Q2 2020

UBAM – GLOBAL 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, global high yield corporates[1] gained 11.5% q/q while their IG peers progressed by 8.7% q/q.
- 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 predominance of growth companies in the hybrid instrument's universe, alongside convertible bonds' proven asymmetric behaviour, have been key drivers to the asset class' outperformance since the beginning of the year.
- At June-end, global convertible bonds[2] are up 5.1% YTD when global equities[3] remain anchored in negative territory (-5.9%) despite Q2 sharp rebound.
- 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 Global High Yield index. [2]Thomson Reuters Global Hedged Convertible Bond index (EUR). [3]MSCI World Net Total Return Hedged (EUR).

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.

Performance Review

- UBAM - Global Convertible Bond ended the quarter up +15.97% (after fees, IC EUR share class). YTD the strategy is now up 4.44%. For purpose of comparison, the Thomson Reuters Global Hedged Convertible Bond (EUR) ("the index") progressed by 19.22% in Q2, bringing its YTD performance to 5.09%.
- Unsurprisingly, the equity sensitivity component contributed to most of the strategy's performance in Q2 – although the optional and fixed income features were also positive contributors over the period.
- The performance of the strategy in Q2 should be put in perspective with a rebound of +18.2% for global equities (MSCI World Net TR EUR Hedged) – meaning, an equity upside capture of nearly 90%, achieved with a balanced equity sensitivity of 49.6% on average during the quarter, and significantly lower volatility (15% annualised for the strategy vs. 38% for the global equity index).
- Our long-standing bias in favor of companies with superior growth levels (and prospects) was key in achieving that performance. Sector-wise, the portfolio's allocation in US Tech (e.g. Microchip Tech), US Communications (e.g. Twilio) and US Consumer Non-cyclicals (e.g. Chegg) were the largest contributors in aggregate terms over the quarter. Regionally, the US bucket led the way, accounting for 80% of the strategy's Q2 performance.
- In relative terms, the underperfomance of the strategy vs. its index in Q2 comes mainly from our (assumed) absence – or strong underweight positioning – to names embedding lower credit quality according to our analysis, that have largelly 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 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 41% end of March up to nearly 55% 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 superior and sustainable growth prospects. Throughout the first half, this enabled to improve the convexity profile of the strategy relative to equities, but also to limit the trading activity during a period of lesser liquidity.
- We took the opportunity of markets' rally to take some profits on some of our good performing convertible holdings (e.g. Microchip Tech, Twilio), reinvesting the proceeds on convertible bonds with more balanced profile, thereby strengthening the portfolio's bond floor.
- During the quarter, we kept an attentive yet "credit-cautious" eye to the flow of new deals that poured into our universe. Within the portfolio, we notably participated in the new Southwest Airlines 2025. Despite still limited visibility on the airline industry, we believe the leading position and relative robustness of the company should help it gain market share once the situation subsides. We additionally initiated positions in the new Artemis/Puma 2025, Safran 2027, Leg Immobilien 2028 and HelloFresh 2025 convertible bonds. The latter is a good example of an attractive trend we are seeing in the European convertible space – namely, the increasing presence of tech-related companies, embedding superior growth prospects.
- As of June 30, the portfolio exhibits an average credit spread of 323bps which compares to 430bps 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 (222bps 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 tends to be 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

This is a marketing document and is intended for informational and/or marketing purposes only. This document is confidential and intended only for the use of the person(s) to whom it was delivered. It may not be reproduced (in whole or in part) or delivered, given, sent or in any other way made accessible to any other person without the prior written approval of Union Bancaire Privée, UBP SA or any entity of the UBP Group ("UBP"). This document reflects the opinion of UBP as of the date of issue. This document is for distribution only to persons who are Qualified Investors in Switzerland, or Professional Clients, Eligible Counterparties or an equivalent category of investors as defined by the relevant laws (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. It is not intended for distribution, publication, or use, in whole or in part, in any jurisdiction where such distribution, publication, or use would be unlawful, nor is it directed at any person at whom or entity at which it would be unlawful to direct such a document. In particular, this document may not be distributed in the United States of America and/or to US persons (including US citizens residing outside the United States of America). This document has not been produced by UBP's financial analysts and is not to be considered financial research. It is not subject to any guidelines on financial research and independence of financial analysis. Reasonable efforts have been made to ensure that the content of this document is based on information and data obtained from reliable sources. However, UBP has not verified the information from third sources in this document and does not guarantee its accuracy or completeness. UBP makes no representations, provides no warranty, and gives no undertaking, express or implied, regarding any of the information, projections or opinions contained herein, nor does it accept any liability whatsoever for any errors, omissions or misstatements. The information contained herein is subject to change without prior notice. UBP gives no undertaking to update this document or to correct any inaccuracies in it which may become apparent. This document may refer to the past performance of investment interests. Past performance is not a guide to current or future results. The value of investment interests can fall as well as rise. Any capital invested may be at risk and investors may not get back some or all of their original capital. Any performance data included in this document does not take into account fees, commissions, and expenses charged on issuance and redemption of securities, nor any taxes that may be levied. Changes in exchange rates may cause increases or decreases in investors' returns. All statements other than statements of historical fact in this document are "forward-looking statements". Forward-looking statements do not guarantee future performances. The financial projections included in this document do not represent forecasts or budgets, but are purely illustrative examples based on a series of current expectations and assumptions which may not eventuate. The actual performance, results, financial condition and prospects of an investment interest may differ materially from those expressed or implied by the forward-looking statements in this document as the projected or targeted returns are inherently subject to significant economic, market and other uncertainties that may adversely affect performance. UBP also disclaims any obligation to update forward-looking statements, as a result of new information, future events or otherwise. None of the contents of this document should be construed as advice or any form of recommendation to purchase or sell any securities or funds. This document does not replace a prospectus or any other legal documents, which can be obtained free of charge from the registered office of the fund they relate to, or from UBP. The opinions herein do not take into account individual investors' circumstances, objectives, or needs. Each investor must make his/her own independent decision regarding any securities or financial instruments mentioned herein and should independently determine the merits or suitability of any investment. In addition, the tax treatment of any investment in the fund(s) mentioned herein depends on each individual investor's circumstances and may be subject to change in the future. Investors are invited to carefully read the risk warnings and the regulations set out in the prospectus or other legal documents and to seek professional financial, legal and tax advice. This document should not be deemed an offer nor a solicitation to buy, subscribe to, or sell any currency, funds, products, or financial instruments, to make any investment, or to participate in any particular trading strategy in any jurisdiction where such an offer or solicitation would not be authorised, or to any person to whom it would be unlawful to make such an offer or solicitation. Telephone calls to the telephone number stated in this document may be recorded. UBP will assume that by calling this number you consent to such recording. UBP is authorised and regulated in Switzerland by the Swiss Financial Market Supervisory Authority and is authorised in the United Kingdom by the Prudential Regulation Authority. UBP is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority.
Any subscriptions not based on the funds' latest prospectuses, KIIDs, annual or semi-annual reports or other relevant legal document shall not be acceptable. The latest prospectus, articles of association, KIID and annual and semi-annual reports of the funds presented herein (the "Funds' Legal Documents") may be obtained free of charge from Union Bancaire Privée, UBP SA, 96-98 rue du Rhône, P.O. Box 1320, 1211 Geneva 1 ("UBP"). The Funds' Legal Documents may also be obtained free of charge from UBP Asset Management (Europe) S.A., 287–289 route d'Arlon, 1150 Luxembourg, Grand Duchy of Luxembourg, and from Union Bancaire Gestion Institutionnelle (France) SAS, 116 avenue des Champs-Elysées, 75008 Paris, France.
The Swiss representative and paying agent of the foreign funds mentioned herein is UBP. The Funds' Legal Documents may be obtained free of charge from UBP, as indicated above.