Translation of an article published in French in French newspaper Funds Magazine on 02.2019

Funds magazine

"CONVERTIBLES' OPTIONS CONTINUE TO BE THE MAIN ATTRACTION OF THE ASSET CLASS"

"Generally, European convertibles have become highly defensive. The risks in investing in this asset class are therefore limited, as economic growth is still relatively solid and the outlook is decent for companies."

What is going on in the world of European convertible bonds? This asset class seems to be encountering strong headwinds.

Convertible bonds – just as the majority of asset classes – put in negative performances in 2018. However, convertibles' behaviour was roughly in line with expectations, as, in Europe, we have been too used to an environment in which volatility and risk were undervalued as a consequence of the ECB's quantitative easing programme. The ECB bought up a huge amount of bonds, which reduced the perceived risk on this asset class and this effect spilled over into equities. Today, with interest rates rising in the United States and the ECB having wound up its bond-buying programme, we're pricing in risk once again. Put simply, we're no longer used to this. The falls we've seen are in line with a classic correction and, and besides volatility is not particularly high either.

How do you explain the speed of the correction, as the ECB is going to maintain its accommodative monetary policy and reinvest coupons and maturities?

The market is expecting the macroeconomic environment to be slightly less favourable, with widening spreads and higher volatility. Of course the widespread sell-off shows a lack of confidence, and this could pose a higher risk. Convertible bonds are facing this both from the credit risk borne by issuers and from the equity risk contained in the conversion option. This low sentiment is making the asset class much more attractive, as we're seeing valuations that are more in line with their historical averages, whereas at the beginning of the year they were relatively overvalued in an environment where everyone was buying up risk. Convertibles' options are no longer overpriced and they continue to be the main attraction of the asset class given rising rates and widening spreads. Generally, European convertibles have become highly defensive. As a consequence, investing in this asset class represents a limited risk, as economic growth is still relatively solid and the outlook is decent for companies.

What strategy can you use so that investors get the performances they expect of convertibles?

At the moment, we're essentially looking for convertibles with low credit risk, so as not to suffer from any significant spread-widening and to ensure capital preservation in the long term. This means that we have a cautious bias when selecting credit as it is a limited performance driver for the asset class, and instead we target the equity performance delivered through the option. We choose companies that have positive outlooks and higher growth prospects. After last quarter's drop, we may even consider investing in names that previously looked overvalued. We are selective, both in terms of credit and the underlying equity.

Does this selectiveness lead you to focus the portfolio only on your best ideas?

On average, the Europe fund is made up of 70–80 names. We aim not only to build conviction portfolios but also diversified ones, particularly in terms of credit risk. In contrast, the exposure to equity risk is more concentrated as the portfolio comprises a significant allocation to bond-like convertible bonds.

Looking ahead to the coming months, what are your major tactical options?
With Q4 2018 having been really quite turbulent, we opted for a somewhat defensive bias in an effort to preserve our clients' capital. We added defensive but convex bonds at the beginning of the year to benefit from low valuations. Market sentiment is still prudent as investors are confronted with a number of uncertainties starting with political risks. Short-term outcomes are difficult to predict. But strategically we are expecting strong performances from many companies in the convertibles universe which have long-term growth prospects in some parts of the economy like digitalisation in healthcare services. We are still constructive on long-term investing and a good way to do so defensively is through the convexity of convertible bonds.

Marc Basselier – Head of Convertible Bonds, UBP Asset Management (France)