UBAM CONVERTIBLES GLOBAL

Quarterly Comment | Q1 2019

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

Market Comment

- The first three months of the year were marked by a dramatic rally in global financial markets – both on the equity and credit sides –, which allowed them to recover the losses endured in the latter part of 2018. The US Federal Reserve's U-turn in January, followed by increasingly dovish rhetoric through the quarter (Fed, ECB…) and combined with the easing in the US-China trade conflict were key drivers of this rebound.
- In the US, the S&P 500 TR ended the quarter up +13.5%; cross-Atlantic, the Stoxx Europe 600 NR climbed +13.0%; in Japan, the Nikkei 225 TR progressed by +9.3% q/q. Credit markets, on their hand, saw a broad tightening trend (-24bps q/q on the US IG credit spreads; -101bps q/q on the US HY credit spreads).
- In this context, volatility remained contained throughout the quarter, as evidenced by the VIX index which went down from 25pts at December-end to 13.7pts at the end of March. Similarly, in Europe, the V2X index declined 8.6pts q/q, closing at 15.3pts.
- The dovish stance of both the Fed and the ECB, coupled with economic data that were often disappointing, led to a significant drop in long yields. The 10Y-US Treasury yield thus declined by 28bps q/q, down to 2.41%; in the meantime, in Europe, the 10Y-Bund yield dropped 31bps, down to -0.07% as of March 29th.
- In Q1, the combination of a positive momentum in equity markets, a downward move on rates, and a tightening trend on credit spreads proved favourable for convertible bonds overall. This translated in an overall rebound in convertible bonds' implied volatility from end-December discounted levels across the main regions.
- Q1 19 saw a solid volume of USD 21.7 billion of new convertible bond issuance globally. The US market was the main contributor to the new supply (USD 10.5bn), followed by Europe (USD 6.9bn) and Asia (USD 4.2bn). At the end of March, "first time issuers" accounted for 38% of the global new convertible bond issuance over the past 12 months. (Source: BofA Merrill Lynch)

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 Convertibles Global ended the quarter up 6.80% after fees. This compares to a performance of 7.79% for the index* (Thomson Reuters Convertibles Global EUR Hedged index).
- With the strong rally observed in risky assets in Q1, the portfolio's underlying equity bucket was the main contributor to performance during the quarter (+6.13%). The fixed income bucket also contributed positively, although to a lesser extent (+1.55%), thanks to supportive credit effect. Optional features added +9bps due to positive Vega (evolution in implied volatility). Forex (hedging and implied forex) cost 64bps and "others" (management & trading fees) -32bps.
- Region-wise, the portfolio's exposure to the US market was the main driver to performance in Q1 (+5.9%), due primarily to positive contributions of the Tech, Communications and Consumer Non-cyclical sectors in the region. Europe contributed +1.4%, Asia +43bps and Japan +5bps.
- At firm-level, major contributors to performance this quarter were Alibaba (+44bps, Asia Internet), ServiceNow (+34bps, US Software) and Anglo American (+31bps, Europe Metals & Mining). On the negative side, main detractors were Vodafone (-5bps, Europe Telecom), Dassault Aviation (-4bps, Europe Aerospace & Defense) and Kandenko (-4bps, Japan Construction & Engineering).
- In relative terms, the underperformance of the strategy vs. its index* in Q1 is explained by the negative relative contributions of the fixed income (-65bps), forex (-5bps) and "other" buckets (-38bps), while the underlying equity component added +7bps. At firm level, our underweight to Alibaba (-16bps) as well as our absence from Mercadolibre (-15bps, online trading site for LatAm markets) and Sea (-11bps, Asia internet company) were the main relative detractors last quarter. In contrast, our overweight to ServiceNow (+21bps), Insmed (+18bps, US Healthcare) and Palo Alto Networks (+14bps, US Software) proved particularly beneficial.

Portfolio Activity

- With strong rebound in equity markets, the average equity sensitivity of the portfolio increased during the quarter, from 35.6% at December-end up to 47.6% at the end of March (+2pts vs. the index*).
- Region-wise, at March-end, the portfolio's equity exposure is split as follow: US 28.7% (+5pts q/q); Europe 12.4% (+5pts q/q); Asia 3.9% (+1.5pts q/q); Japan 2.6% (stable).
- The average interest rate sensitivity of the portfolio remained fairly stable quarter-on-quarter, at 2% for an average duration of 4 years. At March-end, the average OAS spread of the portfolio settles at 200bps (vs. 298bps for the index*).
- With near-term risk drivers still at play despite recent supportive developments (easing in trade tensions, central banks' shift in tone, etc.), we have maintained a disciplined approach in terms of profit-taking and rebalancing of our portfolios towards convertible bonds with more balanced equity profiles, whilst keeping core attention to the credit quality.
- This should remain at the core of our approach in the coming months. This would be done whilst also maintaining exposure to some convertible bonds with higher equity sensitivity profiles, where we have strong bottom-up conviction on the underlying potential, including in sectors which benefit from positive secular trends (e.g. healthcare, digitalisation, middle-class consumption in Asia etc.).
- During the quarter, we notably opened up new positions in the Adidas 2023 (apparel & textile products) and Grand City Properties (real estate) in Europe – two instruments that offered attractive technical attractivness in an European market that had become highly defensive post- end of 2018 correction. In the region, we also took a participation in the new jumbo deal from Vodafone (telecom). Other major moves in Q1 included, in the US, participation in the new Exact Sciences 2027 (conviction name in the healthcare space) and strengthening of our position in the Illumina 2023 (heathcare).

* For information and comparison purposes only. The fund has no official benchmark.

Outlook

- Equity volatility made a noticeable comeback last year, and potential for higher volatility levels remains high as several of the issues that weighted down on investor sentiment in the latter part of 2018 remain unsolved today. At the same time, we remain cautiously constructive on equity markets for the months ahead, considering more reasonable valuations post Q4 18 de-rating, and our long-term view of an “elongated” cycle, rather than of a cycle coming to a close-end.
- Having said that, after “V-shape” equity markets and a +12% rebound in global equities in Q1, we believe that a meaningful allocation to financial instruments combining equity upside potential and downside mitigation benefits makes sense.
- Throughout 2018 until Q1 19, global convertible bonds lived up to their long-term benefits. Last year, amid challenging market conditions, the asset class demonstrated solid resilience during the shocks that affected financial markets, outperforming global equities with lower volatility, and significantly reduced drawdowns. In addition to these downside mitigation benefits, global convertible bonds posted solid performance during the first quarter rally, capturing a significant proportion of equity markets’ rebound year-to-date.
- In today’s advanced phase of the cycle, the convertible market additionally provides investors with a risk-controlled exposure to stocks for which the growth potential is linked to favourable secular trends (e.g. digitalisation of the economy, middle class consumption in Asia, healthcare, etc.) and thus, less exposed to the overall softening economic activity.
- Looking ahead, considering central banks’ increasingly dovish stance, and the recent easing in the US-China trade conflict, we believe it is too early to reposition the portfolios with a more defensive biais. However, uncertainties remain (lack of visibility on the strength of the economic momentum; developments over the Brexit; etc.) and call for cautiousness. In this context, we believe that regular and disciplined profit taking is key to manage the robustness of the portfolio, whilst maintaining a constructive positioning in terms of overall exposure.
- On the credit side, concerns have diminished in the short-term on the back of central banks’ policy shift. Nonetheless, and in line with our historic DNA, we remain particularly attentive on credit metrics in our investment decisions.
- The upcoming earnings season should provide more insights regarding the actual state of the economic activity, and be determinant of equity markets’ direction in the short-term. We will take this opportunity to re-assess our investment convictions in the light of current valuations.

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