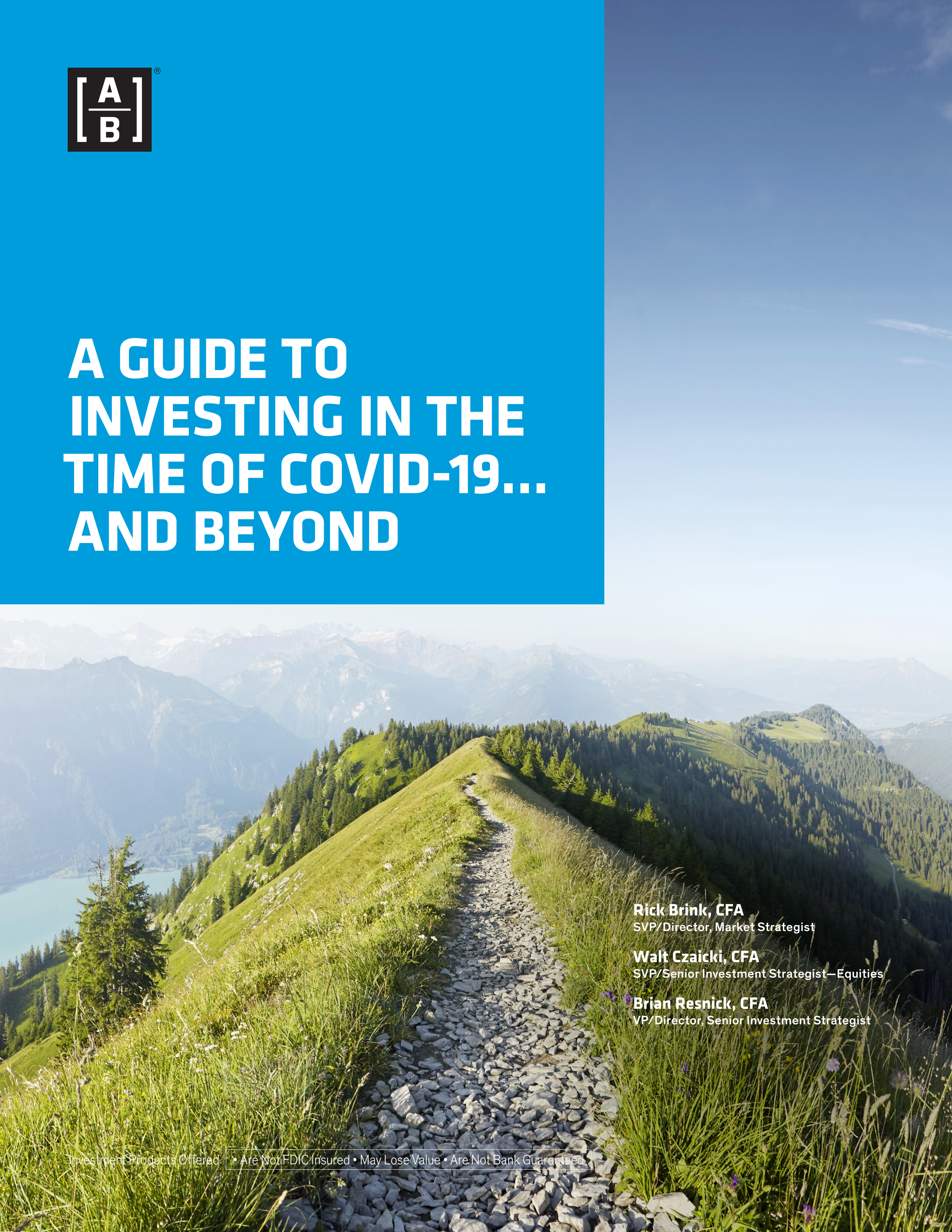
# A GUIDE TO INVESTING IN THE TIME OF COVID-19... AND BEYOND

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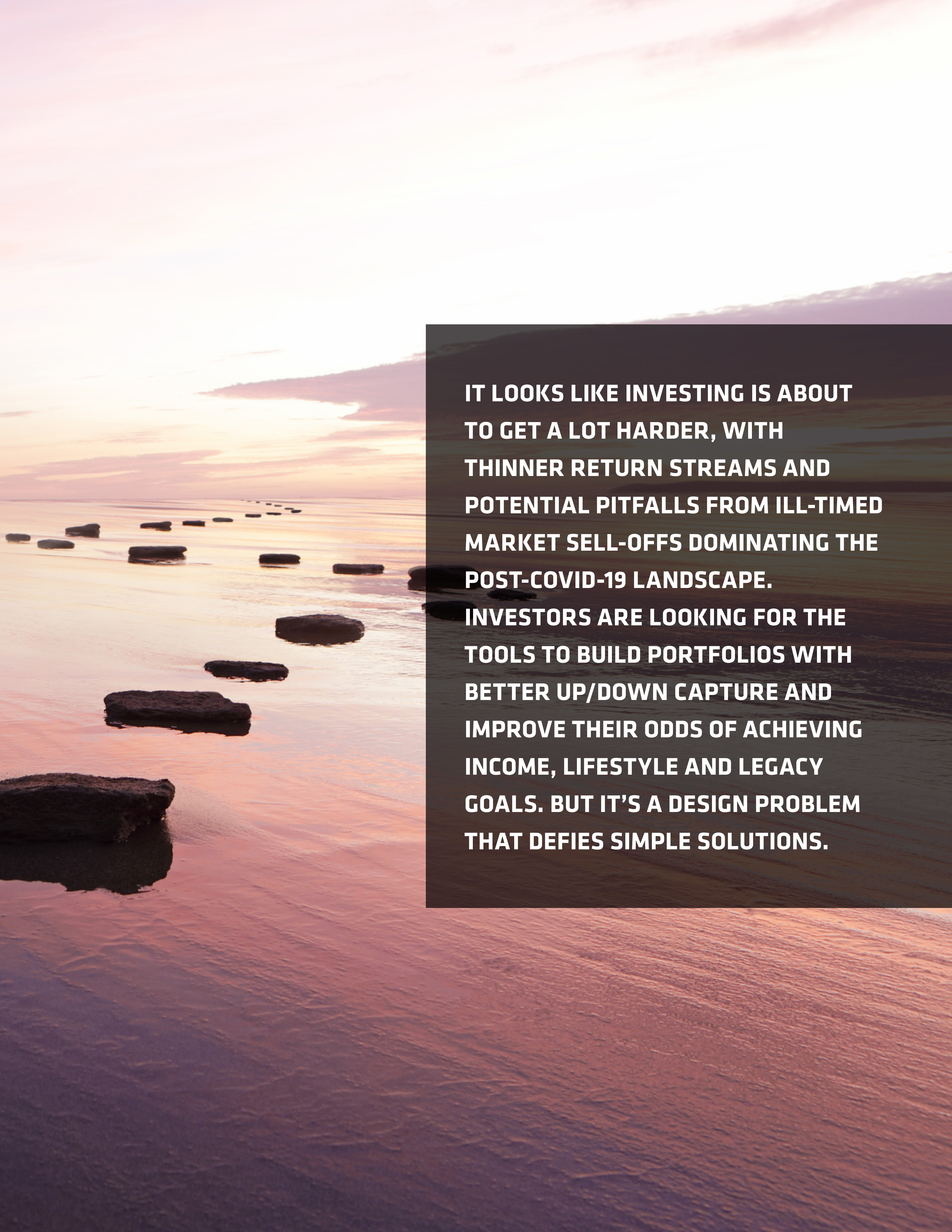


**IT LOOKS LIKE INVESTING IS ABOUT TO GET A LOT HARDER, WITH THINNER RETURN STREAMS AND POTENTIAL PITFALLS FROM ILL-TIMED MARKET SELL-OFFS DOMINATING THE POST-COVID-19 LANDSCAPE. INVESTORS ARE LOOKING FOR THE TOOLS TO BUILD PORTFOLIOS WITH BETTER UP/DOWN CAPTURE AND IMPROVE THEIR ODDS OF ACHIEVING INCOME, LIFESTYLE AND LEGACY GOALS. BUT IT'S A DESIGN PROBLEM THAT DEFIES SIMPLE SOLUTIONS.**

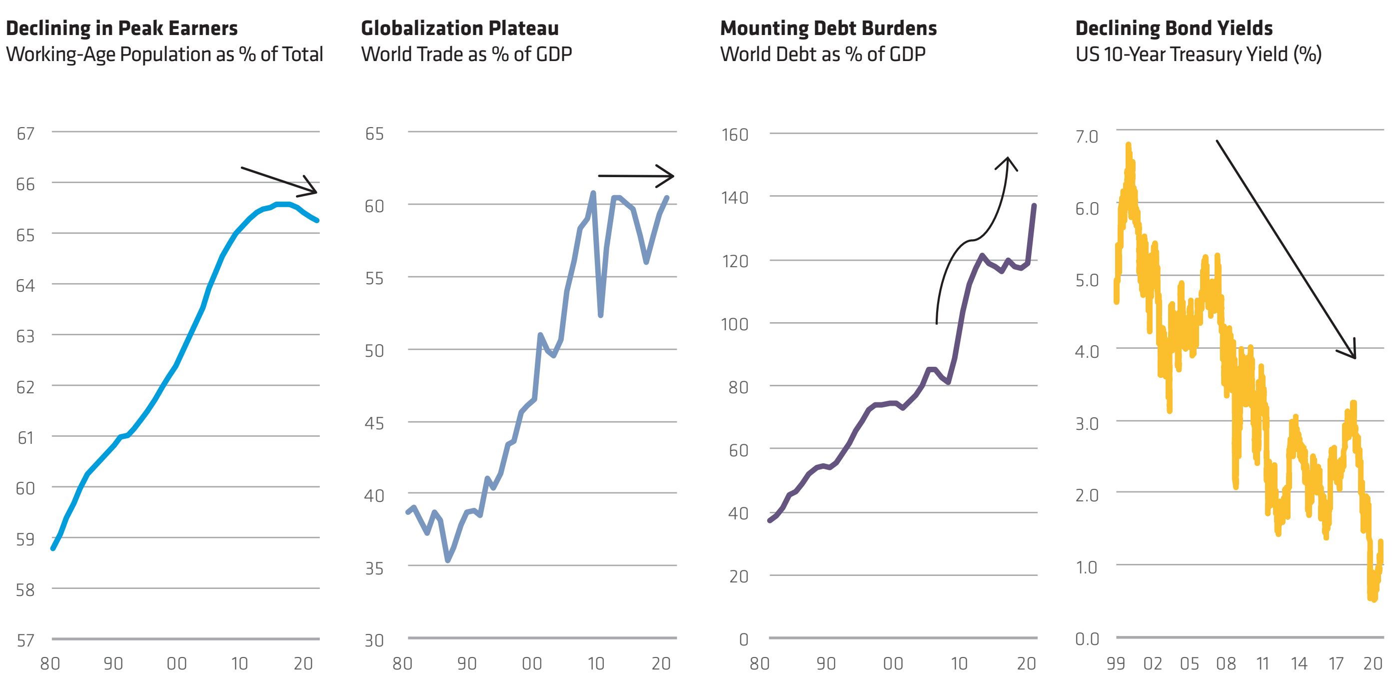
# THE INVESTMENT LANDSCAPE AT A CROSSROADS

As the public-health battle against COVID-19 continues, markets have climbed back from their early 2020 depths and the global economy is rebounding—though full recovery won't come until the pandemic is largely in the rearview mirror. Unfortunately for investors, outsize market returns will likely be in that rearview mirror too.

Since 2000, decades-long market tailwinds have been steadily fading (*Display 1*), and economic growth has faded as well. Peak-earning baby boomers have been moving into retirement. Resurging populism has dampened enthusiasm for globalization. Government debt has mounted. And US Treasury yields have fallen to near-historic lows, reducing income potential and support for expanding equity valuations.

What's kept markets going as the momentum has faded? The driver has been massive fiscal and monetary policy support, whether it was expanding debt and leverage in the decade between the tech bubble and the global financial crisis; central bank easy-money policy, driving a long "great beta trade"; Trump tax cuts; or, most recently, massive pandemic relief measures. In the limited periods when stimulus was less robust, capital-market returns have been modest.

**DISPLAY 1: CAPITAL-MARKET TAILWINDS HAVE BEEN FADING**




**Past performance and current analysis do not guarantee future results. For illustrative purposes only.**
Through November 30, 2020
Source: Bloomberg, Federal Reserve Economic Data, Haver Analytics, US Department of Labor, US Department of the Treasury, World Trade Organization and AB

## CHAPTER ONE: INVESTING IN THE TIME OF COVID-19

Against the backdrop of the gradual economic recovery and abundant stimulus, and despite the healthy market gains already seen, investors can still wring some value out of the uncertainty premium surrounding the path back from COVID-19. Continued progress in vaccine distribution is allowing economies to reopen, mobility to improve and economic activity to broaden.

For investors in this "time of COVID-19," more risk-asset gains are still possible, particularly in credit and through selective equity positioning. At a high level, we suggest that investors approach this opportunity by rebalancing thoughtfully because dislocations won't last for long—and no one knows exactly when the uncertainty premium will fade completely.

**CONTINUED PROGRESS IN VACCINE DISTRIBUTION IS ALLOWING ECONOMIES TO REOPEN, MOBILITY TO IMPROVE AND ECONOMIC ACTIVITY TO BROADEN.**

## CHAPTER TWO: INVESTING AFTER THE CORONAVIRUS

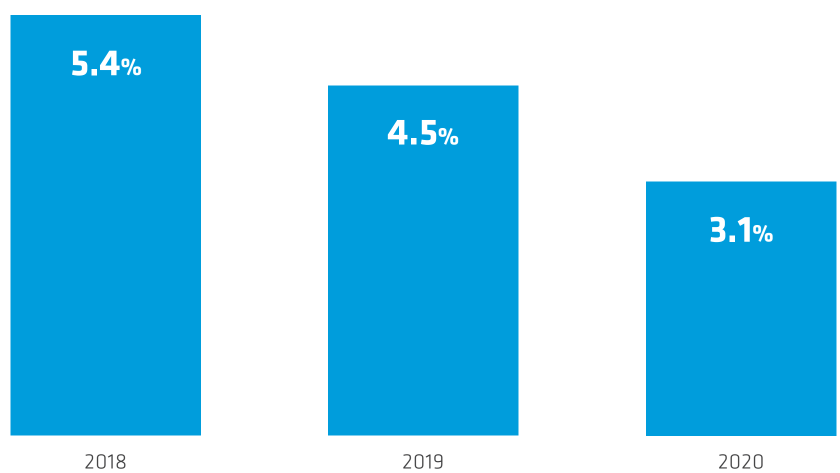
At some point, however, the return to normal trade in capital markets will be fully played out. There won't be a single point in time when the pandemic is declared over; but eventually there will be enough progress that the economic wreckage from COVID-19 will be, for all intents and purposes, behind us.

For investors, what will come next is a back-to-the-future scenario. The same issues that existed before COVID-19 will remain, and they'll be more acute because stimulus has pulled forward returns and racked up more debt. In this next chapter, which will start "the day after the virus," investors are very likely to face lower returns and other possible side effects from the secular trends we described—one of which could be longer-term structural inflation.

What could returns look like going forward? Take a classic 60/40 stock/bond portfolio, for example (*Display 2*): Forecasts at the end of 2018 called for roughly 5.4% annualized returns over the next 10 years. By late 2020, that number had shrunk to 3.1%, with a more than 40% chance of investors experiencing a 20% peak-to-trough loss.

**DISPLAY 2: INVESTING AFTER COVID-19—LOW RETURNS LIKELY AHEAD**

Projected Median 10-Year Annualized Return for 60/40 Portfolio*




**Past performance does not guarantee future results. Data do not represent past performance and are not a promise of actual future results or a range of future results. There is no guarantee that any estimates or forecasts will be realized.**

* Represents projected median compound annual growth rates over the next 10 years for a portfolio of 60% stocks/40% bonds. The globally diversified stock allocation comprises: 16.2% US value, 16.2% US growth, 12.0% US diversified, 6.0% US small-/mid-cap, 23.7% developed foreign markets, 7.3% emerging markets, 9.6% US low-volatility equity, 9.0% high-risk international. This allocation is scaled down to 60% of the 60/40 portfolio. Equity geography weights may shift. Bonds are represented by diversified intermediate-term municipal bonds in the proportions noted. Additional details regarding allocation are available upon request.

As of December 31, 2020

Source: AB

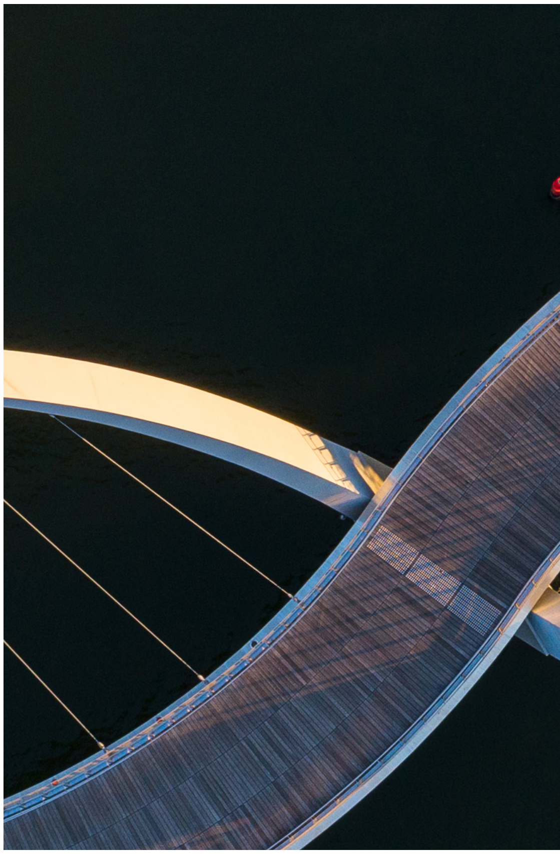
## ILL-TIMED DRAWDOWNS: THREATS TO INCOME, LIFESTYLE AND LEGACY

An ill-timed market downturn—magnified by inefficient portfolio design that may create vulnerabilities—could devastate retirement savings. A sizable drawdown as investors near their retirement years could put large amounts of savings at risk, which can impair lifestyles, philanthropy objectives and legacy plans.

A simple exercise highlights the stakes. Let's compare two 60/40 strategies that begin at retirement, with one critical difference—one portfolio suffers a severe early loss just as retirement begins. If we use historical returns from 1990 through 2020, we can demonstrate this "early loss" experience by simply swapping the 1990 and 2008 calendar-year returns (*Display 3*).

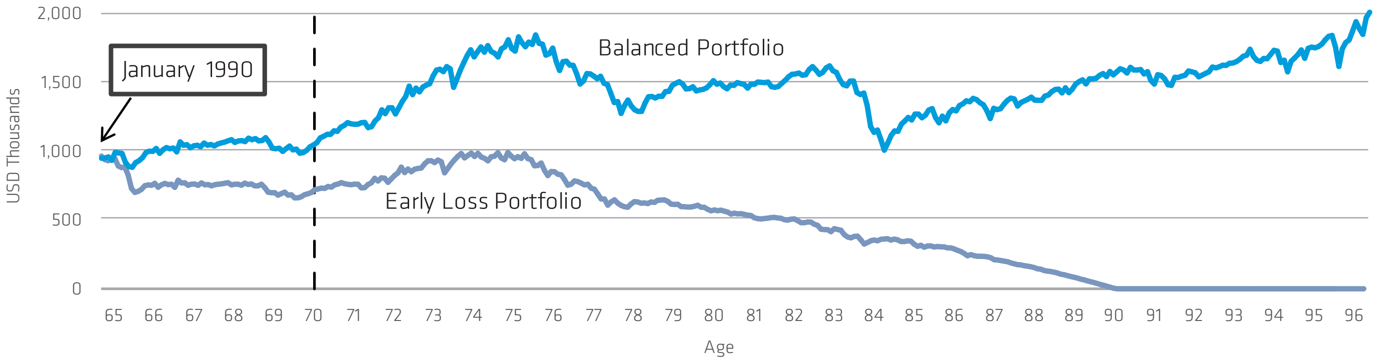
The portfolio that avoided the early loss would have kept building a cushion to weather the eventual down year. It likely would have supported income for life, even at an abnormally high withdrawal rate of 8.4%, demonstrating just how powerful market returns were over those two decades. The early loss portfolio would have a very different experience. Saddled with a terrible 2008 at the outset of retirement, it would struggle to support withdrawals and be tapped out by age 90.

The stellar market returns of the last 20 years likely won't be repeated, so even at much lower withdrawal rates retirees still face the very real possibility of running out of money. Even if their accounts don't run dry, an ill-timed market downturn might still create a yawning "means gap," with plans for philanthropy, legacy and other life goals taking a major hit. If one unfortunate drawdown—perhaps magnified by a vulnerable portfolio—can jeopardize retirement plans, what can investors do?



**DISPLAY 3: SEQUENCE RISK—BIG DRAWDOWNS THREATEN RETIREMENT GOALS**

Portfolio Value, Assuming 8.4% Withdrawal Rate




**Past performance does not guarantee future results. For illustrative purposes only.**
Results are simulated. This is a hypothetical illustration only.
Balanced portfolio represented by 60% S&P 500/40% Bloomberg Barclays US Aggregate. Early loss portfolio represented by 60% S&P 500/40% Bloomberg Barclays US Aggregate, but swaps 1990 and 2008 monthly returns to simulate experiencing a sharp drawdown early in retirement. All portfolios incur monthly withdrawals of US$7,000.
As of December 31, 2020
Source: Morningstar Direct and AB

## TACKLING RISK THROUGH BETTER UP/DOWN CAPTURE

It's clear that mitigating downside risk in the years directly before and after retirement is a key to engineering a successful retirement. Designed effectively, such a portfolio will likely exhibit a lower probability of big drawdowns. But in long-term wealth building, upside matters too. That's the conundrum investors face today—the need to participate and defend.

In our view, the solution is to build a portfolio that has better up/down capture: the percentage of rising markets it captures versus the percentage of falling markets it captures. Getting that balance right is the challenge for every investor—whether building wealth, generating income or seeking some combination of the two. From our perspective, there are three main elements to achieving better up/down capture:

**Better beta.** Some markets—and approaches—have persistently delivered better up/down capture—quality equities, for example. Over the past 10 years, the MSCI World Quality Index captured 99% of the MSCI World Index's upside but only 80% of its downside. That's an up/down capture ratio of 1.24 versus the MSCI World (which, as the reference benchmark, is by definition 1.0).

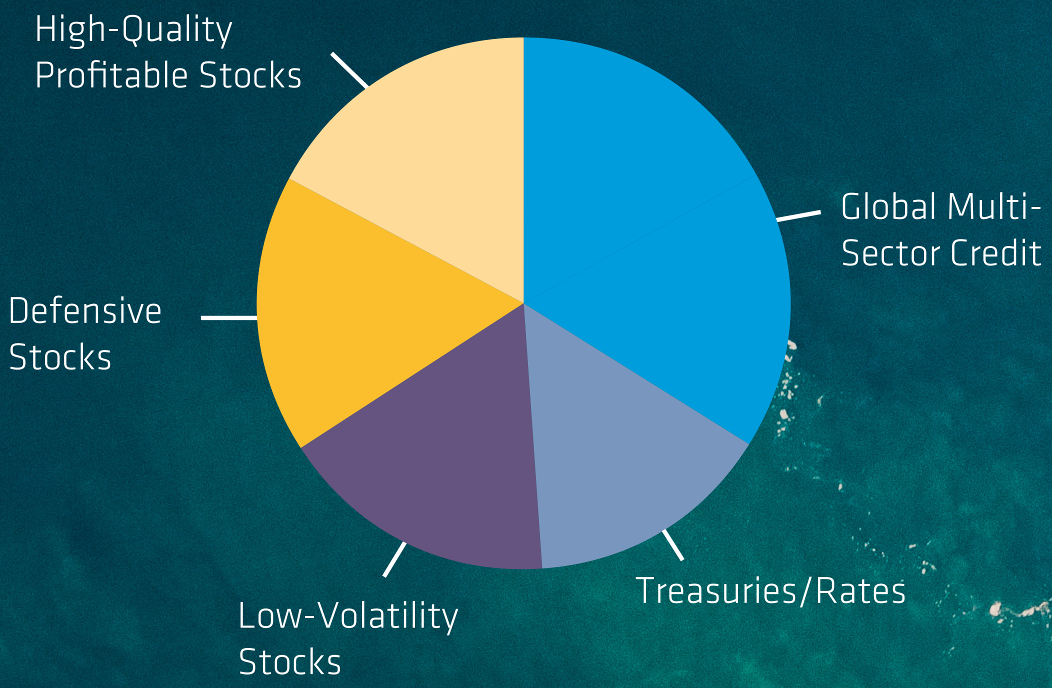
**Efficient structure.** Combining different betas can create structures that also result in a smoother return path. For example, over the past decade, a combination of two fixed-income betas—50% US Treasury bonds and 50% US high-yield bonds—has historically produced a 1.49 up/down capture ratio versus US corporate high-yield bonds alone.

Let's look at a quick example of how investors can improve on the traditional 60/40 portfolio, with a simple blend of better betas—equal allocations to dividend-growth stocks, consumer-staples stocks, low-volatility stocks, emerging-market debt and high-yield bonds, plus an allocation to US Treasuries (Display 4, page 6). Each brings something to the table: high-quality stocks, for instance, offer a risk-off play, while global multi-sector credit offers income generation and a lower-risk proxy for some equity exposure.

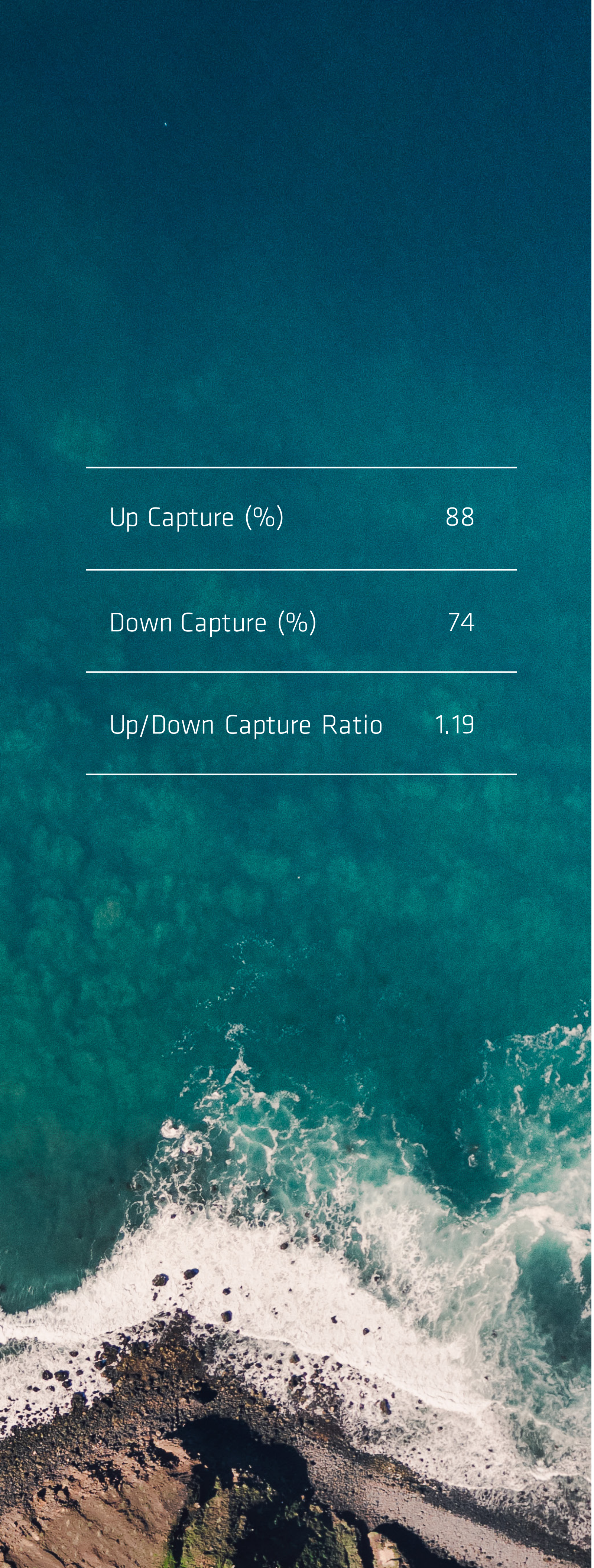
Since 2005, this mix would have delivered 88% of the 60/40's upside and 74% of its downside—a very attractive up/down capture ratio of 1.19. We'll revisit this example—and other variations of better up/down capture constructs (*see* "Putting It All into Practice: Improving Portfolio Up/Down Capture," *page 22*).

**DISPLAY 4: IMPROVING ON THE TRADITIONAL 60/40 WITH BETTER BETAS**

CAPTURE RATIOS OF HYPOTHETICAL PORTFOLIO VS. 60/40 PORTFOLIO: 2005 THROUGH 2020




**Past performance and historical analysis do not guarantee future results.**
For illustrative purposes only. Not intended as investment advice.
High-quality profitable stocks are represented by S&P 500 Dividend Aristocrats; defensive stocks by S&P 500 Consumer Staples; low-volatility stocks by S&P 500 Low Volatility; global multi-sector credit includes global bonds and is represented by the J.P. Morgan EMBI Global Diversified and high-yield bonds/credit by the Bloomberg Barclays US Corporate High Yield Index; and Treasuries/rates by the Bloomberg Barclays US Treasury Index. The 60/40 portfolio is represented by 60% S&P 500 and 40% Bloomberg Barclays US Aggregate Bond Index. Index examples 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. Calculations are based on performance from June 1, 2005, through December 31, 2020.
As of December 31, 2020
Source: Bloomberg Barclays, J.P. Morgan, Morningstar Direct, S&P and AB



| | |
|---|---|
| Up Capture (%) | 88 |
| Down Capture (%) | 74 |
| Up/Down Capture Ratio | 1.19 |

Of course, building such a portfolio involves more than just a naïve construct. The selection of the components, their assembly and interactions, and their ability to adapt to dynamic markets all come into play in determining portfolio success. So does exposure to targeted alpha opportunities—the third pillar of building better return sequences.

**Targeted alpha.** Passive investing has its benefits, with many options to choose from that offer a cheap form of beta exposure. But broadly indexing certain segments of the market can create structural issues (broad exposure to bank loans with high downside, for example) and definitional issues (defining quality is a case in point that we'll explore in the next section). Because each passive strategy uses its own rules and metrics, there's surprisingly large dispersion among passive offerings—even though they're nominally designed to track market indices.

Outperformance from skilled active management, by contrast, has the potential to improve return sequences in many markets by navigating risks and uncovering opportunities. This ability is magnified in arenas such as high-yield corporate bonds and small-cap stocks, which, broadly speaking, tend to be less-efficient markets. The concept of defining and implementing an active/passive allocation "budget" can help investors determine the mix that's right for them.

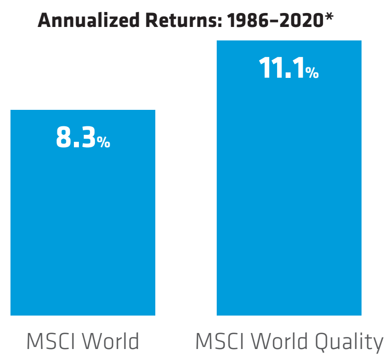
Each of the elements we've discussed—better beta, efficient structure and targeted alpha—can create a favorable return sequence and be even more powerful in combination. But to what end? Investors are trying to achieve diverse outcomes through portfolio construction, but in our more recent experience, three goals—two classic and one newer—seem front and center on investors' minds. Let's drill down into some of the options for improving the path of returns through the lens of stable-growth, efficient-income and purpose-driven investing goals.

## GOAL 1: ACHIEVING STABLE GROWTH WHEN IT'S HARDER TO FIND

Having climbed all the way back from its pandemic lows and then some, the S&P 500 is sporting valuations not seen since the time of the tech bubble. Broadly speaking, US stocks aren't offering easy bargains for investors, and we don't expect a big boost from expanding valuation multiples.

When this current environment is combined with the need to guard against the downside, we think one effective approach is to pursue the better beta of quality in equities. Quality equities have outpaced the broad equity market by a substantial margin over time (*Display 5*) while reducing the downside in notable sell-offs. During the pandemic, for example, the MSCI World Index fell by more than 20%; quality stocks declined by less than 16%, a 76% down-market capture. In practice, investing in quality means leaning heavily on the stocks of companies supported by strong business models while staying ready to thoughtfully rebalance the mix of high-quality cyclical stocks and profitable growth stocks as visibility into the US economic recovery improves.

**DISPLAY 5: QUALITY STOCKS PROVIDE BENEFITS IN GOOD TIMES AND BAD**




| CRISIS | PERIOD | MSCI WORLD | MSCI WORLD QUALITY | MSCI QUALITY RELATIVE RETURNS | DOWN-MARKET CAPTURE |
|---|---|---|---|---|---|
| **Tech Sector Crash** | 2000–2002 | –43.1 | –36.1 | 7.1 | 85.0 |
| **Global Financial Crisis** | 2007–2009 | –52.6 | –43.1 | 9.5 | 79.8 |
| **COVID-19 Pandemic** | 2020 | –20.6 | –15.8 | 4.8 | 75.6 |

**Historical analysis and current forecasts do not guarantee future results.**
Right chart based on downturns of more than 10% in the MSCI World Index. Tech sector crash from March 1, 2000, through September 30, 2002; global financial crisis from October 1, 2007, through February 28, 2009; COVID-19 pandemic from February 1, 2020, through March 31, 2020.
*As of December 31, 2020
Source: FactSet, MSCI, S&P and AB

Earlier, we mentioned the challenge of defining quality in equity investing. It may seem like a straightforward exercise to find quality by using different combinations of metrics; however, in our experience, quality is a forward-looking business characteristic, not a backward-looking metric—or even a combination of metrics.

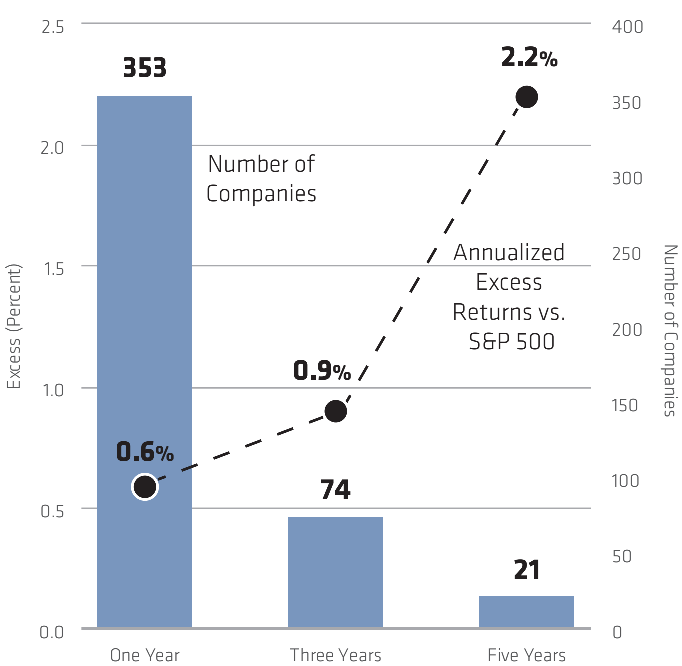
Quality, correctly identified, has been durable over time within both the growth and value styles. Given current economic and market conditions—with a sizable amount of stimulus still to be deployed—it's possible that value's recent strength could have more legs. Whether investors are tapping value or growth, in-depth fundamental research is the key to identifying traits such as strong business models, dominant competitive positions, innovation edges and strong management teams.

Our research suggests that it may not be easy to find these winners, but the reward can be worth the effort. From a portfolio of the 1,000 biggest US stocks, reassembled at the beginning of each year from 1979 through 2020, 353 stocks would have produced growth of 10% or more over one-year periods, beating the S&P 500 by 0.6% annualized (*Display 6*). Only 21 stocks topped 10% growth over five-year periods, but they won by a sizable 2.2%.

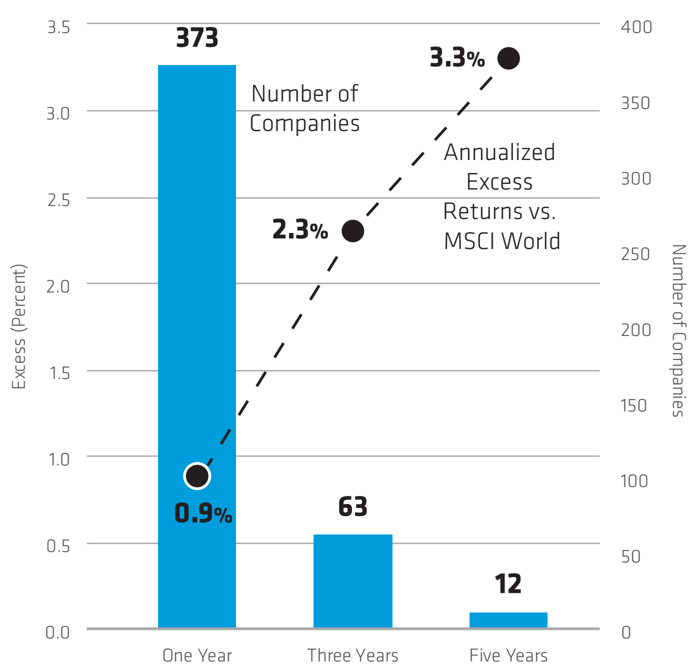
**DISPLAY 6: PERSISTENT EARNINGS GROWTH HAS BEEN A REWARDING APPROACH**

Companies Persisting with ≥10% YoY Earnings Growth

**Top 1,000 US Companies (1979–2020)**




**Top 1,000 Global Companies (1989–2020)**




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

Historical data is for informational purposes only. Left display universe consists of the top 1,000 US companies by market cap each year from 1979 through 2020, with annual rebalancing; right display universe consists of top 1,000 global companies by market cap each year from 1979 through 2020, with annual rebalancing.

As of December 31, 2020

Source: Center for Research in Security Prices, FactSet, MSCI, S&P Compustat and AB

We've seen a similar quality benefit globally, with plenty of strong performers available beyond the US. In fact, since 2011, despite US stocks outperforming international stocks in aggregate, 76% of the top 50 performing stocks were ex US on average—and much higher in some years. So, better equity betas like quality are available in an arena where active managers have demonstrated an edge. That's important, because one of the most talked-about elements of the return-to-normal trade from COVID-19 dislocations is that of US stocks versus the rest of the world.

Investors can also seek to develop a more favorable sequence of returns by targeting alpha-friendly equity segments. The US small-cap market, for example, is generally less traveled by analysts, creating openings for strong research and active management to boost returns. Small-cap stocks have tended to thrive in economic recoveries, and we've found that exploiting growth and value opportunities in the style "tails" has historically fared better than a core small-cap approach.

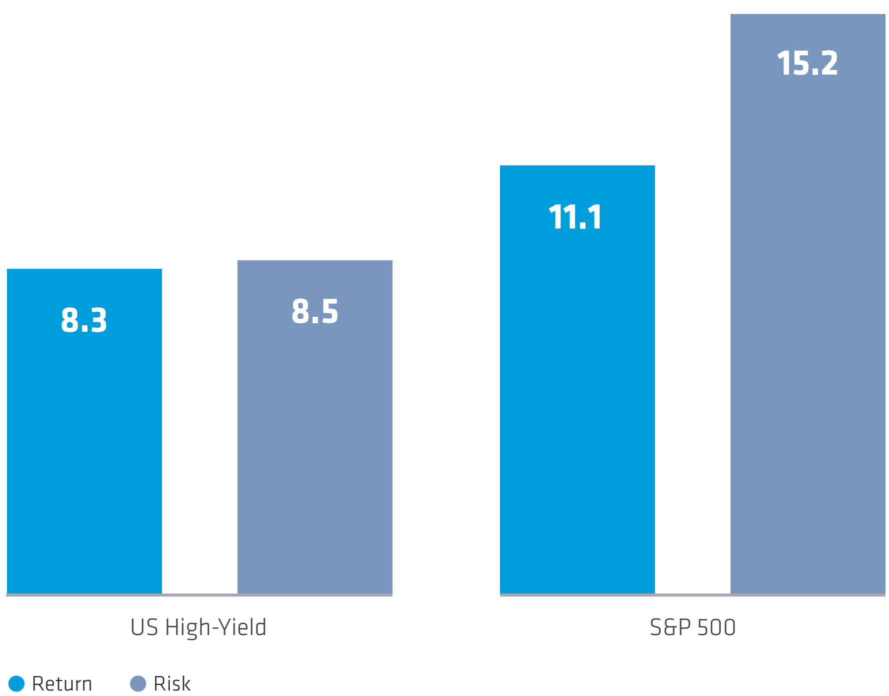
### HIGH-YIELD BONDS AS AN EQUITY DE-RISK

Investors can also pursue better equity beta by looking beyond stocks—allocating some equity exposure to US high-yield bonds, which have historically produced returns approaching those of equities with roughly half the volatility (*Display 7*). And high-yield sell-offs haven't been as deep as equity sell-offs: since 1998, the average high-yield drawdown has been –6.0% versus –11.5% for stocks. Also, high-yield has rebounded relatively quickly.

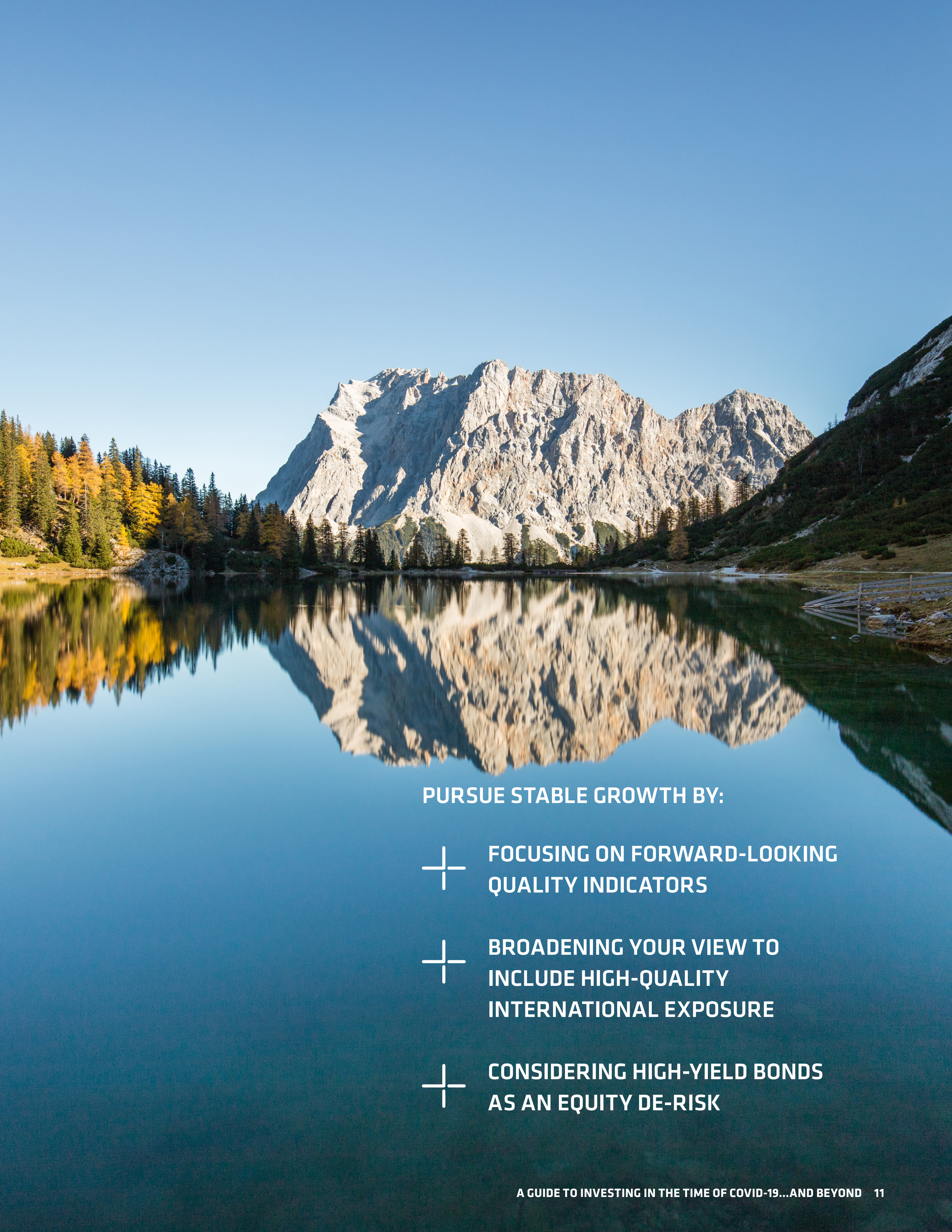
All of this evidence, in our view, makes high-yield an effective equity de-risking tool—and an excellent place for investors to spend the active part of their active-passive budget.

**DISPLAY 7: HIGH-YIELD BONDS—EQUITY-LIKE RETURNS WITH LESS VOLATILITY**

Historical Returns and Volatility
January 1986–December 2020 (Percent)




**Past performance does not guarantee future results. An investor cannot invest in an index.**
US high-yield is represented by the Bloomberg Barclays US Corporate High Yield Index. Inception of the index is January 1, 1986.
As of December 31, 2020
Source: Bloomberg Barclays, Morningstar Direct, S&P and AB



## PURSUE STABLE GROWTH BY:

- FOCUSING ON FORWARD-LOOKING QUALITY INDICATORS
- BROADENING YOUR VIEW TO INCLUDE HIGH-QUALITY INTERNATIONAL EXPOSURE
- CONSIDERING HIGH-YIELD BONDS AS AN EQUITY DE-RISK

## GOAL 2: GENERATING EFFICIENT INCOME℠...NOT CHASING YIELD

Income is a key goal for many investors, and the intensity of that need only grows as they move closer to—and enter—their retirement years. The basic income formula used to be straightforward: simply buy a portfolio of US core bonds, clip relatively safe coupons and benefit from an extra tailwind of secular interest-rate declines on the way to a secure retirement.

Things have definitely changed a lot since then.

Shrinking bond yields have driven many investors to pour capital into higher-income sources, in many cases bank loans, high-yield bonds and dividend-yielding stocks. But stretching for yield can magnify risk. For example, since 2001, core bonds have had a beta of near zero to the S&P 500 and a maximum drawdown of about 4%; for high-dividend equities, the beta is 0.84 and the maximum drawdown is multiples higher at –51%.

We think investors would be better served by seeking efficient income through investments that pursue the highest level of income per unit of risk they take on. And returning to the notion of an active-passive budget, we believe that the active part of the allocation budget should lean into alpha-rich segments such as credit that require deep fundamental research and nimble positioning.

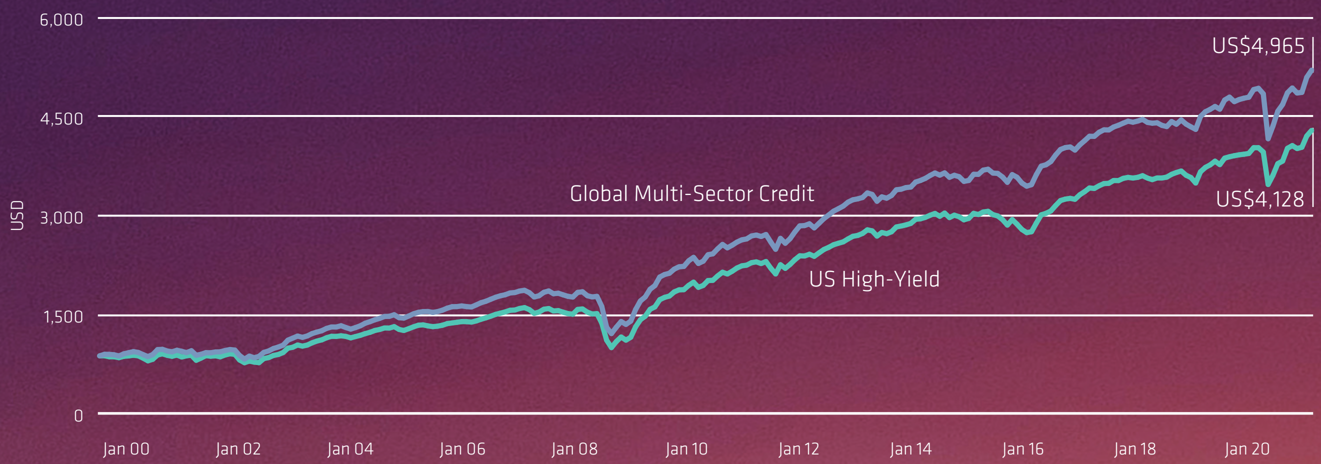
In fast-moving and fragmented bond markets, technology can be a force multiplier for active fixed-income investing, helping investors identify opportunities and avoid risks. Innovation can even create new sources of alpha through more efficient, connected trading (trading alpha) and streamlined portfolio building that puts money to work faster (speed alpha).

An important principle in generating efficient income is to globally diversify credit exposure. We've always maintained that a global multi-sector credit portfolio is a better beta than US high-yield bonds alone, given its broader opportunity set and flexibility to cushion against downturns. In fact, a global multi-sector credit approach has outperformed US high-yield corporates over the long run, winning in 82% of trailing three-year periods.

While diversified credit portfolios offer numerous benefits, the drawdowns they may experience over time could be too much for some investors' risk tolerances. One possible solution to this challenge is to consider an efficient structure we described earlier—a barbell. Much like a classic 60/40 portfolio with high-quality bonds balancing the higher risk of stocks, high-quality bonds diversify income-enhancing credit exposure in the barbell strategy.

That balance is an especially important tool today, given the worries about rising rates leading many investors to focus on low-duration bonds—and even cash. These investments, however, have failed to deliver the type of countercyclical behavior necessary to cushion portfolios against sell-offs. From our perspective, an efficient income (*Display 8*, *page 13*) portfolio involves blending risks—not avoiding them.

**DISPLAY 8: A GLOBAL MULTI-SECTOR APPROACH HAS BOLSTERED CREDIT STRATEGIES**



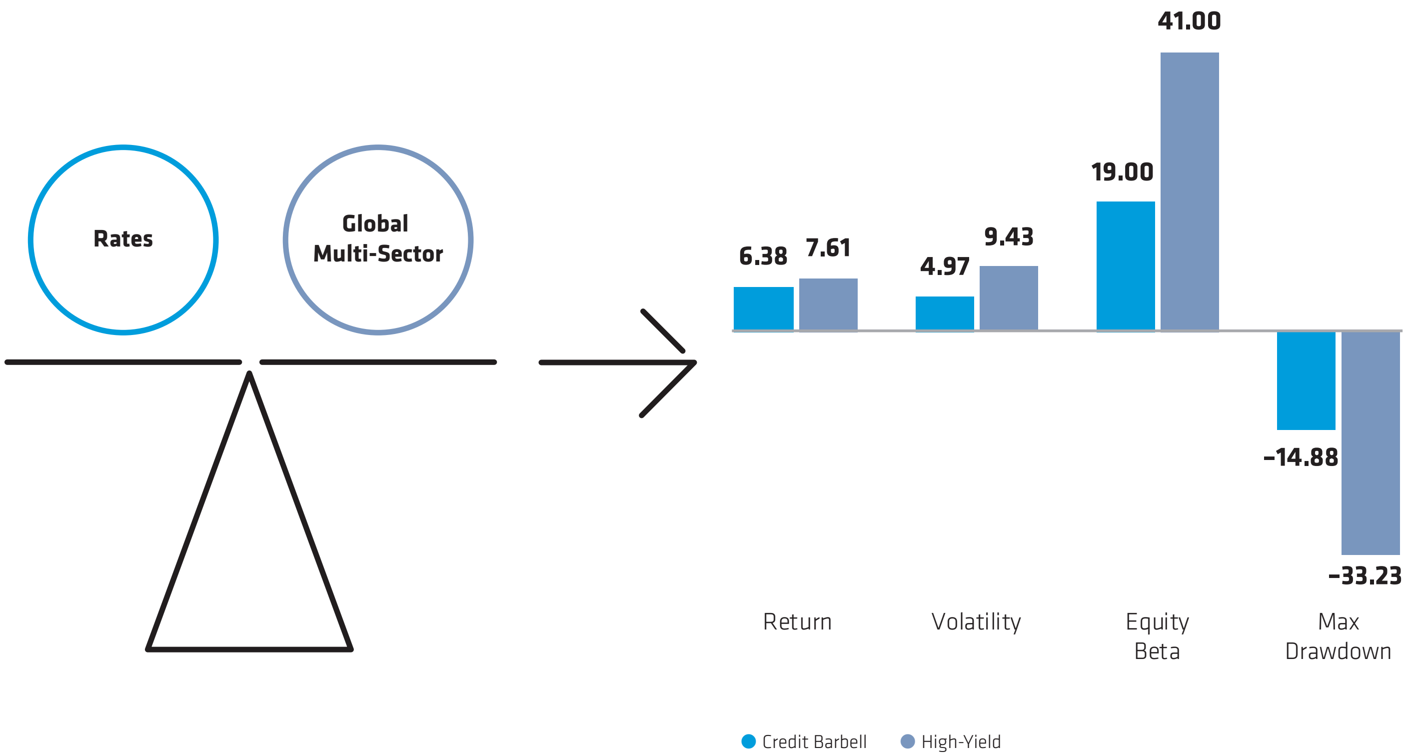

| | Total Return | Standard Deviation | Sharpe Ratio | Up Capture | Down Capture | Overall Capture Ratio | Relative Three-Year Batting Average* |
|---|---|---|---|---|---|---|---|
| Global Multi-Sector Credit | 8.24 | 9.42 | 0.74 | 99.94 | 92.47 | 1.08 | 82% |
| US High-Yield | 7.61 | 9.43 | 0.67 | 100.00 | 100.00 | 1.00 | 18% |

**Past performance does not guarantee future results.**
Global multi-sector credit represented by 100% Bloomberg Barclays Global High Yield Total Return Index (Hedged USD); US high-yield is represented by the ICE BofAML US High Yield Master I Index
* Relative batting average is calculated by measuring the percent of three-year rolling periods where the portfolio outperforms the other portfolio in this display.
As of December 31, 2020
Source: Bloomberg Barclays, ICE Data Indices, Morningstar and AB

An efficient "barbell" structure (*Display 9*), with duration and credit exposures carefully blended, has the potential to produce a yield and return similar to high-yield bonds, with about half the risk. It may also check all three boxes in the recipe for effective up/down capture: better beta, efficient structure and exposure to targeted alpha potential in multi-sector credit. As an added benefit, shallower drawdowns can leave portfolios with more dry powder to redeploy into segments made attractive by market fluctuations.

For tax-sensitive investors, the barbell's efficient structure can be deployed in the municipal bond market too. On one end of the barbell are high-quality municipal bonds with returns bolstered through active yield-curve strategies to take advantage of "roll," which is the change in a bond's value as it moves closer to maturity (independent of other factors). On the other end of the barbell is income-generating credit exposure from high-yield municipal bonds—another alpha-rich market.

**DISPLAY 9: RETHINKING FIXED INCOME—BARBELL OF RATES AND DIVERSIFIED CREDIT**




**Past performance does not guarantee future results.**
Global multi-sector is represented by the Bloomberg Barclays Global High Yield Total Return Index (Hedged USD). Rates is represented by 50% Bloomberg Barclays Intermediate US Treasury Index/50% Bloomberg Barclays US Aggregate Bond Index. Return-based statistics use a 20-year time period.
As of December 31, 2020
Source: Bloomberg Barclays, Morningstar and AB

## SEEK EFFICIENT INCOME BY:

- USING A BARBELL APPROACH TO RATES AND CREDIT
- IMPLEMENTING A GLOBAL MULTI-SECTOR APPROACH
- EXPLORING TECHNOLOGIES THAT CAN PROVIDE BOTH TRADING AND SPEED ALPHA

## GOAL 3: INVESTING WITH PURPOSE—AND ESG INTEGRATION

Investors are increasingly pursuing a third goal—ensuring that their investments exhibit good behaviors from an environmental, social and governance (ESG) perspective—and even targeting investments to advance ESG-aligned causes in addition to generating financial returns.

Because ESG considerations and management quality are so tightly interwoven with financial considerations, it's challenging to invest responsibly through large-scale blanket exclusions of issuers or segments, or through a passive screening based on quantitative metrics. ESG considerations are in fact financial considerations, so they need to be fully integrated with traditional fundamental analysis.

A case in point is a company that's a heavy carbon emitter, bringing exposure to costly carbon taxes and possibly higher operating costs from legally mandated equipment upgrades. It's a mistake, in our view, to approach the financial and ESG ramifications independently. So, whether investors are analyzing an issuer for a large-cap growth or high-yield bond strategy, ESG consideration must be deeply integrated in the investment process and informed by direct engagement with issuers.

Investors are increasingly moving beyond security-level ESG integration and exploring purpose-driven investment solutions. These strategies offer different ways to access equity market beta, with numerous choices of markets and approaches to refining that universe to align with purpose. Sustainable strategies, which seek to invest in issuers that can meet present needs without compromising future well-being, are one such solution.

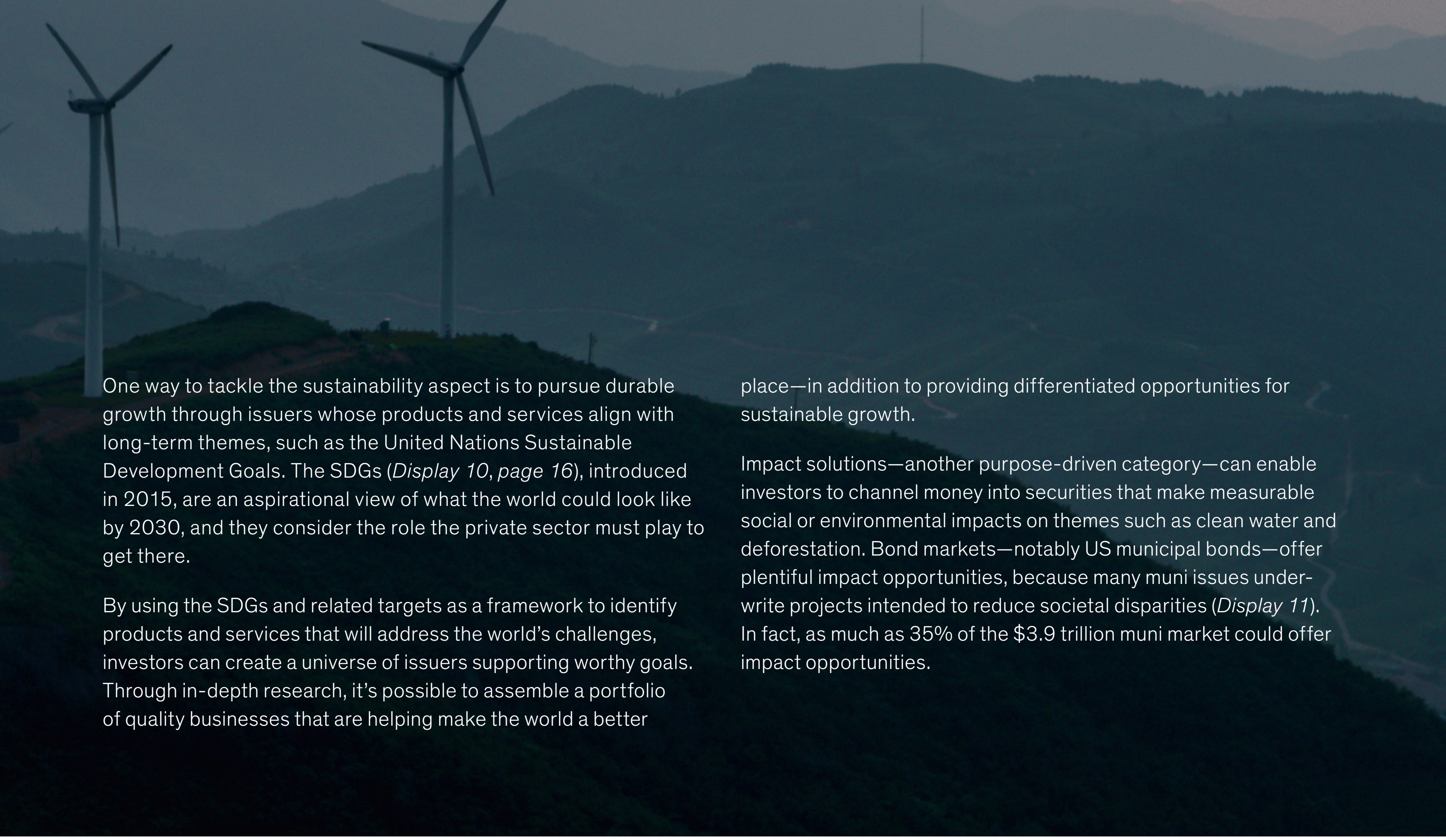
**DISPLAY 10: SUSTAINABLE DEVELOPMENT GOALS (SDGs)—ROAD MAP FOR THEMATIC INVESTORS**

**The SDGs Are a Powerful Framework of 17 Goals**


**Why Align a Portfolio with the SDGs?**

| | |
|---|---|
| **Thematic Relevance** | The United Nations Sustainable Development Goals (SDGs) offer a road map for identifying thematic opportunities that are **underappreciated by traditional investors**. |
| **Investment Opportunity** | The estimated investment required to achieve the SDGs is massive—**roughly US$90 trillion**. |
| **Global Consensus** | **193 nations have committed** to achieving the goals, signaling broad global consensus and creating a powerful tailwind for aligned companies. |
| **Social and Environmental Objectives** | Investments that align with the SDGs can help to end poverty, protect the planet and **improve the lives and prospects of everyone, everywhere**. |

For informational purposes only.
Source: United Nations and AB



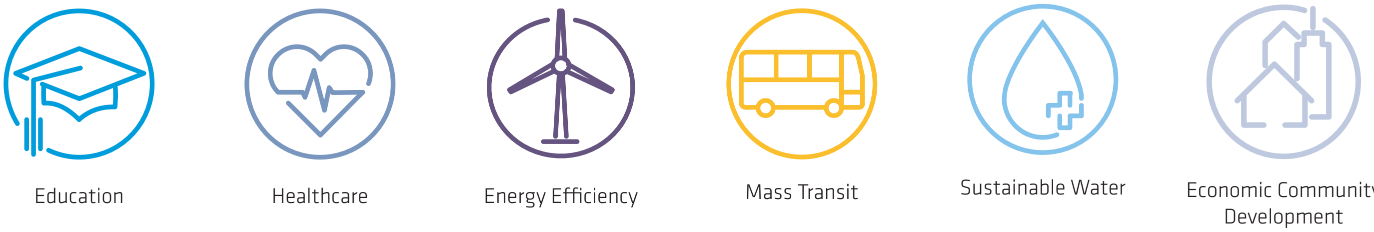
One way to tackle the sustainability aspect is to pursue durable growth through issuers whose products and services align with long-term themes, such as the United Nations Sustainable Development Goals. The SDGs (*Display 10, page 16*), introduced in 2015, are an aspirational view of what the world could look like by 2030, and they consider the role the private sector must play to get there.

By using the SDGs and related targets as a framework to identify products and services that will address the world's challenges, investors can create a universe of issuers supporting worthy goals. Through in-depth research, it's possible to assemble a portfolio of quality businesses that are helping make the world a better place—in addition to providing differentiated opportunities for sustainable growth.

Impact solutions—another purpose-driven category—can enable investors to channel money into securities that make measurable social or environmental impacts on themes such as clean water and deforestation. Bond markets—notably US municipal bonds—offer plentiful impact opportunities, because many muni issues underwrite projects intended to reduce societal disparities (*Display 11*). In fact, as much as 35% of the $3.9 trillion muni market could offer impact opportunities.

**DISPLAY 11: HOW MUNI INVESTING CAN MAKE A POSITIVE IMPACT ON THE WORLD**

**Sample Focus Sectors***




+ Promote and favor investments in historically underserved and low-socioeconomic-status communities.
+ Ensure each investment has a specific intention to deliver a positive environmental and/or social impact.
+ Track intention with key performance indicators that are idiosyncratic to the specific sector.

For illustrative purposes only. There can be no assurance that any investment objectives will be achieved.
*Derived from Impact Reporting and Investment Standards, as established by the Global Impact Investing Network
As of December 31, 2020
Source: AB

**LEAN INTO PURPOSEFUL INVESTING BY:**

- **MOVING BEYOND SIMPLE EXCLUSION FACTORS TO ACTIVE INTEGRATION AND ENGAGEMENT**
- **EXPLORING THE SDGs AS A LONG-TERM FRAMEWORK FOR EMERGING SUSTAINABLE THEMES**
- **DIVERSIFYING INTO INVESTMENTS THAT CAN PROVIDE LOCAL IMPACT**

## PUTTING IT ALL INTO PRACTICE: IMPROVING PORTFOLIO UP/DOWN CAPTURE

No matter what combination of income, growth and purpose investors are seeking, investing is likely to be a lot more challenging in the years ahead, with a post-COVID-19 environment of low returns putting the traditional 60/40 stock/bond portfolio model under duress. With many investors nearing or in retirement, an ill-timed market downturn could scuttle income, legacy and philanthropic goals.

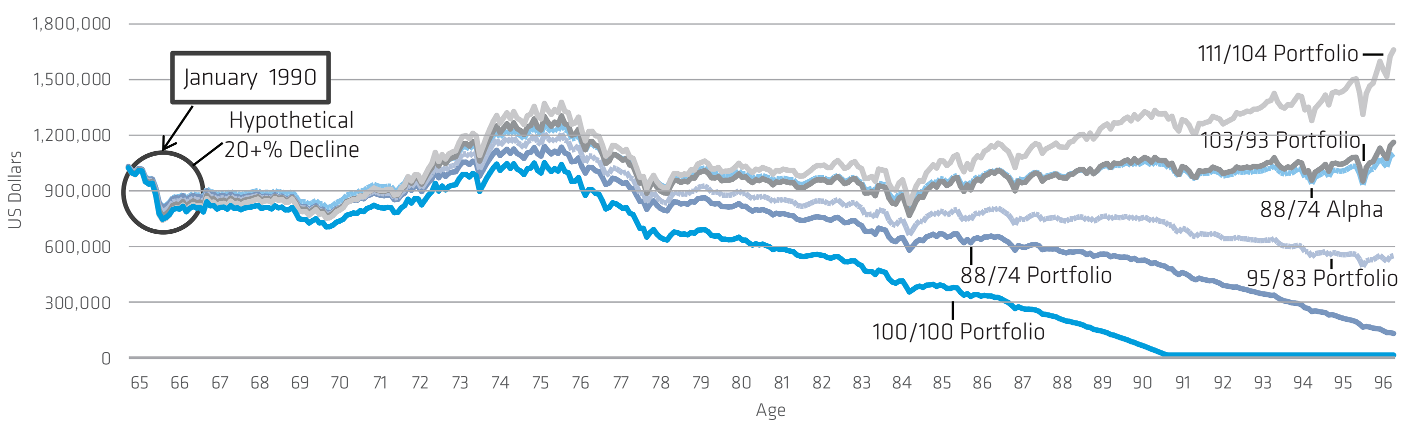
That's the bad news.

The good news? A wide array of building blocks exists that investors can use to reshape portfolio exposures and achieve a wide range of different up/down captures that align with individual risk tolerances, offer an avenue to capitalize on the return-to-normal trade and can help navigate the less-forgiving market environment on the other side of the pandemic.

Let's look at some of the combinations of up/down capture portfolios that investors can design using these principles—and how they might fare over a long retirement time frame that endures a very large 2008-style market drawdown just as retirement starts and investors begin withdrawing income. We can do this in a straightforward way by simply taking historical annual returns and exchanging 1990, a positive year, for 2008, a terrible year, so that 2008 happens at the beginning.

**DISPLAY 12: BETTER UP/DOWN CAPTURE CAN HELP IMPROVE RETIREMENT OUTCOMES**

Experiencing "2008 Returns" in First Year of Retirement with Different Up/Down Captures




**Past performance does not guarantee future results. For illustrative purposes only.**

Results are simulated. This is a hypothetical illustration only.

All portfolios swap 1990 and 2008 monthly returns to simulate experiencing a sharp drawdown early in retirement. All portfolios incur monthly withdrawals of US$7,000. 100/100 portfolio consists of 60% S&P 500 and 40% Bloomberg Barclays US Aggregate Bond Index; 111/104 portfolio consists of 25% low-volatility, 25% consumer-staples, 25% dividend-growth, and 25% high-yield bonds; 95/83 portfolio consists of 85% four equity better betas, 15% US Treasuries; 103/93 portfolio consists of 20% low-volatility, 20% consumer-staples, 20% dividend-growth, and 20% high-yield bonds; 88/74 portfolio consists of 85% five equity better betas, 15% US Treasuries; and 88/74 alpha portfolio consists of 85% five equity better betas, 15% US Treasuries + 60 basis points of alpha each year. Better betas are represented by: low-volatility (S&P 500 Low Volatility); consumer staples (S&P 500 Sector consumer staples); dividend growth (S&P 500 Dividend Aristocrats); high-yield (Bloomberg Barclays US Corporate High Yield) and emerging-market debt (J.P. Morgan Emerging Markets Bond Index Global Diversified).

Index examples 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.

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

As of December 31, 2020

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

Let's start with the classic 60/40 portfolio, the 100/100 line (*Display 12, page 19*), representing 100% up capture and 100% down capture. As discussed, that portfolio struggles, with the early loss overwhelming subsequent market returns and draining the portfolio completely before age 91. Other portfolios with varying blends of better up/down capture would have improved on that experience and—to different degrees—built and maintained income throughout retirement.

The 88/74 portfolio, for example is somewhat of a "classic" mix, with less up capture and significantly less down capture to cushion against bad markets. It's also the better beta example presented earlier (*see page 7*). That formula would have dramatically improved retirement fortunes and avoided running out of money. For investors seeking more upside potential, a 95/83 portfolio would have captured nearly all of the market's upside and moderated down capture—building more wealth over time than the 88/74.

All of the up/down capture examples shown illustrate different mixes of better betas and efficient structures that would have improved on the experience of the 60/40 portfolio formulation. And, in the case of the 88/74 alpha line, targeted alpha potential can enhance the mix. A modest positive contribution from active management of 60 basis points per year would have substantially improved the outcome on the standard 88/74 formulation.

**The takeaway?** Investors have many formulas at their disposal to pursue a more favorable return path, and the mix doesn't have to be one size fits all. Of course, getting the design right isn't easy: many building blocks defy basic metrics-based passive approaches, which may magnify inherent risks. Investors must think carefully about which market segments might make cheap passive exposures worth considering and which markets are better suited to active management in order to tap opportunity and—just as critical—adapt to evolving risks.

**INVESTORS HAVE MANY FORMULAS AT THEIR DISPOSAL TO PURSUE A MORE FAVORABLE RETURN PATH, AND THE MIX DOESN'T HAVE TO BE ONE SIZE FITS ALL.**

**DISPLAY 13: CHECKLIST FOR POST-PANDEMIC INVESTING**

**Overall Portfolio**

- Align up/down capture with long-term goals and risk tolerance.
- Address overlap among portfolio components that may magnify exposures.
- Resolve exposures to components with greater crowding/liquidity risk.
- Allocate active/passive budget.
- Consider rebalancing plan and how to deploy "dry powder."

**Stable Growth**

- Diversify across broad exposures and downside cushions.
- Identify characteristics of exposures: quality, style, cap size, low volatility, thematic.
- Consider de-risking equity, where appropriate, with allocations to alternatives or equity surrogates.
- Determine importance of income/growth allocation within equity exposure.
- Allocate active/passive budget.

**Efficient Income**

- Balance income potential and downside protection.
- Diversify globally across multiple income generators.
- Explore allocations to other income-producing betas.
- Assess importance of—and approach to—protecting against inflation.
- Allocate active/passive budget.

**Purpose**

- Identify specific purpose goals.
- Define success measures for achieving purpose goals vs. financial goals.
- Determine reference beta or market segment.
- Determine impact of applying purpose-driven rules to reference beta or market segment.
- Allocate active/passive budget.

What factors do investors need to consider (*Display 13*)?

There are many facets to portfolio construction—with respect to goals and overall design. While there's not room in this format for an exhaustive discussion of each item in the checklist, a few examples help illustrate the moving parts.

When pursuing stable growth, for instance, investors should cast a wide net globally for both broad market equity exposures and equity strategies that focus on providing some degree of downside cushion and/or volatility management. It's also a good idea to explore strategies that might be outside the equity realm but nonetheless make good proxies for equity exposure.

In terms of efficient income, diversifying globally across a number of income generators is a sensible approach, and it can also help to consider how important inflation protection is in the mix. Investors might also look at other beta exposures, such as dividend equities, that can deliver income. And when investing for purpose, the specific purpose should be in focus from the outset, as well as an understanding of what constitutes success and how applying purpose-driven rules alters beta.

With respect to each of these goals—and at the overall portfolio level—the allocation of the active/passive budget is a key decision point. And for the overall portfolio, avoiding crowded exposures and tailoring the up/down capture ratio to risk tolerances are musts.

As is clear from this sizable checklist, there's a lot to consider when designing a portfolio that's well equipped to achieve diverse mixes of goals and provide the right degree of up/down capture. However, if investors can get the design right, we believe that they stand a much better chance of building enough wealth and income potential to improve retirement outcomes in the post-COVID-19 world.

**MSCI World Quality Index—**The MSCI World Quality Index is based on MSCI World, its parent index, which includes large and mid cap stocks across 23 Developed Market (DM) countries. The index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage. The MSCI Quality Indexes complement existing MSCI Factor Indexes and can provide an effective diversification role in a portfolio of factor strategies. **MSCI World Index—**The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. Since June 2007 the MSCI World Index consisted of the following 23 developed market country indices: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The index represents the unhedged performance of the constituent stocks, in US dollars. **Bloomberg Barclays US Corporate High Yield Index—**The Barclays Capital U.S. Corporate High-Yield Index the covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. **Bloomberg Barclays US Treasury Index—**The Barclays Capital U.S. Treasury Index is a measure of the public obligations of the U.S. Treasury. **Bloomberg Barclays US Aggregate Bond Index—**Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. **Bloomberg Barclays Global High Yield Total Return Index—**The Barclays Capital Global High Yield Index is a component of the Multiverse Index, along with the Global Aggregate index. It represents the U.S. High-Yield, Pan-European High-Yield, U.S. Emerging Markets High-Yield, CMBS High-Yield, and Pan-European Emerging Markets High-Yield indices. **US High Yield Master I Index—**designed to track the performance of U.S. dollar-denominated, high-yield corporate bonds **Bloomberg Barclays Intermediate US Treasury Index—**The Barclays Capital Intermediate U.S. Treasury Index is an unmanaged index representing public organizations of the U.S. Treasury with a remaining maturity of one year or more. **J.P. Morgan Emerging Markets Bond Index Global Diversified—**JPMorgan Government Bond Index-Emerging Markets Global Diversified Index (Unhedged) is a comprehensive global local emerging markets index, and consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure.

**An investor cannot invest directly in an unmanaged index.**

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**Standard deviation** is a measure of volatility, indicating the percentage by which an investment's performance has varied from its average; the higher the standard deviation, the greater the range of performance, indicating greater volatility. **Alpha** is the risk-adjusted measurement of "excess return" over a benchmark. A positive alpha of 1.0 means the portfolio has outperformed its benchmark index by 1%. Correspondingly, a similar negative alpha would indicate an underperformance of 1%. **Beta** is a measure of an investment's volatility in comparison to the market as a whole. A beta below 1 indicates less volatility than the market; a higher beta indicates more volatility. **Sharpe Ratio** is the average return earned in excess of the risk-free rate per unit of volatility **Up Capture** measures the percentage of market gains captured by a manager when markets are up **Down Capture** measures the percentage of market losses endured by a manager when markets are down.

## WORD ABOUT RISK

**ESG Risk:** Applying ESG and sustainability criteria to the investment process may exclude securities of certain issuers for nonfinancial reasons and, therefore, the Fund may forgo some market opportunities available to funds that do not use ESG or sustainability criteria. **Foreign 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. **Credit Risk:** 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, then the issuer's rating may be lowered, and the bond's value may decline. Medium-, lower-and unrated securities may be subject to wider fluctuations in yield and market values than higher-rated securities. **Interest-Rate Risk:** mixed-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.

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