THE DRIVE YOU DEMAND

UBAM - EUROPE EQUITY DIVIDEND+

Quarterly Comment | Q2 2019

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Markets

- June ended with positive performance across asset classes, which marked the reversal of the weakness we observed during the month of May. Indeed, while published economic data was weak and the trade outlook remains uncertain, investor sentiment improved as both the Federal Reserve (Fed) and the European Central Bank (ECB) indicated that there would be further monetary stimulus to address the low level of economic activity in the economic bloc.
- This led to a +4.9% expansion of the MSCI Europe ex-UK index, which corresponds to a full recovery of what was lost in May. In other geographies, the U.S. market performed strongly with the S&P 500 up +7.1%, followed by the emerging markets index (MSCI EM) up +4.7%. Strong returns were achieved on the credit side too, +2.4% for the Euro Treasuries. While counterintuitive at first sight, the rally in both asset classes was made possible by the continued expectation of rate cuts, which is now combined with anticipation of more quantitative easing.
- Concerning the G20 meeting, the US and China have agreed to pursue trade negotiations, indicating neither an escalation of the tariffs nor progress addressing the key issues. Investors will probably find some relief in the fact that the worst case scenario has been avoided for now, but the continued uncertainty and potential degradation of the relationship is likely to weigh on sentiment. This is visible through the US Consumer Confidence level which decreased significantly from 134.1 to 121.5, a stable Manufacturing PMI (50.6 vs. 50.5 in May) and a slowdown in the pace of hiring.
- Surveys have weakened in Europe too and all manufacturing, services and consumer confidence indices came in lower than expected. For example, the Manufacturing PMI came in at 47.6 instead of 47.8, marking a contraction from the 47.7 of May. Similarly to the Fed, the ECB announced that unless the economy improves, it would loosen its monetary policy saying that it has plenty of ammunition left if further quantitative easing is required and that rates could continue decreasing if needed.
- Following Theresa May's resignation, the UK news has been dominated by the race to leadership for the Conservative Party, and the polls give Boris Johnson as strong favourite to be the next Prime Minister. The June retail sales measures came in at their weakest level since the financial crisis, but due to concerns around the limited spare capacity in the UK economy and the recent years' wage growth, the Bank of England was less dovish than the Fed and the ECB. Interest rate cuts could still happen if economic data deteriorates further.
- Overall, economic data has been weak throughout geographies, but markets have ignored it hoping for central bank stimulus probably on account of the rate of change showing some stabilisation rather than an increasing deterioration.
- In a particularly low-yielding environment in Europe, many investors are considering alternatives to EUR-denominated bonds while seeking or maintaining a moderate equity exposure at the overall portfolio level.

- UBAM - Europe Equity Dividend+ is a cost efficient solution that is designed to access additional and diversifying sources of yields through high dividend stocks and call premium, while reducing equity beta over a full market cycle.

Performance Review

- In Q2 2019, UBAM - Europe Equity Dividend+ had a net performance of -1.41% (Class IP EUR), underperforming its 50% MSCI Europe High Dividend Index over the quarter.
- In terms of contribution by expertise, our Long Only bucket was a positive contributor of +234bps (gross of fees) to the overall portfolio, this bucket having underperformed the MSCI Europe High Dividend Index. Our Yield Enhancement Overlay bucket was a negative contributor of -334bps (gross of fees) in absolute terms, slightly underperforming its 50% reverse MSCI Europe High Dividend benchmark.
- Within the Long Only bucket:
  - The MSCI High Dividend benchmark rose 1.53% during Q2, while the underlying equities held in UBAM - Europe Equity Dividend+ appreciated by 2.34%. Germany and the UK (the two largest country exposures) provided the lion's share of that nominal return. At the sector level, Industrials, Financials and Consumer Staples drove the portfolio's rise with only very minor headwinds coming from Utilities and Telcos.
  - At the stock level, some of the portfolio's bank holdings provided a performance headache, in sympathy with the sector's wider malaise. The European banks sector is now at a three-year relative low when compared with the wider market. However, RELX, Allianz and LVMH all registered >11% share price appreciation in the quarter, thereby reflecting the overall balance within the portfolio.
- Within the Yield Enhancement Overlay bucket:
  - Call Selling, which represents 90% of the overlay allocation, detracted some alpha during the quarter (-233bps), as European equity markets witnessed some strong up and down moves with some lag in signals adaptation and positioning.
  - Tail Risk, which represents the remaining 10% of the overlay allocation, underperformed as well (-8bps). The continuing underperformance of European volatility and some signals volatility in May led the strategy to underperform slightly.

Portfolio Activity

- During this second quarter of the year, we made a few substantial changes to the underlying portfolio. The largest transaction was to reduce our holding in Vodafone. The company updated the market with a new strategy involving high spending on capital expenditure and a lower dividend payout. In summary, this left the stock looking less attractive as a dividend payer, and we have reflected this lower conviction in the portfolio weighting.
- Within the Yield Enhancement Overlay bucket:
  - At the Call Selling level and during April, given the continuing bullish trend in global equities, the portfolio was tilted towards a more offensive stance. Unfortunately, the sell-off in May led the strategy to shift more defensive with a lag hitting the carry generation. Finally, in June, signals turned again more offensive with a lag. Also, the succession higher than expected moves in equity markets caught the carry generation.

- Within the Tail Risk bucket, the exposure to volatility futures was lean and not exciting during most of the quarter, being close to (or even at) the minimum exposure possible. This was mainly the result of the bearish momentum in volatility futures as well as steep term structure increasing the cost of carry a long positions in such instruments. However, in May, as volatility spiked at the beginning of the month, signals began to turn more bullish on volatility futures. Vstoxx futures reacted quickly to the first leg of correction leading the strategy to add some volatility exposure with a lag, but as volatility fell back positioning returned to minimum by early June.

Outlook & Positioning

- Stock market indices remain near their highs as participants have chosen to take the weaker economic indications and the dovish tones from central banks positively. Indeed, in many ways this environment simply extends the framework for strong equity returns. However, we also know from experience that this is not an environment for the value end of the market to outperform. For that to happen, we would need a normalisation of rates at a higher level. As a result, we continue to select high quality dividend payers within the European universe as dictated by the lower risk appetite associated with the UBAM - Europe Equity Dividend+ strategy.
- Looking at the Yield Enhancement Overlay bucket at the end of June, current trend signals with 3 months', 6 months' and 12 months' time-horizons were indicating a bullish trend in European equity markets. As a result, the portfolio sold only 40-delta calls, reflecting our under portective approach towards European equity markets.
- The volatility signals on the Vstoxx index and futures were indicating a bullish view on European equities: the momentum in volatility futures was bear (hence representing a bull equity regime), the volatility regime was standard (hence referring to normal equity market conditions), and the volatility futures term-structure was steeply in contango i.e. upward sloping with a high premium on forward volatiltiy (hence being typical of non-stressed markets).
- As a result, the Fund had an over-weighted positioning at the beginning of July 2019.

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