

AllianceBernstein— European Income Portfolio

Market Overview

The most influential factors affecting rates over the month were the events surrounding Greece and the actions of the European Central Bank (ECB)'s rate setting committee. The ECB maintained interest rates at 1.25% during its monetary policy meeting, though President Jean-Claude Trichet has since indicated a rate hike in July is likely, using the key phrase "strong vigilance" when speaking to the European Parliament at the end of June.

Greek Prime Minister George Papandreou was successful in passing the five-year austerity plan, which was an essential condition set by European leaders in order to receive further aid. German banks agreed to roll over Greek debt maturing through 2014, which amounts to roughly €3.2 billion, as voiced through Finance Minister Wolfgang Schaeuble. Although Greek bonds jumped in response to this, they finished the month 171 basis points (b.p.) wider to German bonds in the two-year area, while five-year Greek bonds finished the month 214 b.p. wider.

German bond yields fell markedly early in the month on concerns that the Greek deal would not be ratified. The improved sentiment with respect to Greece later in the month encouraged a greater risk appetite. This, combined with expectations of an interest-rate increase drove the rise in German bond yields, which finished the month flat across much of the curve. The exceptions were the one-year bond, which rose 7 b.p.; the seven-year bond, which declined 2 b.p.; and the 10-year bond, which fell 23 b.p.

The total return on the Barclays Capital Pan-European High Yield Index declined 2.19% in June, while the yield on the Barclays Capital Euro Aggregate Government Bond Index declined 3.53%. In June, the euro ended at a spot exchange rate of €1.45/\$.

Portfolio Performance

In June, the Portfolio underperformed its blended benchmark, the 65% Barclays Capital Euro Aggregate Bond/35% Barclays Capital Pan-Euro High Yield Index. The Portfolio declined 1.17% during this time. Year to date, the Portfolio is in positive territory, returning 1.78%, but underperformed the benchmark.

Although security selection was positive during the month, sector selection detracted from returns, primarily due to overweights in non-investment-grade corporates and emerging-market non-investment-grade corporates and an underweight in Treasuries. Our overall underweight in duration detracted. We were underweight Italian and Spanish Treasuries, which helped, but we were underweight Treasury bonds of European core countries, which offset the boost.

Currency selection detracted slightly. Country selection and yield-curve positioning contributed positively to returns. Specifically, an overweight in Swedish krona helped. In addition, our positioning along the euro-area curve, where we are underweight at the long end of the curve where interest rates rose, benefited returns.

Outlook

Widening European swap spreads are an indication of the market's shift to a more bearish sentiment about economic growth and the difficulties of European banks. In the periphery, investors are pricing in more negative outcomes amid ongoing uncertainty about several peripheral countries, including Greece, Spain and Italy. In our view, although Greek bonds comprise a relatively small portion of the European debt market, the complex politics surrounding Greece's predicament, compounded by the sovereign troubles of other peripheral countries, should fuel more volatility in European debt markets.

We continue to manage the Portfolio to meet its income objectives through security selection. We remain underweight in sovereign debt of peripheral countries. Within European credits, we maintain modest overweights in investment-grade and high-yield bonds and continue to look to opportunistically purchase new issues. We are underweight utilities and bank credits as those tend to exhibit higher correlations with sovereign bonds. We are also shifting out of investment-grade credits that are vulnerable to extreme scenarios.

We continue to selectively add to positions in euro-covered bonds in core Europe, toward an overweight target. These securities can be more attractive than senior unsecured bonds, particularly when yields of both classes of securities are comparable and when some covered bonds are AAA-rated and are collateralized, which raises their rank in the

capital structure relative to senior unsecured bonds.

We continue to find European investment-grade bonds attractive on a risk-adjusted basis. As the investment-grade market normalizes over the next two years, we expect that the yield spread could narrow

to 140 b.p. from roughly 200 b.p. today, in particular for core European corporate bonds that are little correlated to sovereign-debt risk of countries in the euro periphery.

At today's spreads, investment-grade bonds appear to be undervalued, given

their strong fundamentals. We believe that the elevated level of defaults will take less time to subside than we had previously expected as the balance sheets of investment-grade companies are resilient enough to minimize material-credit risk.

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