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UBAM CONVERTIBLES GLOBAL

Quarterly Comment | Q4 2018

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

Market Comment

- Volatility ran high in Q4, as markets moved sharply amid concerns of weakening growth momentum, trade headlines, commodity prices and central banks' policy. As expected, the Fed raised its key rates by 25bps in December, to 2.25-2.50%. Governors' tone remained confident on growth; they reiterated their determination to keep adjusting rates, as well as reducing the central bank's balance sheet. In Europe, the ECB put an end to its net purchases of bonds whilst keeping its main interest rate on hold.
- All these, combined with the US government's partial shutdown and lingering political risks in Europe (the Brexit gridlock; negotiations over Italy's budget; social unrest in France; etc.) resulted in a broad "risk off" mode in the market.
- The investor fear gauge (VIX index) closed at 25.4pts on December 31st, up sharply from its end-September level (+13pts q/q). In Europe, the V2X ended the year at 23.9pts (+9pts q/q).
- In this context, major equity indices retreated sharply. In the US, the S&P 500 index dropped 13.5% q/q, ending the year down 4.4%. In Japan, the Nikkei 225 tumbled even further (-16.9% q/q), closing 2018 down 10.4%. In Europe, the Stoxx Europe 600 NR lost 11.6% in Q4 (-10.8% over the year).
- In contrast, government bonds benefited from the surge in risk-aversion. In the US, the yield on the 10Y Treasury note declined to 2.68% at December-end, from a high level of 3.24% reached early-November. In Europe, the yield of the 10Y Bund closed the year at 0.24% (-19bps y/y).
- Regarding convertible bonds' valuations, average implied volatilities (IV) in the universe moved in quite opposite directions during the quarter. While European and Asian convertible bonds' IV held up relatively well overall, ending in line with their September-end levels, US and Japanese convertible bonds cheapened.
- On the issuance side, convertible bond primary activity was very quiet in December amid challenging market conditions. Looking at the entire year, however, 2018 was very active in terms of new issuance, especially in the US. Globally, USD 84.4bn came to the market this year (source BofAML), including USD 51bn in the US – the most the region has seen since 2008. The European market contributed USD 11.9bn; Asia USD 16.2bn (the highest yearly volume since 2007) and Japan USD 5.3bn.

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

- Performance in the convertible bond space in Q4 has been impacted by overall challenging market conditions that saw a strong drop in equities and a widening of credit spreads. In this context, UBAM Convertibles Global ended the quarter down 8.14% after fees, bringing its performance in 2018 to -4.94%. As way of comparison, the index* declined 7.48% in Q4 and -4.43% over the year.
- As expected amid difficult markets for risky assets, the underlying equity component was the main detractor to performance in Q4 (-7.9%). This should however be put in perspective with the performance of global equities over the same period (-13.7% for the MSCI World EUR Hedged).
- The fixed income bucket was positive (+86bps) thanks to supportive curve and duration effects. The option component had a slightly negative contribution (-30bps): while the Gamma effect (convexity) played out relatively well, the evolution in the portfolio holdings' Vega (implied volatility) proved detracting overall. Lastly, Forex (hedging and implied forex) cost 55bps and "others" (management and trading fees) -26bps.
- Region-wise, the portfolio's exposure to the US market was the main detractor to performance in Q4 (-4.9%) due primarily to negative contributions of the Consumer Non-cyclical, Tech and Communication sectors in the region – those very same sectors that had driven performance throughout 2017 and into the start of 2018.
- Within these sectors that cost the most in Q4, some conviction names yet stood apart, such as Red Hat (+11bps, US Software), Twilio (+7bps, US Internet Software & Services) and Workday (+6bps, US Software). These positive contributions were however offset by the negative impact of names such as Square (-39bps, US IT Services), AMD (-36bps, US Semiconductors) and Sarepta (-30bps, US Biotech).
- In relative terms*, our absence – or underweight positioning – to certain names of the index proved favourable throughout the quarter (e.g. Transocean +15bps, Weatherford International +12bps, Caesars Entertainement +9bps). On the other hand, Teladoc (US Health Care, fund-only position) cost 18bps, Sarepta (US Biotech, overweight) -18bps and Square (US IT Services, overweight) -14bps.

Portfolio Activity

- The average equity sensitivity of the portfolio decreased by 17pts q/q, down to 35.6% at December-end. This move was primarily the result of the gamma effect (convexity) amid corrections in the underlying stocks. Part was also explained by the implementation of an index Put option strategy, early-November, designed to enhance the overall convexity of the portoflio.
- Region-wise, at December-end, the portfolio's equity sensitivity was split as follow: 23.8% (-9pts q/q) in the US; 7.1% in Europe (-5pts q/q); 2.4% in Japan (-2pts q/q) and 2.4% in Asia (-1pt q/q).
- With near-term risk drivers still at play (trade, central banks, geopolitical…), we have maintained a disciplined approach in terms of profit-taking and rebalancing of our portfolios towards convertible bonds with more balanced profiles in terms of equity sensitivity, whilst keeping core attention to the credit quality.
- This should remain at the core of our approach heading into 2019. 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, to boost the overall convexity potential of the portfolio.
- During the quarter, we notably opened-up new positions in IFF (specialty chemicals) and Splunk (web-based application software) in the US. Primary issuance remained strong in the region overall, with a bias towards Tech and Health Care names. Within the portfolio, we participated in the new Boingo Wireless (internet based services). Other major moves in Q4 included, in Europe, participation in the Carrefour 2024 (balanced profile) and, in Japan, participation in the Relo 2021 (Japan real estate services) following meeting with the management.

*Thomson Reuters Convertibles Global Hedged (EUR). For information and comparison purposes only. The fund has no official benchmark.

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Outlook

- Against the difficult backdrop of global trade tensions, concerns over the growth path and domestic political issues – to name but a few –, investors ended 2018 on a risk-off mode. The start of 2019 should not be any different with investors still on the lookout.
- Equity volatility made a noticeable comeback last year. Looking ahead, we expect volatility to remain high as most of the issues that weighted down on investor sentiment in Q4 2018 are still mostly unsolved today.
- This being said, we remain cautiously constructive on equity markets for the months ahead, considering more reasonable valuations post- the recent de-rating, and our long-term view that we are in a “softened growing economy” rather than at the end of the global economic cycle.
- In this context, we believe that a meaningful allocation to financial instruments with equity upside potential and downside mitigation benefits makes sense. Historically, the convex nature of convertible bonds has provided investors with long-term benefits, such as excess return versus equities over a complete market cycle; significantly reduced volatility and drawdowns; lower sensitivity to interest rate moves.
- During the bull run from 2012 up to 2017, equities naturally outperformed. In comparison, 2018 stood as a transition year. Amid challenging market conditions, global convertible bonds took the lead over equity indices, and demonstrated solid resilience during the shocks that affected financial markets.
- Region-wise, the equity correction in Q4 2018 has rendered the US a more accessible universe in terms of convertible bonds’ technical profiles and valuations. While we remain vigilant in the region with erratic policy trends, we see value in robust macro indicators. As such, we are looking for convex opportunities in the “newly balanced” pool, whilst keeping core attention to the bond-floors. Besides, in a US convertible market biased towards Tech and Biotech names, we continue to see upside potential due to positive secular trends and M&A potential.
- In Europe, we have noted for several quarters now that the convexity has been deceptive on some convertible bond names because of “failing” bond-floor. This leads us to re-focus our portfolios on companies whose convertible’s bond-floor should hold up even in the event of significant downward movements on the underlying, in order to recover convexity potential in our investments in the region.
- In Pan-Asia, we are seeing strong convex potential thanks to low implied volatility levels. As such, we will look to increase our investments in the region upon opportunities. In China specifically, while we avoid property names (which we rather play through proxies in Philippines or Vietnam), we find value in Banks/Insurers, as well as in domestic plays with strong positioning. In Japan, we favour companies with convincing growth plans focused on domestic economy, as well as industrial names with strong market share.
- Against current challenging market conditions, our primary objective going into 2019 will be to refocus our portfolios towards the most balanced – and hence convex – segments across the main regions. To that extent, the recent collapse in earnings revisions ratios should offer attractive entry opportunities in single names.

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