AB Tax Aware Portfolio

Separately Managed Accounts

Market Overview

Volatility increased in the third quarter as yields continued to march higher. Inflation was once again the catalyst, surprising to the upside in both August and September. Stubbornly high inflation has put the Federal Reserve in an increasingly challenged spot and has forced them to continue their aggressive path raising short-term interest rates. During the quarter, the Fed raised rates by 150 basis points (b.p.) to a range of 3.00% to 3.25%. This is now the quickest rate-hike sequence in more than 50 years.

Given the increasingly difficult macro environment, it is not surprising that financial markets have been weakened and are more volatile as investors recalibrate their expectations with heightened attention to any data that portends a discernable trend. Similarly, municipal market performance continued to struggle during the third quarter. Despite a strong start in July, with the Bloomberg Municipal Index returning 2.64%, performance quickly turned negative in the subsequent two months. September ended up being the worst month of performance so far in 2022. For the quarter, the Bloomberg Municipal Index returned –3.46%, bringing year-to-date returns to –12.13%, the worst nine-month start since the index was incepted in 1980.

Record year-to-date municipal mutual fund and exchange-traded fund outflows of $92 billion continue to cause dislocation across the municipal market. Municipals, which came into the year looking expensive versus their US Treasury counterparts, now look cheap on a relative basis. Ten-year after-tax spreads are close to five times wider than where we began this year, with municipals offering 105 b.p. of relative yield increase.

For flexible investors, there are other areas of the municipal landscape that offer value as well, particularly within municipal credit, which, in our view, has dislocated from the continued improvement in underlying fundamentals. Based on available tax data through the second quarter, year-over-year tax collections have increased 14%, versus the same period in 2021. The combination of better-than-expected tax revenues and stimulus money has bolstered municipal government balance sheets significantly. Rating agencies have taken notice, as credit upgrades were responsible for 81% of rating revisions in the second quarter of 2022, according to Moody's—the sixth consecutive quarter of upgrades. However, despite this backdrop, BBB-rated and high-yield municipals have underperformed year to date as credit spreads have widened. The average BBB-rated bond now offers near 130 b.p. of additional yield, otherwise known as a credit spread, versus comparable AAA-rated municipals, presenting an opportunity for investors to increase weight to municipal credit.

Portfolio Performance

For the quarter, the AB Tax Aware Portfolio outperformed its benchmark, the Bloomberg Municipal Bond Index, gross of fees but underperformed its benchmark net of fees. Gross of fees, the Strategy's yield-curve positioning was beneficial to performance, as the curve flattened. Additionally, during the quarter, we used the Portfolio's flexibility to add a position in short US Treasuries. Toward the end of July, short municipals looked extremely expensive on a relative basis to short Treasuries. For instance, on July 20, investors could purchase a two-year US Treasury and pick up 22 b.p. of after-tax yield versus a two-year AAA-rated municipal bond, even after paying full federal income tax (40.8%). This position increased Portfolio after-tax yield and reduced volatility, as we saw short after-tax spreads widen over the next six weeks. Once municipals looked attractively priced again in early September, we exited the position and reentered the muni market at more favorable valuations.

The Portfolio's overweight to municipal credit detracted versus the benchmark as credit spreads widened. Although spreads widened during the quarter, our view on municipal credit remains constructive, and we are using this spread-widening event as a way to selectively add credit risk at more attractive valuations. Security selection within Tobacco and Electric Utility bonds detracted from returns, while our positions in Local G.O. and Healthcare bonds contributed.

Outlook

While volatility will remain present in the short term, current valuations suggest an attractive entry point for long-term investors. First, yields on the Portfolio and index have nearly quadrupled year to date. At the start of the year, the AB Tax Aware Portfolio yield to worst was 1.25%. Today, that number is 4.40%, or a taxable equivalent yield of 7.43%. Furthermore, now that income levels are higher, investors are more insulated against future rate increases as higher levels of income can more quickly offset price losses associated with rising rates. In addition, relative valuations in municipals are significantly more attractive today than where we began the year. Eventually, after-tax spreads will migrate closer to fair value—which will provide additional return potential above the Portfolio's yield.

With expectations regarding a US economic recession increasing, a common question is how municipalities will hold up in a recessionary environment. The answer to that question is that municipal credit fundamentals remain sound. States and municipalities have learned their lessons from the 2008 crisis, have bolstered reserves and are in their strongest fiscal position in recent memory. During strong economic periods, states can add to reserves, shore up pension funds and increase infrastructure spending. State budget officials update revenue projections frequently, allowing officials to proactively address revenue underperformance with expenditure cuts and reserve draws. Tax increases can also be implemented to address longer-term budget shortfalls. Budgets have been bolstered by significant federal aid and revenues that generally outperformed forecasts, resulting in reserves that have reached unprecedented levels. According to a recently released report by the National Association of State Budget Officers, state rainy day funds and total balance levels are at record levels. At the end of fiscal 2021, rainy day fund balances totaled $124.5 billion, or 13.5% of general fund expenditures. For fiscal 2022 and 2023, these balances are expected to come down slightly, but states have significant reserves that they can draw from were the US economy to enter into a recession. These massive reserves also have the ability to assist local municipalities. Even though credit spreads are widening, states and municipalities remain in a strong financial position, which makes investing in credit today quite attractive.

Looking forward, we will continue to utilize the AB Tax Aware Portfolio's flexibility to navigate the challenging fixed-income landscape. With higher yields, we are targeting a neutral duration position versus our benchmark and will selectively add municipal credit as opportunities present themselves. These allocations are designed to increase Portfolio yield, while providing the additional opportunity for excess total return resulting from credit spread compression. Furthermore, we will continue to look to execute tax swaps and harvest Portfolio losses—creating a tax benefit while reinvesting into similar municipal bonds at higher yields. It is ever important to remain active and proactively adjust Portfolio positioning as market conditions change.

Please refer to the following legal disclosures.

Based on a model portfolio as of 09/30/22. ***Net of a maximum 1.5% annual managed account fee, which includes transaction costs, custodial service fees and investment advisory fees. Actual returns to an individual investor or client would be reduced by any such fees and expenses.*** *Portfolio holdings, characteristics and weightings will vary over time. Contact your financial advisor for a complete list of portfolio holdings.*

The value of an investment can go down as well as up, and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

There is no assurance that a separately managed account will achieve its investment objective. Separately managed accounts are subject to market risk, and the market values of securities owned will fluctuate so that your investment, when redeemed, may be worth more or less than its original cost.

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

Past performance does not guarantee future results. There is no guarantee that any forecasts or opinions in this material will be realized. Information should not be construed as investment advice.

References to specific securities are presented to illustrate the application of our investment philosophy only and are not to be considered recommendations by AB. The specific securities identified and described in this presentation do not represent all the securities purchased, sold or recommended for the Portfolio, and it should not be assumed that investments in the securities identified were or will be profitable.

MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed or produced by MSCI.

AllianceBernstein Investments, Inc. is a unit of AllianceBernstein L.P., the manager of the Portfolio, and is a member of FINRA.

Doc ID: 233, SMA-311048-2022-10-18