Q4 2023

UBAM – EUROPEAN 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

- The last quarter of 2023 has been characterized by the shift in central banks' tone. From the end of October, it has appeared clearer that we may have passed the peak in interest rates. According to their December meetings, the ECB reiterated that a potential rate cut is not yet on the table while the Fed sounded more dovish. FOMC members revised their inflation expectation lower and implied that the hiking cycle ended, they even started to discuss the timing for the first rate cut. This accommodative stance combined with slower inflation rate in US and Europe pushed bond yields lower over the quarter. US 10yr yield moved 69bps lower to 3.88%, while in Europe, German and France 10yr yields ended the month 82bps and 84bps lower at 2.02% and 2.56% respectively. After a spike in October, volatility has fallen through November and December across asset classes. High Yield credit spreads tighten over the quarter, down by 69bps and 42bps in the US and Europe respectively. This global decrease in yields fueled a strong rebound in equity markets, in particular for Growth and Technology names.
- Major equity markets rallied and posted strong gains over the last quarter of the year ending at +9.4% (MSCI World TR hedged in euros). In Europe, the Stoxx Europe 600 index lagged being up only 6.8% q/q. In terms of investment styles, the "Growth" play outperformed the "Value" style, as revealed by the MSCI Europe Growth index up 8.3% q/q, while the Value index was higher 4.7% q/q. Interest rates sensitive sectors, in particular Technology, outperformed with semi-conductor names posting the largest performance 21.3% q/q.
- Being up 3.5%, convertible bonds exhibited an encouraging behavior showing its capacity to capture 53% of the equity upside. This is more than could have been expected when entering the quarter with an equity sensitivity of 27%.
- Primary market has continued to be strong with $18.2bn issued over the fourth quarter. The US contributing $12.3bn, Europe $3.4bn, Asia $1.2bn and Japan $1.2bn. The primary market ended the year 2023 with a total volume of $79bn, in line with pre-coved trend ($76bn issued annually between 2010 and 2019). Europe contributed $13.4bnto this annual volume.

Performance Review

- In the last quarter of the year, the UBAM – European Convertible Bond increased by 3.8% after fees (IC EUR share class), ahead of its index, the Refinitiv Europe Hedged Convertible Bond index (EUR), by +0.2%. This brings year-to-date performance to +4.2% vs. +7.0% for the index.
- During Q4, Technology sector has benefited from the strong momentum in Artificial Intelligence, in particular we saw a significant outperformance of Software & Services and semi-conductors names. Therefore, Technology was the main contributing sector (+51bps), followed by Healthcare (+20bps) and Industrials (+15bps). Our positions in Financials (-23bps) and Communication Services (-18bps) detracted to the overall fund relative performance while we suffer from our underweight to the Real Estate sector (-23bps). Relative to the index, main contributors are BE Semiconductor (+40bps), Schneider Electric (+21bps, overweight), and STMicroelectronics (+13bps, overweight), while main detractors include Fastighets Balder (-18bps, underweight), Rheinmetall (-20bps, not in portfolio) and Safran (-23bps, not in portfolio).

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 the end of December, the average equity sensitivity of UBAM – European Convertible Bond stands at 34.1% (+4pts q/q), +5pts above the index's. The strategy's interest rate sensitivity is very much contained at 1.9 for a 3.0-year duration. Lastly, the portfolio exhibits an average credit spread of 157bps (-7bps q/q) vs. 258bps for the index – levels that reflect the "quality" bias inherent to our security selection process.
- From a sector standpoint, the sub-fund is primarily exposed to equity markets through investments in Industrials (7.8%), Consumer Discretionary (5.0%) and Financials (4.9%). Despsite being in our lagest sector exposure, we actually are underweight in Industrials (-1.3pts) when compared to the index. Vs. the index we are overweight in Consumer discretionary (+2.4pts), Technology (+2.3pts) and Financials (+1.5pts).
- This quarter, we participated to only one deal on the European primary market, the Bechtle 2.0% 2030. Bechtle is a German quality company in the IT sector, more precisely in IT consulting and Services, which saw an opportunity to raise debt through the convertible bond market at a lesser cost when compared to straight bond. Overall, we moved the portfolio towards convertible bonds with more balanced profiles. We reinforced Prysmian, we initiated a position in the exchangeable Citirgoup / L'Oréal and a position in Fastighets Balder 3.5% 2028, to get exposure to a name with delta in the Real Estate sector offering some diversification. With the strong momentum in markets, we have been taking profits and reducing our exposure to some names such as BE Semiconductor, STMicroelectronics, Zalando, Accor and Qiagen.

Outlook

- Economic data release over December in Europe are confirming the stagnation in activity. European PMI indices are still below 50 and are showing little signs of improvement. That being said, consumer confidence studies have been slightly better toward the end of the year, and so far we don't see any contagion to the real economy and the labor market is strong as unemployment is still low.at 6.4%. The good news has been coming from the inflation front since it has continued to ease with headline CPI came at 2.4% YoY in November and should therefore be less a drag to economic activity. Combining the ease in global inflation pressure and the more dovish stance from central banks, it appears clearer that we have seen the peak in rates. This pictures a new environment where downside risk in yields surpasses upside risk, which has historically been supportive for our asset class. When it comes to Growth companies, Technology and Healthcare sectors, accounting for a large chunk of our universe, the end of the hiking cycle is a strong positive catalyst as it has been a significant headwind over the last 18 months. Furthermore, the shift in yield environment should also help the pickup in M&A activity, which could be a supporting factor for convertible bonds as issuer are often M&A targets.
- This year the primary market activity has returned to its historic issuance level, and we expect this trend to accelerate in 2024. We do not expect the lower yield to be a challenge for the primary market. Significant amounts of debt refinancing are coming towards the end of 2024 & 2025. Cost of debt is still dramatically higher than over the last 10 years, even for Investment Grade issuers. As a result, compared to straight bonds or bank loans, the relative interest to issue convertible bonds has increased. This should bring new opportunities to our market in 2024, with a more diversified set of issuers than what we have seen in the last few years.
- From a macroeconomic viewpoint, uncertainties should not be underestimated, we see desynchronized economic cycles and a volatility regime navigating at a higher level. When combined, this has been refraining risk-on positioning among investors. This type of foggy market environment is precisely when convertibles should be considered to build or maintain an equity exposure. Convertibles can also provide compelling benefits when investors want to diversify and/or enhance their bond/credit allocation, and/or to optimise the risk-return of their equity investment.

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