UBAM - EUROPE EQUITY DIVIDEND+

Quarterly Comment

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

Market Comment

- Despite starting the new decade in a good mood, the change in momentum of risk markets as 2020 progressed was inevitably noticeable. Investors were already on the lookout for an economic slowdown, but the cycle was interrupted more abruptly than anyone anticipated as the Covid-19 virus spread across regions. As of today, the disease has been declared a pandemic, causing large parts of the global economy to idle and making a global recession a reality.
- Following mixed performance in January where the initial virus impact was offset by the start of the year optimism, the quarter revealed itself to be very volatile, displaying negative returns across the board. The S&P500 index is down -19.6% for the quarter and set a number of records on its way down – fastest -30% decline, most violent peak to trough move and volatility comparable to 2008 despite markets only moving half as much… so far. The MSCI Europe ex-UK returned similar double-digit returns of -20.9%, followed by the MSCI EM at -23.6%. The UK FTSE All-shares was further behind with -25.1% during Q1. All indices are total return in local currency, except MSCI EM in US Dollars.
- A mixed picture on the credit side – higher prices for government bonds due to the announcements of lowered interest rates and the restart of quantitative easing programs but negative returns from the corporate bonds due to the threat of profits being under pressure as industries shutdown. The resulting performance is +8.2% for US Treasuries, +6.9% for UK Gilts and +0.3% for Euro Government bonds ranging from -1.5% for Spain to +1.6% for Germany. This contrasts sharply with corporate bonds which display -5.4% for Global Investment Grade and -14% for High Yield for both the Euro and US regions. All indices are total return in local currency, except global ones in US Dollars.
- Representative of the economic disruption, commodity prices were also hit as demand for most of them declined. Oil prices fell more than most, -60%, due to a combination of lower demand and interruption of the supply constraints between Russia and the OPECs. The one exception is gold which is up +5% this quarter as it tends to be an asset of preference when patterns fail and panic gains the markets. The extent of the hit to the economy is still unknown but a selection of indicators highlights the disruption: Chinese car sales fell by -80% in February, restaurant bookings are down -100% on some mobile apps and US unemployment claims doubled and were nearly 7 million. Most governments and central banks have taken supportive action by issuing government-backed loans or other fiscal stimulus, cutting rates and restarting asset purchase programs in an attempt to mitigate the economic consequences of the virus. This should allow to limit unemployment from growing further and prevent good business from going bankrupt.
- Overall, the first quarter of the year has seen sharp falls on both the equity and credit markets leading investors to navigate an extremely volatile environment with low liquidity. These factors limit the potential for efficient markets and will remain until short-term uncertainty decreases.

Performance Review

- In Q1 2020, UBAM - Europe Equity Dividend+ had a net performance of -12.43% (Class IP EUR), outperforming its 50% MSCI Europe High Dividend Index over the quarter.
- In terms of contribution by expertise, our Long Only bucket was a negative contributor of -2087bps (gross of fees) to the overall portfolio, this bucket having outperformed the MSCI Europe High Dividend Index. Our Yield Enhancement Overlay bucket was a positive contributor of +1273bps (gross of fees) in absolute terms, underperforming its 50% reverse MSCI Europe High Dividend benchmark.
- Within the Long Only bucket:
  - The MSCI High Dividend benchmark fell 25.47% whereas the underlying holdings of the fund fell a more modest 18.32%, performing admirably in its first market challenge for some years. The underlying portfolio contains a well balanced exposure to all major sectors and despite a 28% weighting to financials returning -31% in aggregate, the holdings in Utilities, Healthcare and Consumer Staples significantly outperformed the market. Our bias towards large cap also contributed well to performance.
  - At the stock level, as highlighted above, our poorest holdings were in the ING, Munich Re, Royal Dutch Shell and Unibail Westfield which all understandably were hit hard in the uncertainty surrounding the global pandemic. More favourably, Roche, Wolters Kluwer and Nestle all protected capital with Roche actually rising in share price during Q1 and the other two names falling less than 2%. Dividend + was created to protect equity investors in periods of volatility and so it is with some satisfaction that we report an overall fund performance for Q1 down less than half that of the market fall, at -12.43%.
- Within the Yield Enhancement Overlay bucket:
  - Call Selling, which represents 90% of the overlay allocation, contributed 672 bps but detracted some alpha during the quarter. In fact, the strategy preconised to be under protected since the beginning of the year and the sudden sell-off in European equities prevented the strategy to adapt quickly. To sum up, the premiums cashed in offered some cushion by mitigating the drawdown, but not enough due to the amplitude of the move.
  - Tail Risk, which represents the remaining 10% of the overlay allocation contributed 135bps, adding some alpha during the quarter. As the market was going down the volatility reacted accordingly – Vstoxx futures gaining +279% over the period. This spike benefited to the Tail Risk strategy compensating the call selling strategy, especially in March.

Portfolio Activity

- During the fourth quarter we started new positions in Rational, the Germany commercial oven maker and in Spirax Sarco. We took the opportunity to buy these new positions in reaction to the market fall which gave us an attractive entry point. In both cases these companies offer high quality exposure to a healing global economy as and when this moment arrives. However, we continue to maintain overall a defensive positioning.
- Within the Yield Enhancement Overlay bucket:
  - Within the call selling strategy, the quarter began with an under-protected positioning overall. Signals remained stable during January and February and turned to more protective around the end of February, to finish Q1 2020 to the maximum level of protection. Looking forward, the level of volatility priced in Eurostoxx 50 index options is very attractive offering even more cushion in case of continuing drawdowns but also good level of carry on case of rebound in equities accompanied with normalization of volatility.

- Within the Tail Risk strategy, the exposure to volatility futures was lean in January when signals remained at their floor. Early February, signals started to increase, then came back to the floor a few days later. Finally, around February 18th signals increased with the market turmoil to reach high levels of exposure at the end of the month and kept this level during March

Outlook

- We wanted to take some time in this section to discuss the outlook for dividends in the coming year. It’s somewhat unprecedented in our investment lifetimes to have seen such deep and sweeping dividend cuts/suspensions, particularly to final 2019 dividends which had already been announced but were pending payment post AGMs. Whether it’s to secure liquidity, has been directed by regulators or simply a question of moral duty, companies have been quick to cut payouts to shareholders, even those with strong balance sheets.
- Thus far, 2020 dividends have been cut for 130 companies in the EuroStoxx600, a 20% share, dominated by the Financials, Industrials and Consumer Discretionary (retail/luxury/autos) sectors, although note that many Energy companies have yet to make announcements. European dividend futures are already implying that 2020 dividends will be cut by ~50%. By way of comparison, in the global financial crisis of 2008/9, 73 EuroStoxx constituents cut dividends, and these fell cumulatively by 28%, vs earnings which fell 42%.
- At this point in time we have not shifted the portfolio in a material way in response to widespread dividend cuts – we simply have to go through this challenging situation alongside many other income-based strategies. Rest assured however, that we are monitoring the situation on a day-to-day basis and if we come across portfolio holdings whose prospects are more than temporarily impaired by the current state of affairs, then we are prepared to take decisive action.
- Ultimately, given that our focus rests heavily on bottom-up stock picking - building a portfolio of long-term, high quality, resilient, well-capitalised businesses run by managers who think and act like owners - we believe that those fund holdings impacted by current events will be in a position to emerge as leaders in their respective sectors as and when normality resumes.
- At the end of March, the signals with 3 months’, 6 months’ and 12 months’ time-horizons were indicating a bearish trend in Europe. The turning points were rather faraway given the exceptionnal drawdown of the equity markets in February and March. As a result, the call selling strategy adopted an over-protected positioning and suggested to sell only ‘in-the-money’ calls.
- The Tail Risk signals in Europe (Vstoxx futures) were also indicating a bearish environment. More specifically, the momentum in volatility futures was bullish (hence representing a bear equity regime), the volatility regime was high (reflecting stressed market conditions on a historical basis) and the volatility futures term-structure was steeply in backwardation (typical of stressed markets). As a result, the Tail Risk strategy had an important exposure to volatility futures.
- As a result, the Fund had an over-protected positioning to European High Dividend equity market at the beginning of Q2 2020.

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