AB Short Duration High Yield Portfolio

Advisor Class: ALHYX

Portfolio Performance

In the fourth quarter of 2023, the AB Short Duration High Yield Portfolio* (Advisor Share Class) delivered positive absolute returns and outperformed its benchmark, the Bloomberg US High Yield 1–5 Year Cash Pay 2% Index, which returned 5.61%. Year to date, the Portfolio increased in absolute terms but underperformed the benchmark's return of 12.20%.

In July of 2023, we transitioned Limited Duration High Income into a Short Duration High Yield strategy. The fund will continue to invest in shorter-duration high yield but will change its investment profile. This includes reducing the fund's off-benchmark exposure across securitized and emerging markets, and increasing our high-yield corporate allocation to at least 80% weight in the fund; duration will be on the shorter end, closer to the 2–2.5 range on average. Our benchmark also changed to the Bloomberg US High Yield 1–5 Year Cash Pay 2% constrained from the Bloomberg Global High Yield 1–5 Year Index—Hedged.

Global Market Review

During the quarter, developed-market (DM) government bond yields fell sharply in all markets except Japan's, as most central banks basically ended their hiking cycles as economic growth slowed and inflation continued to abate. In aggregate, DM government bonds rose 5.45%, fueled by investor expectations of favorable central bank monetary policy next year. Most credit risk assets outperformed. DM investment-grade corporate bonds rose 7.53%, with corporates in the US exceeding the return of US Treasuries, while eurozone corporates trailed the 7.74% return of eurozone treasuries. High-yield corporates gained 6.89%, with US high yield outperforming US Treasuries, while eurozone high yield trailed eurozone treasuries. Among securitized assets, collateralized loan obligations returns were mixed, while credit risk–transfer securities trailed other credit risk assets. In the US agency mortgage-backed securities (MBS) sector, the investment results of agency MBS outperformed US Treasuries. Emerging-market (EM) hard-currency sovereign and corporate bonds gained 9.16% and 5.52%, respectively, while local-currency bonds rose 8.07% as the US dollar fell against most DM and EM currencies over the quarter.

- Global High Yield: 7.75% (Bloomberg Global High Yield Index, hedged to USD)
- US High Yield: 7.16% (Bloomberg US Corporate High Yield Index)
- Pan-Euro High Yield: 6.09% (Bloomberg Pan-European High Yield Index, hedged to USD)

Outlook and Positioning

The global economy is slowing, and most DM central banks are on the cusp of pivoting from combating inflation to lowering interest rates in order to keep economic growth from falling more than required to reach central bank inflation targets. Although headline inflation has been generally trending down on a monthly basis, getting core inflation to a sustainably low level will take some more time, and will vary by country, based on individual growth trends.

Although there are risks associated with lowering interest rates too soon, it is important to acknowledge that central bankers managed to help keep the global economy from entering a systemic recession in 2023, given aggressively restrictive short-term interest rates.

---

*Prior to July 5, 2023, the Fund was named AB Limited Duration High Income Portfolio. Effective July 5, 2023, the Portfolio's primary benchmark changed to the Bloomberg US High Yield 1–5 Year Cash Pay 2% Index. Prior to then, the benchmark was the Bloomberg Global High Yield 1–5 Year Index.

Economic conditions in most DM are likely to settle down with below-trend growth as inflation continues to abate, a so-called soft landing. This is our base case, and it seems to us that DM central bankers deserve the benefit of the doubt for now.

Financial markets applauded the shift in central bank thinking. Government bond yields in DM plunged and equity markets surged in the fourth quarter, as DM central banks changed their messaging toward monetary policy easing. However, market participants are currently pricing in rate cuts in several markets that are larger than what may occur. Importantly, the more dovish that investors believe central bankers will be, the less likely it is that central banks will be able to deliver what markets expect—because the easing of financial conditions associated with rapidly falling yields could mitigate the magnitude of anticipated rate cuts. Nonetheless, DM rate cuts are now visible on the economic horizon. The quandary for investors is how soon, how fast and how far interest rates will fall. The inevitable trajectory of rate cuts may lead to increased volatility in capital markets as investor expectations change, potentially repricing financial assets.

The evidence supporting near-term rate cuts is weakest in the US. Economic growth in the US was much more than expected for most of 2023, and although the US economy is slowing, growth seems likely to remain positive in 2024. Our forecast is for US GDP to expand at a below-potential rate in coming quarters. Below-trend growth should support gradual disinflation, which should allow the Fed to begin monetary easing. We are skeptical about the early start to, and aggressive pace of, Fed easing currently priced into financial markets, since that path seems more consistent with a hard landing for the US economy. We instead foresee an easing cycle in which the Fed cuts rates in an effort to bring the economy back into equilibrium, rather than a path to forestall a recession—a cycle of choice rather than necessity. A determining variable for the Fed will be the strength of the US labor market and corresponding wage-growth pressures on inflation. Our base case for US GDP, however, suggests a more modest rebalancing of the labor market, leading to a later start of rate cuts and a more gradual pace of easing.

In Europe, the eurozone appears further along in its disinflationary cycle than in the US, where core inflation remains well above target, for now. The ECB's single inflation mandate suggests that the bloc's central bank will need to be cautious rather than aggressive over the near term. Relatively weaker economic performance in the eurozone should give the ECB the confidence that inflation will decline to target because of tepid or flatlined economic growth. The Bank of England (BoE) has a more challenging scenario, because of elevated inflation and weak growth. While the recent progress on the UK inflation front is welcome news, there is still a long way to go, so we anticipate that the BoE will lag the Fed and ECB in cutting interest rates.

The largest Asian economies remain off cycle with their Western peers. As the Fed, ECB and BoE confirm signs that inflation is headed in the right direction, the Bank of Japan (BoJ) is monitoring the Japanese economy for evidence that current levels of inflation are sustainable. Once the BoJ is confident that inflation will hover around its inflation target, a goal that has been absent for decades, we expect the BoJ to finally end negative interest rates and lift its relaxed yield-curve control target sometime in 2024, perhaps as early as April, when the annual wage negotiations are concluded. That means that the BoJ could be tightening monetary policy somewhat as other DM central banks begin to ease.

In China, it is imperative that fiscal and monetary policies support growth and combat disinflation. We remain confident that policymakers have the tools to accomplish their goals, yet investors should temper their expectations for now. The main objective of the Chinese government and People's Bank of China is to manage a long-term sustainable structure for the Chinese economy, rather than producing a near-term outsize acceleration of the economy.

EM have faced high global interest rates, an elevated US dollar, geopolitical instability and below-trend economic growth in China, yet have managed to post trend-like growth. We expect EM growth to remain relatively steady in 2024 amid softer DM growth, as EM monetary easing takes effect and global financial conditions ease.

Financial markets appear to be entering the new year on a firm footing, buoyed by the idea that central banks will soon be cutting interest rates as economic growth slows, and we generally share that optimism. Of course, we remain mindful of any unknowns that could evolve quickly as the global economy settles down after several years of economic challenges during the global pandemic and the recovery thereafter.

The “immaculate disinflation” still seems to be on track. Thus far, central banks have managed the improbable, bringing inflation down without causing serious economic damage. That keeps the global economy on track for a soft landing, though it may not be equally soft everywhere. With inflation falling, the door to rate cuts is opening. We don’t think central banks are yet convinced that inflation is falling far enough fast enough for them to cut, but rate hikes seem very unlikely at this stage. We think it will be a few more months before rate cuts arrive but trying to guess when the cycle starts misses the point: the regime has changed. At the same time, global growth is slipping and will fall below potential in the coming quarters. We believe that over the longer term, the case for diversification remains critical. The yield to worst (YTW) on the Portfolio (which can be used as a gauge of future returns) is 7.1%; that captures approximately 94% of the broader market’s YTW, even though the Portfolio has a much higher quality and shorter duration than the broader high-yield market.

Corporate fundamentals have been very resilient, and balance sheets remain strong. However, they have deteriorated somewhat. We expect this trend to continue as the economy slows and companies have to manage around greater interest expense. Despite this, fundamentals should remain supportive of credit given the strong starting point. Leverage is currently at the lower end versus long-term levels, and interest coverage is still near all-time highs. As rates have become more restrictive and corporations face more headwinds—including higher financing costs—we expect defaults to increase in 2024 to average or slightly higher-than-average levels. During 2023, there have been significantly more rising stars ($125 billion) than fallen angels ($14 billion). Most analysts expect the upgrade/downgrade ratio to be closer to one in 2024. We believe that high yield can provide attractive longer-term returns, as the yield to worst (as measured by the Bloomberg Global High Yield Corporate) ended November at 7.6% and has historically been a good predictor of future returns.

We have generally rotated out of more cyclical industries, such as energy and commodity chemicals, and into more defensive, less-cyclical industries with better downside protection. However, we are overweight some more cyclical sectors where we believe balance sheets are stronger, such as autos.

We continue to allocate to banking. Following March stress, we reduced our additional Tier 1 securities (AT1s) exposure and now prefer senior bonds that should exhibit less volatility. Our small AT1s exposure is focused on stronger banks where we would rather own the subordinated debt of high-quality companies than the senior securities of lower-quality companies, given the deteriorating macroeconomic environment. We view this as a way to go “up in quality” while maintaining a competitive yield. In all our holdings, we are focusing on large national champion banks, where post–global financial crisis regulation has strengthened balance sheets and mandated periodic stress-testing, and avoiding US regional banks. Banks are in a strong position to absorb losses from bad loans and securities, have strong ongoing earnings capacity (as seen in earnings releases) and have created loan-loss reserves. Capital ratios remain high and nonperforming loans are near all-time lows. Deposits are more diversified than in regional banks, enabling larger banks to benefit from a “flight to quality” by depositors. We expect credit metrics to weaken somewhat from their highs as growth declines, but not to the extent that would trigger ratings downgrades. We expect capital adequacy ratios to decrease to medium-term targets and nonperforming loans to move toward “through-the-cycle” levels. Overall, we see banks as well positioned to absorb credit losses as they come through, given their strong starting position. Also, given these banks’ systemic importance, we believe that regulators would provide support in the event of financial distress, as they did in March. During the month, we reduced some idiosyncratic exposure to AT1 securities.

We diversified our US high-yield exposure with an allocation to European high yield, which historically has provided attractive opportunities.

We remain cautious on the energy sector, as it tends to be very volatile and heavily tied to the price of oil, which we believe is tough to predict. Over the last three years, energy has been the best-performing high-yield sector by a long shot and trades at one of the lowest spread levels, so valuations are less attractive. Overall capacity remains below pre-COVID-19 levels, as rig counts have been kept in check. The high-yield energy sector has become higher quality, as many weaker credits have defaulted and there has been a large influx of fallen angels. Year to date, we have increased our position in names that were relatively attractive, such as midstream issuers.

We own BBB-rated bonds that do not give up much yield when compared with BB-rated bonds.

Please refer to the following legal disclosures.

A WORD ABOUT RISK

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:** As interest rates rise, bond prices fall and vice versa—long-term securities tend to rise and fall more than short-term securities. **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:** 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. **Diversification Risk:** Portfolios that hold a smaller number of securities may be more volatile than more diversified portfolios, since gains or losses from each security will have a greater impact on the portfolio's overall value. **Derivatives Risk:** Investing in derivative instruments such as options, futures, forwards or swaps can be riskier than traditional investments, and may be more volatile, especially in a down market. **Below-Investment-Grade Securities 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.

References to specific securities are provided solely in the context of the analysis presented and are not to be considered recommendations by AllianceBernstein. AllianceBernstein and its affiliates may have positions in, and may affect transactions in, the markets, industry sectors and companies described herein.

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, contact your AB representative. Please read the prospectus and/or summary prospectus carefully before investing.

Investment Products Offered: Are Not FDIC Insured | May Lose Value | Are Not Bank Guaranteed

Bloomberg US High Yield (HY) 1-5 Year Cash Pay 2% Index represents the performance of non-investment-grade fixed-income securities in US markets that are cash pay and with more than one year and less than 5 years remaining until maturity. All index positions must be a max of 2% of the market weight.

An investor cannot invest directly in an index and its performance does not reflect the performance of any AllianceBernstein fund. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.

DOC ID: 465, UMF-478184-2024-01-10