Q2 2020

UBAM – EUROPE 10-40 CONVERTIBLE BOND

Quarterly Comment

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

Market Comment

- The second quarter was marked by a sharp rebound in risky assets. The gradual lifting of lockdowns around the world, combined with governments and central banks' unprecedented support measures drove markets' recovery. Simmering geopolitical concerns and ever-increasing number of covid-19 victims globally caused some volatility but barely darkened the overall picture.
- Eventually, the MSCI World index jumped by 19.6% q/q, led by the US (S&P 500 up 20.5% q/q). In Europe, the Stoxx Europe 600 index rose by 13.5% q/q. In Japan, the Nikkei 225 index climbed 18.0% q/q. On the fixed income side, Euro IG corporates[1] added 5.1% q/q while their HY peers progressed by 11.2% q/q (indices performance expressed in local currencies).
- After hitting record highs at the peak of the crisis, equity markets' volatility returned to more contained levels in Q2, swinging in the 25-40pts ranges – yet still well above the VIX long-term average.
- In this overall context, convertible bonds stood out once again confirming what can be summarized as an historic H1 for the asset class. The holding of the bond-floor, alongside the noticeable share of growth-biased companies in the universe and convertible bonds' proven asymmetric behaviour, have been key drivers to the asset class' outperformance since the beginning of the year.
- At June-end, European convertible bonds[2] are down 3.7% YTD, which should yet be put in perspective with a negative performance of -12.1% for European equities[3] and of -5.0% for Euro HY corporates.
- In the first half, the global convertible bond market priced nearly USD 92 billion of new papers – the most in H1 on record. Region-wise, the vast majority came from the US market (USD 67bn). Europe and Asia priced around USD 12bn each. Looking into details, new issues can be split into two main categories. On the one hand, "rescue" deals from companies struggling amid pandemic-triggered lockdowns. On the other hand, and in sharp contrast, "opportunistic" deals from companies which have seen an acceleration of their activity during that period (especially companies in the tech and healthcare sectors).

Sources: UBP, Bloomberg Finance LP, BofA Merrill Lynch. [1]ICE BofA Euro Corporate index. [2]Thomson Reuters Europe Hedged Convertible Bond index (EUR). [3]Stoxx Europe 600 Net Return.

Performance Review

- UBAM - Europe 10-40 Convertible Bond rose by 6.07% in Q2 (after fees, IC EUR share class), bringing its performance year-to-date to -2.70%. For purpose of comparison, its index, the Thomson Reuters Europe Convertible Bond EUR Hedged, progressed by 6.84% in Q2. YTD the index is down 3.70%, meaning an outperformance in favour of our strategy of +1%.
- Unsurprisingly, the equity sensitivity component contributed to the vast majority of the strategy's performance in Q2 – although the fixed income and option features were also positive contributors over the period.
- The performance of the strategy in Q2 should be put in perspective with a rebound of +13.5% for European equities – meaning, an equity upside capture of about 45%, achieved with a balanced equity sensitivity of 32% on average during the quarter, and significantly lower volatility (10% annualised for the strategy vs. 34% for the European equity index).
- Our long-standing focus on companies with robust and visible growth prospects was key in achieving that performance. Sector-wise, the portfolio's allocation in Tech (e.g. Worldline, STM), Communications (e.g. Cellnex Telecom) and Consumer Non-cyclical (e.g. HelloFresh, TakeAway.com) were the largest contributors in aggregate terms over the quarter.
- In relative terms, the 1%-underperfomance of the strategy vs. its index in Q2 comes from our – assumed – absence (or strong underweight positioning) to names embedding lower credit quality according to our analysis, that have benefited from the broad market rebound in Q2. It is however worth noting that our careful approach to the credit quality is also the reason why we were not exposed to Wirecard AG, which proved relatively favorable in June as the stock lost almost all its value in a few days on worrisome audit data.

Portfolio Activity

- With sharp rebound in equity markets, the average equity sensitivity of the portfolio increased during the quarter, from 30% end of March up to nearly 36% at the end of June.
- Our portfolios exhibit a combination of structural bias towards higher credit quality names, and long-standing focus on companies offering sustainable growth prospects. Throughout the first half, this helped to improve the convexity profile of the strategy relative to equities, but also to limit the trading activity during a period of lesser liquidity.
- Although not comparable to the unprecedented volume recorded in the US, the European convertible market yet witnessed solid dynamism on the primary front. Beyond the sole volume figures, it is worth noting that a noticeable share of the new issues have come from companies exposed to attractive secular trends (e.g. digitalisation of the economy, upscaling consumption, longer life expectancy) and therefor offering solid growth prospects. Within the portfolio, we particularly took the opportunity to participate in the HelloFresh 2025 (German meal-kit company, with strong market share in the US), Takeaway.com 2026 (European leading online food delivery marketplace, domiciled in the Netherlands) and Artemis/Puma 2025 exchangeable bond.
- Generally speaking, recent market developments have conforted us in our long-standing focus on "Quality" and "Growth" companies. Accordingly, most of our recent trades have consisted in further strengthening this bias within our portfolio, through convertible bonds we like the most from a fundamental standpoint (e.g. Worldline, Nexi, Symrise…).
- As of June 30th, the portfolio exhibits an average credit spread of 227bps which compares to 307bps for the index. These levels reflect the quality bias inherent to our philosophy, and suggest normalisation potential, considering the average credit spread of the portfolio (179bps over the past 5 years, monthly basis).

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Outlook

- In recent “V-U” shaped equity markets, convertible bonds have demonstrated strong asymmetric behaviour. The predominance of growth companies in the convertible space, combined with robust bond-floors and efficient adjustments in the asset class’ equity sensitivity proved key in that respect. Looking ahead, the case for convertible bonds remains strong.
- First, the convex nature of convertible bonds makes them compelling assets for those who wish to maintain an equity exposure whilst dialling back their risk a bit after Q2 overall sharp rebound. As risks continue to weigh on stock markets’ short-term prospects, an asymmetric equity exposure appears as a valid alternative to a full directional positioning. Convertible bonds’ appeal is equally strong in a low-to-zero yield world, for those willing to gradually return to equity markets to boost their fixed income investments whilst keeping the defensive benefits of the bond floor.
- Second, a focus on Growth makes sense, to favour companies with robust and visible prospects. The pandemic has put unprecedented strain on many industries, and adverse effects of the lockdowns remain to be seen. In sharp contrast, some segments of the economy – tech- and healthcare-related businesses on top – have witnessed a sharp acceleration in their activity, propelled by the faster-than-expected adoption of new consumer and business behaviours (work-from-home, e-business, factory automation etc.). In a climate of deep uncertainty, the visibility and strong growth prospects those companies offer are highly desirable assets. Their attractiveness is further strengthened in the ultra-low interest rate environment we are in (and which is here to stay, considering central banks’ actions), which is supportive of their valuation.
- The convertible bond market is rich in growth-biased companies, and primary activity has been booming in this segment. Through their “hybrid” nature, convertible bonds allow investors to enjoy an equity exposure to these superior-growth, but also traditionally highly volatile, names.
- Convexity should however not be taken for granted. Recent events have reminded of the importance of a sound credit selection – a building block of our security selection process. At a time when the market is seeing a stream of new issues – from “rescue” deals to opportunistic offerings –, we reaffirm our focus on “Quality” to access convertible bonds’ asymmetric benefits.
- Besides, the quality bias inherent to our investment approach should allow us to benefit from the normalisation we expect in credit spreads – and that remains to be seen for most part from the highly stressed levels reached at the peak of the crisis. As markets continue to normalize, we are confident that robust companies which were unfairly hit in our view should recoup further part of the losses.
- On the primary activity side, issuance momentum is expected to remain strong as higher credit spreads tend to strengthen convertible bonds attractiveness for issuers with financing needs – as seen in Q2. Careful selection will remain paramount to focus on companies with robust credit quality, and sound prospects.

Disclaimer