UBAM – EUROPE 10-40 CONVERTIBLE BOND

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws. The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- Reflationary pressures and the cyclical rotation remained pressing topics in Q2. The "momentum" and growth parts of the markets, however, regained vigor starting mid-May as long-term interest rates experienced volatility. Solid M&A dynamism in these fields along with strong earnings reports helped fuel the rebound.
- Eventually, global equities ended the quarter up 7.9% (MSCI World). In the US, the S&P 500 index closed the quarter up 8.5% and the Nasdaq 100 +11.4%. In Europe, the Stoxx Europe 600 progressed by 6.4% q/q. Conversely, the Nikkei 225 ended the quarter down 1.2%.
- After a bumpy start into the year, convertible bonds have been making a comeback since mid-May, buoyed by the rebound in growth stocks and a relative slowdown in the issuance pace compared with Q1's exceptional volumes. The Refinitiv Global Convertible Bond Index (EUR hedged) progressed 3.3% in Q2. Region-wise, the global convertible bond market was led higher by the US, Europe and Asia while Japanese convertible bonds closed the quarter in negative territory.
- Global convertible bond issuance was strong in the quarter: ICE BofA reported $39.6 billion in new convertibles. The US market topped the list with $15.3bn, closely followed by Asia ($15.0bn). Europe saw $8.6bn in volume. Japan issued $0.7bn. Year-to-date, $98.9bn has been priced globally ($55.9bn from the US, $22.2 from Asia, $18.9bn from Europe and $1.9bn from Japan) – an all-time high.

Performance Review

- For the quarter ended 30 June 2021, the UBAM – Europe 10-40 Convertible Bond ended the quarter up 2.90% after fees (IC EUR share class), outperforming the Refinitiv Europe Hedged Convertible Bond (EUR) ("the index"), by +1.31%.
- In comparison to the traditional asset classes, the fund outperformed corporate bonds (+2.31% versus the Bloomberg Barclays Euro Agg. Corporates EUR-Hedged index) and managed to capture 45% of European equities' return (Stoxx Europe 600 EUR-Hedged), in line with the strategy's average equity sensitivity level in Q2.
- Relative to the broader equity market, European convertible bonds remained held back by the "cyclical rotation" in the first half of the quarter before rebounding sharply starting mid-May. For the period 12 May to 30 June, the UBAM – Europe 10-40 Convertible Bond captured the full performance of European equities.
- Unsurprisingly, most of the strategy's absolute performance in Q2 was driven by the equity sensitivity bucket. The credit component also had a positive impact whereas the yield curve slightly detracted. Sector-wise, our security selection in Consumer Discretionary, Real Estate and Industrials concentrated most of the gains.
- At single security level, top contributors include Deutsche Wohnen (+56bps), Deutsche Post (+42bps) and HelloFresh (+39bps). Conversely, our investments in STM, Shop Apotheke or Deutsche Lufthansa hurt performance. Relative to the index, our overweight positioning to HelloFresh, Deutsche Post and Adidas proved the most beneficial.

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.

Portfolio Activity

- At June-end, the average equity sensitivity of the UBAM – Europe 10-40 Convertible Bond fund stands at 44% (+2pts q/q), +4pts above the index. The strategy's interest rate sensitivity remained contained at 2.4 for a 4-year duration.
- From a sector standpoint, the fund is primarily exposed to equity markets through investments in Consumer Discretionary (9.3%), Information Technology (8.7%) and Industrials (4.7%). With the healthcare (3.9%), these also are the sectors that concentrate most of our current equity sensitivity overweight vs. the index.
- Within our portfolio, the large representation of both typically high growth sectors (tech, healthcare) and sectors gathering "recovery" businesses (e.g. leisure/travel and retail in consumer discretionary, aerospace in industrials) is a good illustration of both our historical focus on "quality-growth" companies, and the efforts we have made since 3Q-20 already to diversify our portfolios through companies exposed to the reopening of economies. This has been done by focusing our selection on quality companies with leading competitive positioning. Record primary issuance volumes since 2020, both from repeat and first-time issuers, has been key in that respect.
- At single security level, main buys in Q2 include participations in the Asos 2026 (new issue to finance the acquisition of Topshop; low leverage and strong growth prospects), Michelin 2023 (appealing convexity profile on a cyclical name) and the JPM/LVMH 2024 exchangeable (strong growth). Main sales include the JPM/LVMH 2022 (arbitrage in favor of the 2024 issue), Deutsche Wohnen 2024 (profit taking, post Vonovia's acquisition announcement) and Swiss Prime AG 2023.
- As of June 30, the portfolio exhibits an average credit spread of 117bps (-15bps q/q) vs. 167bps for the index. These levels reflect the "quality" bias inherent to our security selection process.

Outlook

- As we prepare for a more mature phase of the economic cycle, risks of accrued volatility and short-term drawdowns should increase. Proactive risk management becomes increasingly key to navigating the final stages of the recovery phase. As a result, the case for convertible bonds remains strong and cautions against reading too much into the asset class' lag versus equities in the first part of the year. The equity asymmetric nature of the hybrid instrument makes them compelling assets for those who wish to maintain an equity exposure whilst dialling back their risk a bit.
- Convertible bonds' appeal is equally strong considering rising inflationary pressure for those who wish to maintain bond-floor defensive features. Thanks to their conversion option, convertible bonds have much lower interest rate sensitivity than straight bonds of similar duration. Though lagging equity markets year-to-date, convertible bonds are still outperforming all fixed income asset classes.
- Overall, we see the ongoing "recovery trend" as an opportunity to tactically diversify our investments, rather than a questioning of our long-term focus on quality and growth companies. With the economic cycle set to mature in the coming months, we believe that greater selectivity focusing on fundamentals will become critical again. This should benefit the convertible bond market through its large exposure to innovative companies in high growth segments such as the tech, healthcare or internet & distribution, that exhibit good earnings visibility and robust guidance.
- Although we expect the cyclical rotation still has legs, especially in those regions where the "economy reopening" is still early-stage (e.g. Europe), we stay cautious about the lack of visibility as to how fast their business activity can return to pre-crisis levels. In that respect, the rapid spread of the Delta variant in various parts of the world calls for caution when it comes to stock picking. In this context, we reaffirm our bias towards "quality" companies with strong balance sheet fundamentals.
- The recent record dynamism in convertible bonds' issuance has sparked a broad deepening and renewal of the investment pool, led by the "digital transformation" and "economies reopening" themes. Thanks to their dual nature, convertible bonds give investors the chance to be actively positioned on both themes with much lower volatility and downside risk than direct equity investments offer.

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