AB Sustainable Global Thematic Fund

Advisor Class: ATEYX

2023 Recap: Stronger Economic Growth, Market Concentration, Artificial Intelligence Optimism and Expanding Multiples

Recession fears dominated the early part of 2023 as the US Federal Reserve continued its steady path of rate increases. Instead, the economy proved resilient and surpassed bearish expectations. Concern about recession has been replaced by hope for “immaculate disinflation," a scenario where inflation slows without a meaningful impact on growth and employment.

The market’s narrow rally was fueled by a surprisingly strong economy, the artificial intelligence (AI) ambitions of Big Tech and, lately, the prospect of interest-rate cuts in 2024. Even the bond market has perked up after a historic downturn—one that briefly sent yields to 5%.

Global markets, as measured by the MSCI All Country World Index (ACWI), increased by 11.03% during the fourth quarter, bringing full-year returns to 22.20%. During the quarter, fear of higher-for-longer interest rates was replaced by the prospect of easing of financial conditions in what is widely viewed as a “Fed pivot” on the back of disinflation forces.

Looking Ahead

The US economy is slowly weakening. Unemployment is rising, although far more gradually than most had anticipated. That said, some lead indicators point to further deceleration in the first half of 2024, including the drop in M2 money supply. Regardless of the level, it is virtually certain that the growth rate is declining. Financial conditions have certainly eased of late—a trend that has been noticed by the markets and is likely to continue as long as disinflation persists. The fact that it’s an election year increases the chances of a supportive fiscal, and perhaps monetary, environment—though elevated perceived risks relating to the outcome could dampen equity valuations.

Market Outlook: A Broadening Out of Leadership

The strong equity market rally in 2023 has masked more muted returns for most stocks. The 10 largest stocks in the S&P 500 (largely big technology-oriented companies) accounted for an abnormally large share of its weight and year-to-date returns. The equal-weighted S&P 500 underperformed the cap-weighted S&P 500 by 12.42%, while the equal-weighted MSCI ACWI underperformed the cap-weighted MSCI ACWI by 13.32%.

Although some of the returns are justified by the superior profitability of these mega-cap technology stocks and the new growth avenues that AI has provided, the narrowness will likely end in due course, as it has in the past. Catalysts for a change in leadership are often difficult to predict, but a few logical ones include: a recovery in growth from sectors such as healthcare and communications that have been plagued with excess inventories; a recognition that the generative AI wave will benefit more than just the cloud providers as related earnings materialize; and weaker results, and/or multiple compression from historically elevated levels, in one of the individual market leaders that leads investors to question the whole group.

Fundamental Resilience at a Historical Discount

From a timing perspective, many of our themes have been overlooked this year given the dominance of the Magnificent Seven. Incredible benchmark concentration reinforces our view that benchmarks are inherently backward looking. In 2023, this concentration has had a negative impact on our relative performance, but we believe that, over the long term, our disciplined process will help us to uncover more attractive investment opportunities for investors. Our portfolios remain highly differentiated as compared to the benchmark

with many of the mega-cap names absent from our holdings. Indeed, names that our portfolios actually hold have performed well compared with the rest of the market, arguing that the underlying fundamentals of the majority of our holdings remain strong.

Many of our Fund's companies have seen prices reset even as earnings expectations for the Fund as a whole have continued to grow nicely, in line with our expectations. While valuations at the index level have risen dramatically, the increase is distorted by the influence of a few key stocks. In contrast, our portfolios trade at very reasonable valuations and the premium compared with the market is at one of the lowest levels in the past decade.

Fund Performance

For the fourth quarter, the AB Sustainable Global Thematic Fund increased in absolute terms and outperformed its benchmark, the MSCI ACWI. For the full year, the Fund delivered positive absolute returns but underperformed the benchmark. During the quarter, sector selection contributed to overall returns while stock selection was negative. An overweight to technology and an underweight to energy contributed the most. In contrast, stock selection within consumer staples and an overweight to healthcare detracted.

TopBuild, an installer and specialty distributor of insulation and building material products from our Empowerment theme, contributed. Shares traded higher amid rate tailwinds and management's cautious optimism that residential demand could hold up relatively well in 1H:24, supported by improving trends in single-family housing starts and a steady cadence of growth in multifamily units.

Fair Isaac Corporation (FICO), a predictive analytics company best known for its market-dominant FICO score, from our Empowerment theme, contributed as shares were buoyed by strong fourth-quarter results and solid 2024 guidance. The company highlighted continued opportunity for price hikes as well as a robust pipeline for software sales.

Experian, a global data-services specialist from our Empowerment theme, contributed after shares originally weakened ahead of interim results on the back of a negative surprise from industry peer TransUnion. However, Experian's half-year results and reiterated guidance were welcomed by the market. Experian's combination of cyclical and countercyclical businesses continued to deliver consistent growth despite a rising interest-rate environment and accompanying uncertainty, which resulted in credit bureau underperformance in 2023.

BYD, an electric vehicle (EV) manufacturer from our Climate theme, detracted. Shares declined along with Chinese EV peers on recent pricing promotions into the end of the calendar year as the company looks to shed some inventory, which has been slightly above average. We remain optimistic on BYD's growth and profitability profile given its well-documented cost advantage and the increasing contribution from its premium brands and exports.

Alcon, an eye-care product maker from our Health theme, detracted after the company reported mixed earnings results and trimmed the high end of its guidance, citing foreign exchange headwinds and weaker surgical segment results.

Becton Dickinson, a manufacturer of medical devices in the diagnostic segment, from our Health theme, detracted as earnings results highlighted macroeconomic weakness in China, foreign exchange headwinds in light of a strong US dollar, and the impact on margins from inventory work downs. On the positive side, the company is guiding toward decent underlying organic growth next year. Management is improving cash flow and pursuing a smarter strategy around tuck-in mergers and acquisitions versus the much larger consolidation-type deals of five to 10 years ago.

Thematic Check: "Alive and Well"

Amid all the noise, our themes continue to move forward as broad shifts in the global economy run their course. Global challenges such as access to healthcare and infrastructure needs are not solved overnight. Entering the year with a more defensive mindset did not help; however, our core thematic exposures continue to offer robust growth potential.

We believe a portfolio with high-quality companies on the right side of change, trading at reasonable valuations, provides a strong combination for the current market environment. Resilient fundamentals and narrow leadership in the market have created a powerful setup for a group of companies that fit this profile.

Within information, communication and technologies, the latest earnings results from a number of leaders like NVIDIA, AMD and the cloud providers demonstrate that society's move toward intelligent digital economies is leading to increased demand for bigger networks, more powerful and energy efficient data centers, and new consumption models. We continue to expect the key AI enablers—companies that facilitate the training and running of AI models in an energy-efficient way—and the adopters that successfully integrate AI in their applications will enjoy strong tailwinds in the near term.

Within transportation, secular shifts in automotives continue—EV global sales rose more than 50% through September 2023 versus 63% growth in 2022. EV adoption continues to grow, but it will not be a straight line. Additionally, automotive original equipment manufacturer (OEM) stocks are still in a discovery phase, learning what features have the greatest appeal with consumers. As with our other themes, our focus on the enablers of vehicle electrification is driving an earnings tailwind despite OEM-specific challenges. Every EV rolling off the line contains significantly more electronic content, benefiting suppliers in this ecosystem. We're also seeing a standardization of charging standards in the US, which should encourage further adoption.

In our Health theme, there have been a few dynamics at play in 2023. A lot of the diagnostic and testing companies benefited from robust demand during the early days of COVID. Lead time to get products significantly increased, so customers ordered more to ensure supply. In 2023, we saw the reverse as lead times decreased. We are going through a period of inventory digestion (for life sciences and diagnostic tools particularly) along with macroeconomic weakness in China—a double whammy of sorts for suppliers into this ecosystem. The underlying growth rate of their customers (biopharmaceutical production) remains in the double digits. The market enthusiasm around weight loss has also drawn investor attention and buying activity, further depressing valuations for companies outside this group. We expect 2024 should see an improvement in inventory profiles and growth rates for suppliers of medical innovation products as well.

As Ben Graham said, "In the short run, the market is a voting machine but in the long run it is a weighing machine." Rather than chasing the market's chosen few, our focus continues to be on identifying powerful themes and the companies best positioned to capitalize on these opportunities. This approach has delivered strong results for our clients over time and we are highly confident in its ability to do so in the future.

As always, thank you for your continued support.

Dan Roarty

Top Ten Holdings*	Fund %
Visa	3.14
Microsoft	3.10
Partners Group	2.82
Waste Management, Inc.	2.75
Accenture	2.50
MSCI	2.49
Deutsche Börse	2.46
London Stock Exchange	2.41
Flex	2.35
Intuit	2.29

*Based on a representative account as of 12/31/23. Holdings, characteristics and weightings (which are equity only weightings and excluding cash) will vary over time. They are provided for informational purposes only and should not be deemed as a recommendation to buy or sell the securities mentioned.

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