AllianceBernstein®

Designing Efficient Income℠...for Life

IN THIS PAPER

With less-than-inspiring prospects for market returns, investors face a stiff challenge in generating efficient income while still bestowing a legacy at the end of retirement. Reaching beyond traditional market building blocks to embrace the income-generating power of annuities could go a long way toward tackling the income challenge.

2021

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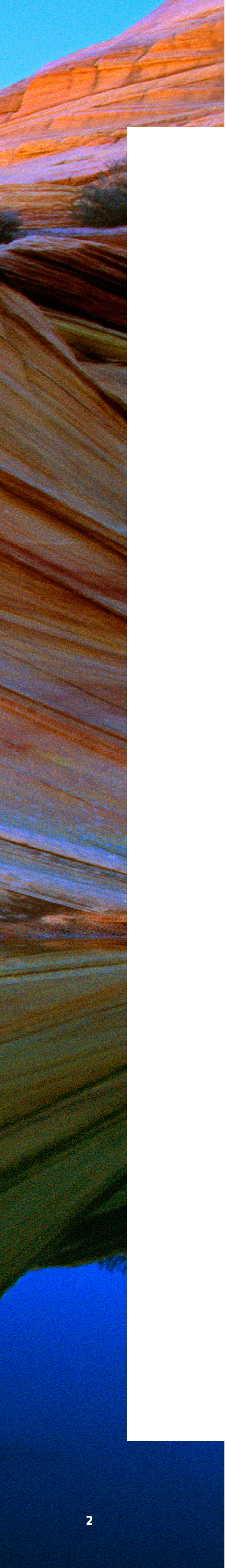
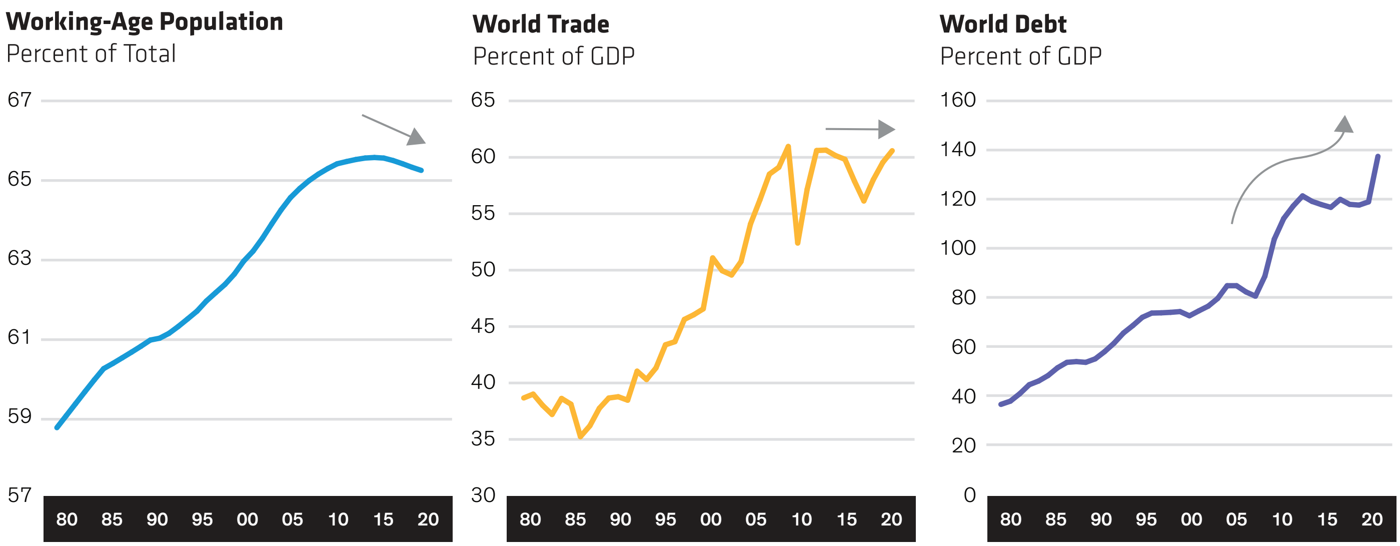


Designing Efficient Income...for Life

As the path back from the depths of the COVID-19 pandemic continues, accompanied by massive stimulus measures, markets have generally fared well. As the recovery progresses, however, eventually the return-to-normal trade will fully play out.

At that point, the same issues that existed before the pandemic will remain, only more acute because stimulus has pulled returns forward in time. In this case, the capital markets landscape will put a strain on traditional investment strategies—and income investing won't escape the pitfalls. What investors do next will go a long way toward determining success or failure in securing income and legacies.

DISPLAY 1: SECULAR HEADWINDS: DEMOGRAPHICS, DEGLOBALIZATION AND DEBT BURDENS



Past performance does not guarantee future results.

Through December 31, 2020

Source: Bloomberg, Department of Labor, Federal Reserve Economic Data (FRED), Haver Analytics, World Trade Organization and AllianceBernstein (AB)

Capital Markets Headwinds Are Intensifying

As we look out over the next decade, we see three secular headwinds—changing demographics, deglobalization and high debt levels—converging (*Display 1*). In our view, this combination will slow economic growth and make investing—whether it's for income, growth or a combination of the two—much more challenging in the years ahead.

A rising tide of globalization has made world trade a support pillar for economic growth and wealth creation for many years. Recently, though, that tide has started to ebb, driven by wide-ranging factors including rising wages in emerging markets (including China), resurgent populism and trade wars, and the desire to balance risk management with cost savings as a result of COVID-19-related global supply-chain disruptions.

Finally, the debt burden of the world's major economies has exploded. In the wake of the global financial crisis, the ratio of sovereign debt to gross domestic product topped 100%; that load is now approaching 140%. Not only does a growing pile of debt divert more of government budgets to servicing debt, it also ties the hands of central banks as they seek to manage inflation and growth.

We expect market returns to be much lower going forward than they've been in decades past.

Traditional Return Sources Will Be Muted

For investors, these forces will impair growth, a challenge compounded by equity valuations that are near historic highs and interest rates still near historic lows. As a result, we expect market returns to be much lower going forward than they've been in decades past (*Display 2*).

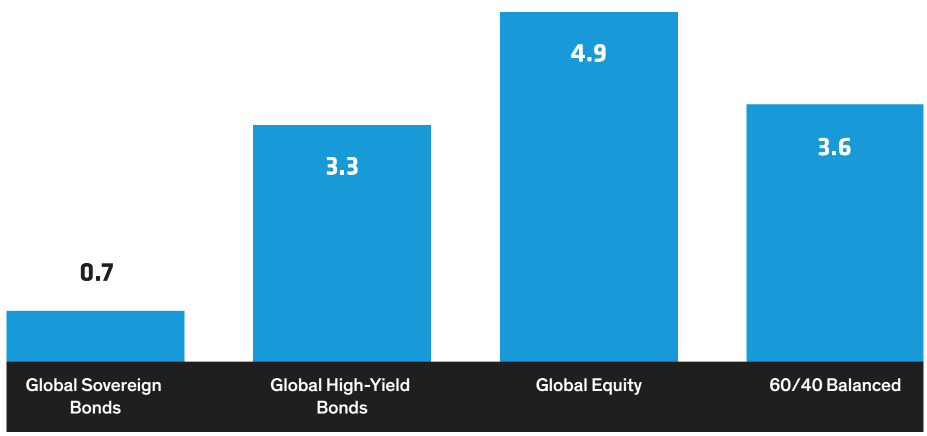
Based on our capital markets projections, global sovereign bonds are expected to return only 0.7% annualized and global stocks 4.9%. For a balanced portfolio of 60% stocks and 40% bonds, a staple of investing for many years, we think investors should expect returns of 3.6% over the next 10 years—before inflation.

With anticipated low returns, investors focused on building retirement income face a tough road, and there's a substantial risk that many of them will be motivated to reach for higher-yielding bond segments. But that stretch can also bring sizable downside risk that may do more damage to accumulated wealth—and potential income—than portfolios can realistically recover from.

How can income investors go about tackling this challenge?

DISPLAY 2: TRADITIONAL ASSET-CLASS RETURNS WILL BE LOWER

Expected 10-Year Annualized Growth Rates (Percent)



Data do not represent past performance and are not a promise of actual results or a range of future results.

Hedged returns in US dollars. Global equity represents a universe similar to the MSCI World Index. Bond markets referenced represent seven-year constant-maturity bonds of the type named: nominal global sovereign and global high-yield. 60%/40% allocation represents 60% stocks and 40% bonds.

As of June 30, 2021

Source: AllianceBernstein (AB)

Stretching for Yield Isn't the Answer

Even though market returns are expected to be lower in the years ahead, capital markets still offer important portfolio building blocks: US and international stocks (including emerging markets) and bonds spanning investment grade and high yield. But that traditional formula could use some help today.

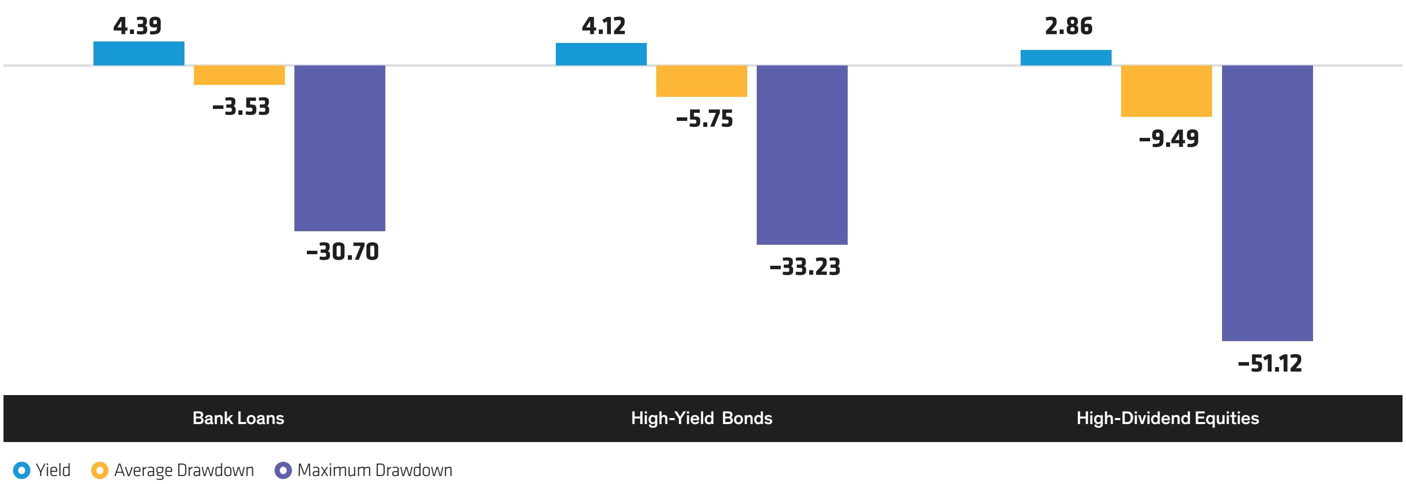
Let's assume that an investor is 10 years from retirement and looking to build as much wealth as possible in order to fund retirement income and leave a legacy. Based on our future return estimates, putting all of those funds into the market would produce a modest annualized return. And that comes with the ever-present exposure to downside risk that could be devastating to retirement income if not managed carefully given the relatively thin return expectations.

A handful of asset classes do generate reasonable income today (*Display 3*)—bank loans yield 4.4%, high-yield bonds 4.1% and high-dividend equities 2.9%. However, each carries substantial downside risk: the average drawdown for high-yield bonds, for instance, has been roughly 6% over the past 20 years, with a maximum drawdown of about 33%.

Stretching into these segments with too much exposure can be risky. Investors should seek to combine different sources of Efficient Income[SM]—designing strategies that generate income but in a way that manages downside risk. To do this, income-oriented investors should also consider looking beyond traditional market-based building blocks and explore "man-made" building blocks, too.

DISPLAY 3: HIGHER INCOME COMES WITH HIGHER RISK

Yield and Drawdown Characteristics (Percent)



Historical analysis does not guarantee future results.

Bank loans, high-yield bonds and high-dividend equities are represented by the S&P/LSTA Leveraged Loan Index, ICE BofA US High Yield Index and MSCI USA High Dividend Yield Index. Variable annuity is assumed to have 5% distribution.

Yields as of July 30, 2021; drawdown data based on period from June 30, 2001 through July 30, 2021

Source: Bloomberg, FRED, Morningstar Direct, MSCI, S&P, *Wall Street Journal* and AllianceBernstein (AB)

Tapping Man-Made Building Blocks—Including Annuities

Man-made building blocks may offer certain advantages over traditional building blocks. Hedge funds, for example, can be used to tailor market beta exposures, cushioning against losses while adding alpha potential. Commodity futures are another example of man-made components. However, returns for these building blocks will also likely be lower ahead. We think investors can do more.

With a contractual accumulation rate of 5%, the annuity's income base will grow by at least 5% annually during the accumulation phase.

This takes us to the variable annuity (VA), another man-made building block with characteristics that can make it an effective income producer. The VA, with an added guaranteed lifetime withdrawal benefit rider, can be tailored to deliver attractive guaranteed income levels for the rest of an investor's life.

For an annuity with a contractual accumulation rate of 5% (in line with rates on today's products*), the income base will grow by at least 5% annually during the accumulation phase—and potentially more if the underlying market portfolio fares better. This has the potential to be a compelling proposition in a low-return world. With its 5% guaranteed payout, the VA can deliver higher—and much more certain—income in retirement.

* For illustration purposes and actual rates vary by insurance product.

DISPLAY 4: MARKET PORTFOLIO UNDERWHELMS WHEN TARGETING ANNUITY TRAITS

Market Portfolio's Performance When Targeting…			
…Annuity's Annual Income Level		…Annuity's Failure Rate	
Annual Income	**$16,289**	Annual Income	**$5,700**
Probability of Market Portfolio Plan Failure*	**48.2%**	Probability of Market Portfolio Plan Failure*	**<1%**

Data do not represent past performance and are not a promise of actual results or a range of future results.

Market Portfolio comprised of 60% stocks and 40% bonds. *Plan failure is defined as a plan with 0 account value. Income target is determined in advance. The probability of plan failure for each income level is calculated using 10,000 simulations of a market portfolio with a 10-year accumulation phase and 30-year distribution phase, using AB's capital market assumptions.

As of December 31, 2020

Source: Bloomberg, Morningstar and AllianceBernstein (AB)

Head-to-Head: Market Portfolio vs. Variable Annuity

Let's see how the VA works out in practice, with the example of a 55-year-old investor with $200,000 to put toward expected retirement in 10 years. Investing all of it in the VA today, with its 5% contractual growth rate and 5% guaranteed income, would lock in a guaranteed lifetime income of $16,289 per year.

How does that stack up against a pure market portfolio without an annuity?

Let's assume the investor wants to have the same $16,289 yearly retirement income and invests the full $200,000 in a 60/40 market portfolio. If the investor draws the same level of annual income as with the VA over a 30-year retirement, there's a 48% chance that the account runs out of money before retirement ends, based on our return and withdrawal simulation (*Display 4*).

Those aren't very attractive odds for a secure retirement. One way to try and reduce the odds of income failure would be to simply withdraw less income annually.

In order to reduce the risk of failure to under 1%, the investor would need to slash annual withdrawals from $16,289 to $5,700, about one-third of the VA's withdrawals. Such a dramatic income reduction might lead some investors to ask whether it makes sense to invest any money in the market at all. Why not just put everything in the VA and certain income?

The Asset-Building Lens: Legacy Matters Too

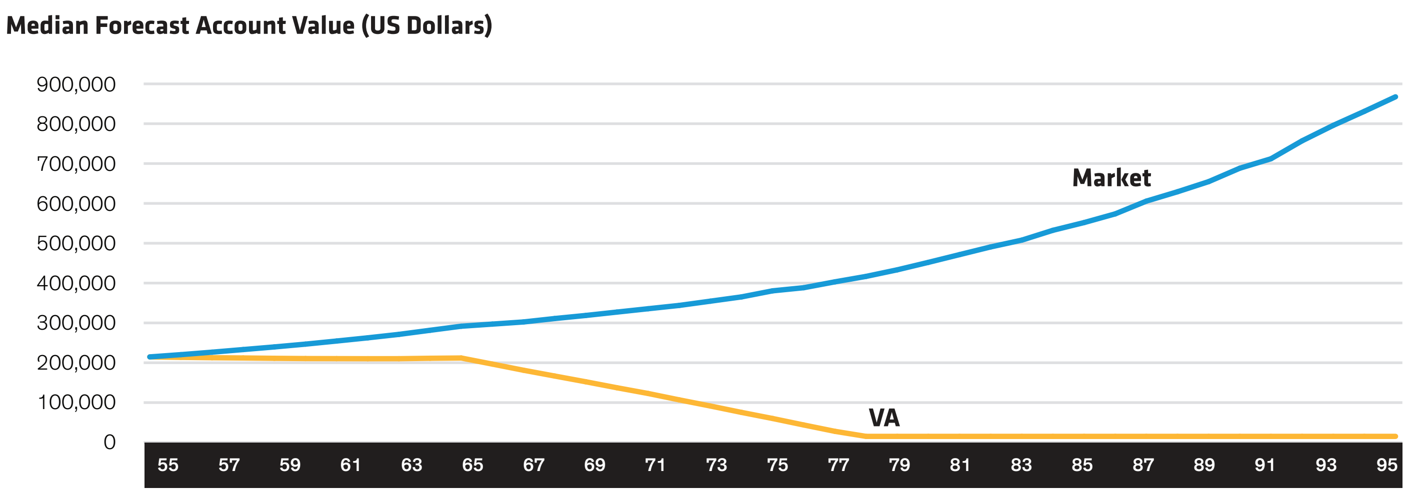
The reason is that the retirement coin has two sides: generating income to support the chosen lifestyle and having legacy wealth to pass on to heirs at the end of life. While the VA guarantees much higher retirement income than the market portfolio, those income withdrawals pare down the assets in the account, acting as a drag on account value over the years.

Based on the numbers, there's a 91% chance that the VA account will be fully depleted before the investor's retirement ends. In the median case over many thousands of simulations, the account value is fully drained by age 78 (*Display 5*). Of course, the investor would still get the contractually guaranteed income for life, but with no assets remaining at the end.

The market portfolio isn't expected to generate as much income as the VA, but it's likely to do a better job of growing the account value over time—and having wealth remaining at the end of retirement, enabling an investor to leave a legacy. While the VA has a decided advantage in retirement-income generation, the market portfolio has a decided advantage in wealth building.

The other benefit of the market account's growth is the investor's ability to tap into it to supplement VA income later in life. Remember, inflation will erode the purchasing power of the roughly $16,000-per-year income, so having money in the account helps to supplement income later in life or to buy a lifestyle enhancer (maybe a boat) in addition to enabling legacies.

DISPLAY 5: INCOME WITHDRAWALS DRAIN VA ACCOUNT VALUE



Data do not represent past performance and are not a promise of actual results or a range of future results.

Account values shown are the median value for 10,000 simulated accounts. Individual simulated portfolios may have a wide range of values around the median.

As of December 31, 2020

Source: Bloomberg and AllianceBernstein (AB)

The blended approach seems like a good solution that taps the best of both worlds: meaningful guaranteed income for life and meaningful wealth growth over the long run.

Income and Wealth: Seeking the Best of Both Worlds

Can investors get the best of both worlds—drawing an attractive level of retirement income and benefiting from a greater likelihood of leaving a meaningful legacy? We believe this can be achieved by combining the two approaches with a complementary blend of market portfolio and VA.

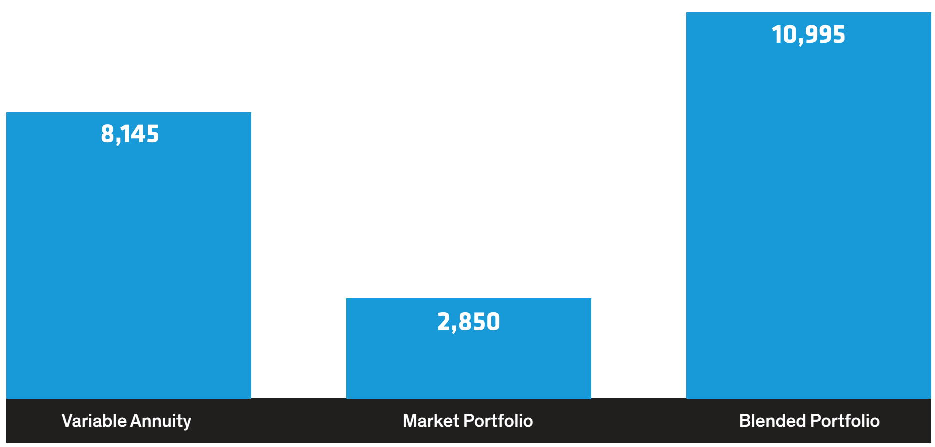
Let's revisit our hypothetical example, only this time we'll assume that the same investor splits the $200,000 investment at age 55, putting half in the VA and half in the market portfolio. In terms of income, the VA generates 5% annually and the market portfolio about 2%.

That 50/50 blend produces just over $8,000 in guaranteed income per year from the VA for life and nearly $3,000 from the market portfolio that's not guaranteed (*Display 6*). The mix of income generation and wealth-building potential eliminates the catastrophic risk of depending solely on a market portfolio. And with the market portfolio creating modest income, total expected lifetime income is almost $11,000 per year.

In terms of underlying account value, the VA/market blend ends up looking a lot more like the market-only account than like the VA account. The probability of losing the entire account value before retirement ends is less than 1% for both the market and blended portfolios.

DISPLAY 6: INCOME OUTCOME: BLENDING VA WITH MARKET PORTFOLIO

Expected Average Annual Lifetime Income (in US Dollars)



Data do not represent past performance and are not a promise of actual results or a range of future results.

Market portfolio comprises a $100,000 investment in a portfolio with 60% stocks and 40% bonds. Variable annuity assumes a $100,000 investment with a 5% accumulation rate, a 6% income rate and a 4% income rate when the portfolio value is exhausted. Assumes a 10-year accumulation period followed by a 30-year retirement time horizon. Blended portfolio is a portfolio with $100,000 invested in a variable annuity and $100,000 invested in the market portfolio.

As of December 31, 2020

Source: Bloomberg and AllianceBernstein (AB)

So, the VA provides a high level of income for life, but its account value is likely to run out before age 80. The market portfolio isn't as much of an income generator but is very good at delivering growth over time. The blended approach (*Display 7*) seems like a good solution that taps the best of both worlds: meaningful guaranteed income for life and meaningful wealth accumulation over the long run.

The sum is indeed greater than the parts in this case.

The 50/50 blend, of course, is an arbitrary formulation to demonstrate the power of the VA/market combination. In reality, investors would have many factors to consider when determining the best individual mix—calibrating their exposures based on retirement goals and needs, risk tolerances, investment portfolio options and the targeted balance of income and growth.

DISPLAY 7: LIFETIME INCOME: WEIGHING THE OPTIONS

Annuity Portfolio	Market Portfolio	Blended Portfolio
Expected Annual Lifetime Income **$16,289**	Expected Annual Lifetime Income **$5,700**	Expected Annual Lifetime Income **$10,995**
Median Account Value at Age 78 **$0**	Median Account Value at Age 78 **$402,000**	Median Account Value at Age 78 **$201,000**

For illustrative purposes only. All guarantees are backed by the claims-paying ability of the issuing insurance company.

As of December 31, 2020

Source: AllianceBernstein (AB)

Looking at the Big Picture

Investors face a historic challenge in generating enough income to last a lifetime and leave a legacy while managing the downside risk that could derail both.

Today's market environment is uninspiring, with interest rates near historical lows and equity valuations elevated. Stretching for higher-yielding assets can boost income but also increases the risk of debilitating market drawdowns that may leave investors with no time—or not enough assets—to fully recover.

Blending a VA and market-based portfolio has the potential to deliver both strong income and growth potential that increases the likelihood of having remaining assets at the end of retirement to pass on a legacy to heirs. For investors who see retirement looming a decade away, we think this combination could go a long way toward tackling the income challenge at retirement.

Learn More

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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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