ASSET MANAGER'S LENS

When a Distribution Isn't Income: Rethinking Bond Alternatives

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The difficult bond market of 2022 prompted many investors to reconsider the role of traditional fixed income in diversified portfolios. Since then, equity-linked strategies—including buffer ETFs and autocallable products—and floating-rate credit strategies such as leveraged loans have attracted attention from investors seeking higher distributions, less interest-rate sensitivity or greater return potential.

These strategies can offer legitimate investment opportunities. But when they are evaluated as alternatives to traditional bonds, an important portfolio-construction question arises: Are investors replacing fixed income with investments that serve the same purpose, or simply exchanging interest-rate risk for equity, credit, liquidity or structural risk?

Answering that question requires looking beyond headline distribution rates and recent performance. Investors need to understand where the cash flow comes from, what risks are involved and how the investment may behave when market conditions change.

Bond alternatives are investments or strategies used in place of, or alongside, traditional high-quality fixed income—often in pursuit of higher distributions, less interest-rate sensitivity or a different return profile. These can include equity-linked strategies, such as buffer ETFs and autocallable products, as well as floating-rate credit strategies, such as leveraged loans. Although these investments may be presented as income solutions, their sources of return and risks can differ substantially from those of traditional bonds.

A Distribution Is Not Necessarily Income

One of the most important considerations when evaluating bond alternatives is the distinction between the cash an investment distributes and the economic return it generates.

Traditional bonds generally provide contractual interest payments and repayment of principal at maturity, subject to the issuer's ability to meet its obligations. Bond funds invest in portfolios of these securities, generating income from underlying holdings while their net asset values fluctuate with market conditions.

Autocallable strategies generate cash differently. Their potential payments and investment outcomes are generally linked to the performance of an underlying equity index or other reference asset. An autocallable ETF, for example, may provide exposure to a group of investments tied to that reference asset. Each underlying investment may make payments while certain market conditions are met and may be redeemed early—or "called"—if the reference asset reaches a specified level. The ETF can then replace positions as they are called or mature. Although these strategies may offer attractive distributions, investors assume downside risk tied to the reference asset and may lose principal if it performs poorly. Those payments are not ordinary bond interest.

Investors may receive attractive distributions while specified market conditions are met, but they also face the possibility of significant losses depending on the performance of the reference asset and the terms of the strategy. In economic terms, the strategy's return potential reflects compensation for assuming contingent downside risk tied to that reference asset; it is not ordinary bond interest.

When these strategies are packaged in an ETF, the fund may make regular cash distributions. However, the amount distributed does not necessarily represent net investment income or the investor's economic return. A distribution may include investment income, realized gains or a return of capital.

Return of capital can arise for accounting, tax and economic reasons and is not inherently negative, nor does it necessarily indicate poor investment performance. It does, however, reinforce why investors should understand what is generating a distribution rather than interpreting the headline distribution rate as earned income or expected return.

Distribution rate, 30-day SEC yield, yield to worst and total return each provide different information. Understanding what each measure represents can help investors make more meaningful comparisons across strategies.

Understanding the Numbers: Four Measures of Yield and Return

Distribution Rate

An annualized measure of cash distributions relative to a fund's share price or net asset value. It is often calculated by annualizing the fund's most recent distribution, which may include investment income, realized gains and return of capital. A distribution rate does not necessarily represent income earned, future distributions or the investor's total return.

30-Day SEC Yield

A standardized measure of a fund's net investment income over a 30-day period, expressed as an annualized percentage using the SEC-prescribed calculation. Unlike a distribution rate, it is based on income earned rather than all cash distributed. It facilitates comparisons among funds but does not represent a guaranteed future yield or capture every potential source of return.

Yield to Worst (YTW)

For a bond, the lowest calculated yield an investor could receive if the issuer repays the bond as permitted under its terms—at maturity or an earlier call date—assuming all scheduled payments are made. At the portfolio level, YTW is an aggregation of underlying bond yields using the provider's methodology. It is not a guaranteed return and generally does not capture future changes in market prices, defaults or reinvestment conditions.

Total Return

The overall investment gain or loss over a specified period, including both changes in market value and distributions, generally assuming those distributions are reinvested. Total return provides a more comprehensive measure of actual investment performance over the measurement period than a distribution rate alone.

A high distribution rate does not necessarily indicate a high level of earned income—or a correspondingly high total return. Investors should consider the source of the distribution, changes in the investment's value and the risks required to generate the payment.

Different Sources of Return, Different Risk Exposures

Strategies positioned as alternatives to traditional bonds may reduce exposure to one familiar risk while introducing another. Understanding that tradeoff is especially important when an investment is intended to replace a portion of a portfolio's fixed-income allocation.

Floating-Rate Credit Strategies

Floating-rate leveraged loans generally have less direct sensitivity to changes in benchmark interest rates than comparable fixed-rate bonds. Because their interest payments adjust with prevailing rates, investors may receive higher income when benchmark rates rise.

Reduced interest-rate sensitivity, however, does not eliminate investment risk. Leveraged loans are obligations of companies that often carry substantial debt burdens, and their values remain sensitive to credit fundamentals, liquidity conditions, refinancing requirements and changes in market sentiment.

Higher borrowing costs illustrate how these risks can interact: Rising rates may increase the income generated by floating-rate loans while placing greater financial pressure on the borrowers responsible for making those payments.

Equity-Linked Strategies

Equity-linked strategies introduce a different set of tradeoffs. Buffer ETFs generally use options to absorb a predetermined portion of an equity index's losses over a specified outcome period in exchange for limiting upside participation through a cap.

Autocallable strategies use a different structure, but their distributions and investment outcomes also depend on the performance of an underlying equity index or other reference asset, as well as the specific terms of the strategy.

Although barriers or buffers may provide a measure of downside protection under certain conditions, investors can still face meaningful losses if those protections are exceeded or do not apply. These strategies remain meaningfully influenced by targets often linked to equity markets and may behave more like other risk assets during periods of market stress, when diversification may be most valuable. An investor seeking to reduce interest-rate sensitivity may therefore assume greater credit or liquidity risk through floating-rate loans—or greater equity-market and structural risk through an equity-linked strategy.

The relevant question is not simply whether one strategy appears less risky than another. It is which risks the investor is assuming, how those risks interact with existing holdings and whether the investment is likely to serve its intended role in the portfolio.

Why Today's Starting Yields Matter

The interest in bond alternatives is understandable in light of the fixed-income market's experience in 2022. Rapidly rising interest rates produced substantial losses across many traditional bond benchmarks, while exceptionally low starting yields provided little income to offset the decline in bond prices.

Today's starting point is meaningfully different. Higher yields can contribute more income to total return, provide a larger cushion against potential price declines and allow investors to reinvest interest payments and maturing principal at more attractive rates than were available during much of the preceding decade.

Higher starting yields do not eliminate interest-rate risk. Bond prices generally decline when yields rise, and longer-duration securities remain more sensitive to changes in rates. Both starting yield and interest-rate sensitivity can significantly influence potential total returns.

How Might Treasury Returns Respond to Changing Rates?

Estimated one-year total returns for hypothetical 3-, 5- and 10-year U.S. Treasury securities assuming yields decline by 100 basis points, remain unchanged or rise by 100 basis points.

Hypothetical Treasury	Yields Decline 100 bps	Yields Unchanged	Yields Rise 100 bps
3-Year	+6.84%	+5.04%	+3.28%
5-Year	+8.79%	+5.13%	+1.62%
10-Year	+12.79%	+5.35%	-1.50%

Source: Bloomberg Finance L.P. Hypothetical Treasury scenario analysis as of September 30, 2026. Estimated one-year total returns under assumed parallel changes in Treasury yields. Hypothetical results are illustrative, not forecasts, and do not represent actual investment performance.

The analysis illustrates how starting yield and interest-rate sensitivity can affect potential returns. In the scenarios shown, the hypothetical 3-year Treasury generates a positive estimated total return even if yields rise by 100 basis points because its income offsets the modeled price decline. The hypothetical 10-year Treasury offers greater appreciation potential if yields fall but experiences a negative estimated return if yields rise by the same amount.

These results are illustrative, not predictive. They do, however, demonstrate why evaluating bonds solely through the lens of 2022—or other recent historical returns—may overlook the potential contribution of today's higher starting yields.

Fixed-income strategies also differ in their exposures. Short-duration strategies generally seek to limit interest-rate sensitivity, while Core Plus and other flexible mandates may adjust duration, sector allocations and credit exposure within their investment guidelines. Understanding those differences can help investors evaluate how a fixed-income allocation may respond as market conditions change.

Portfolio Construction: Understanding What Is Being Replaced

Bond alternatives can serve useful roles within diversified portfolios. Equity-linked strategies may provide modified equity exposure, while floating-rate credit may offer a different combination of income potential and interest-rate sensitivity. But those characteristics do not necessarily make either category a direct substitute for traditional fixed income.

Before replacing a bond allocation, investors should consider what function that allocation is intended to perform and whether the proposed alternative is likely to serve the same purpose across different market conditions. Several questions can help:

- **Where does the cash flow originate?** Is it generated from contractual interest payments, payments contingent on the performance of a reference asset, realized gains or a return of invested capital?
- **What risks support the expected return?** Is the investor assuming interest-rate risk, credit risk, equity market exposure, liquidity risk or some combination?
- **How might the investment behave during market stress?** Could an allocation intended to provide diversification become increasingly sensitive to the same economic conditions affecting equities or other risk assets?

- **What role is the investment intended to serve?** Is the objective income, capital preservation, diversification, total return or some combination?
- **Does the structure match the investor's time horizon and liquidity needs?** Could the timing of a purchase, sale or market decline materially affect the intended outcome?

These questions are particularly important when an investment offers a distribution rate that appears substantially higher than yields available in traditional fixed income. A higher distribution rate may be attractive, but it should be evaluated alongside the source and sustainability of the distribution, potential changes in principal value and the risks required to generate the payment.

Bottom Line

Bond alternatives can offer investors useful ways to pursue cash flow, total return and diversification. But investments that produce similar-looking distributions may rely on very different sources of return and expose investors to very different risks.

The question is not whether bond alternatives are inherently better or worse than traditional fixed income. It is whether investors understand what they own and the tradeoffs they are making. The distinction between receiving cash and earning a return has always mattered; in today's expanding universe of income-oriented investments, it may matter more than ever.

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