Q2 2020

UBAM – EURO EQUITY INCOME

Quarterly Comment

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

Market Comment

- The benchmark index rose +16.98% in Q2, a strong recovery from the low point in markets registered and the end of Q1 and enabled by both the gradual re-opening of economies post lockdown (due largely to a mortality rate that is materially lower than initial expectations) and unprecedented levels of monetary & fiscal stimulus delivered by central banks and governments. In terms of trading Q2 appears, at this early stage, to have been the worst period as a variety of recent company updates highlight sequential revenue improvements throughout the quarter and in many cases the outturn appears no worse than envisaged at the time of Q1 results (April/May) - albeit we still need to see how profits and cash flows develop.

- The market rally was also supported by normalizing levels of volatility throughout the quarter as the indicator remained in the 25-35 region compared to the 70+ highs observed during Q1. The S&P500 index returned +20.5% during the quarter, while the MSCI Europe ex-UK index returned +15.1%. Emerging markets recovered strongly too, with the MSCI EM index registering +18.2% returns while the UK could only manage lower double-digit returns of +10.2%. All indices are total return in local currency, except MSCI EM in US Dollars.

- However behind the headline index performance, sector returns were strongly differentiated. Unsurprisingly the areas most affected by the virus such as hotels, airlines and banks have lagged the rally. Similarly, while food retailers and supermarkets are the best performing sectors year-to-date, they have also lagged for most of the recent rise in markets. The technology sector has, by some margin, emerged as a significant beneficiary of the COVID period as end-demand for semi-conductors, software, games and e-commerce has not only remained resilient but in many cases improved year on year. Lastly value stocks remain largely friendless, -17% over the period whilst growth stocks are up +6%.

- Credit markets also posted a strong performance. On the corporate side the Euro high yield market rallied by +11.2% during the quarter, followed by US high yield which was up nearly +10%. More broadly, Global Investment Grade returned +8.6% during the period, reflecting in part the avoidance of a liquidity squeeze thanks to huge monetary injections by central banks. In contrast, UK Gilts returned +2.6%, followed by Euro Government bonds with +1.7% and US Treasuries at +0.5%. All indices are total return in local currency, except global ones in US Dollars.

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.

- Overall, an undeniably strong quarter across markets stimulated by a gradually improving global environment and renewed investor optimism. Nonetheless, the second half of the year remains highly uncertain given the broad re-basing of markets at a time when the impact of COVID-19 continues to escalate in certain key regions and the early signs of deconfinement elsewhere are, at this stage, little better than mixed.

Performance Review

- The portfolio produced a return, net of fees, of +15.31% in the second quarter, underperforming the benchmark by +167bps (+16.98%). Year-to-date the fund remains ahead of the benchmark by +160bps, net of fees. With a portfolio beta of 0.92 we would expect the fund to underperform a strongly rising market, all else being equal. In spite of this we are broadly pleased with the fund's relative resilience, particularly given the outstanding performance of the Technology sector, where the fund has minimal exposure.

- From a sector standpoint within the fund, the quarter's winner was Financials whilst the principal detractors of performance were Information Technology (IT), Consumer Staples and Energy.

- The fund gained a relative +94bps from the Financials sector during the quarter. Insurance stocks were at the forefront of the rally as gains in equities coupled with tightening credit spreads helped in clawing back significant investment losses sustained in Q1. In addition, more evidence emerged of rate hardening on the P&C side of the industry, evidenced by several UK companies (Lancashire Holdings etc) raising fresh capital to exploit pricing opportunities. In addition, our Spanish bank holding (Bankinter SA) performed well relatively, particularly against local peer Santander, given its high quality loan-book which should result in a less negative non-performing loan cycle.

- The Technology sector was notable for a number of very different reasons. Firstly, the greatest contributor to fund performance during the quarter (+100bps) was the demise of Wirecard AG, the German payments provider. The company filed for insolvency, its CEO was arrested and its auditors accused it of committing an "elaborate and sophisticated fraud", as nearly $2bn went missing. More than offsetting this however, were the strong performances by index Goliaths ASML NV, SAP SE and to a lesser extent Infineon, whilst the fund's only sector holding, Amadeus IT Group SA, continued to lag on the back of lingering concerns over the pace and shape of recovery in air travel.

- The Energy sector was also a strong negative contributor, with all 3 of the fund’s holdings (Royal Dutch Shell PLC, Total SA & Galp Energia SA) underperforming materially during the quarter. Whilst the oil price staged a strong recovery, returning to ~$40/b, demand remains fragile and is unlikely to exceed pre-Covid levels until late 2021 at the earliest. Current prices also support the return of substantial shale volumes whilst the global inventory overhang continues to be significant and investor sentiment remains firmly downbeat in the face of an accelerating energy transition.

- Consumer Staples also performed poorly across the board as investors sought higher-beta names in the sharp market rally. Diageo PLC and Heineken NV, the fund’s two beverage holdings, continue to struggle with weak sales in the on-trade market, albeit at-home consumption has provided some mitigation.

Portfolio Activity

- As discussed last quarter, going forward we expect there to be a lower level of turnover within the portfolio and that has been reflected in Q2 where there were no new purchases or outright sales. Having said that, we remain very active in terms of idea generation and genuinely feel that competition for capital within the fund has rarely been stronger, with a small number of interesting ideas that we are looking to implement over the coming quarters.

The following portfolio changes took place during the quarter:

Increased position size:

- Rational AG: We continued to increase the position size into a further leg of share price weakness. Whilst we accept that the return to any form of normality for many of Rational's customers will take time, we believe the logic for owning the company's products has become even more compelling with the new generation of cooking equipment – offering even stronger savings to be made in terms of labour, energy, time and materials. This comment from SSP's (food & beverage concession operator) recent results statement, in our view, sums up the opportunity well for Rational: ‘We will maintain a tighter cost base, focused on more simplified operations and use technology to eliminate manual tasks where most cost efficient, and finally, we will continue to embed sustainability within our operations’. We believe that Rational is a longer-term winner not only in terms of technology offering the ability to eliminate manual tasks, but also through offering a real improvement in operational sustainability.

- Amadeus: Amadeus continues to suffer from its exposure to airline passenger travel flows, with the majority of revenues directly related to the number of plane tickets sold and passengers boarded onto aircraft. Airline revenues have collapsed in recent months and whilst Amadeus enjoys a leading market position, with ~40% EBITDA margins and a ~20% ROCE, it is not immune. We increased exposure to the company following the weak share price performance and capital raise in early April, which strengthened the balance sheet considerably, (from an already strong position it should be noted) and leaves the company sufficiently well financed to weather a very tough 12-18 months. Ultimately we continue to believe that the company will be the long-term winner in its markets.

- Elisa Oyj: We added to the position started last quarter as a result of reducing our exposure to KPN following a strong relative share price run. We did not want to add aggregate exposure to the telecoms sector hence we rebalanced more towards Elisa. We think the company stands to be a key beneficiary of the 5G rollout as data speed, quality and reliability have become even more important in a post-COVID world. In our view the working-from-home (WFH) theme is set to endure and therefore the ability to monetise 5G will demonstrably set operators apart.

Reduced position size:

- Wolters Kluwer NV**:** We took some profit in the company following a long period of exceptional share price returns. Our longer-term conviction remains undiluted however we wanted to recognise a period of particular strength and provide capital for new ideas or where we felt that positions were trading materially below our assessment of intrinsic value.

- DiaSorin SpA**:** After nearly doubling in the space of just two months we took the opportunity to realise some profit. Whilst we continue to like the company we felt that the valuation had simply run too far, going from ~23x 2020 EBIT to ~40x in a short space of time. Whilst we recognise the near term opportunities arising from the virus, combined with the potentially step-changing medium term growth outlook from greater diagnostic spending, we felt that the shares had over-reacted in terms of valuation. This was particularly apparent when compared to Roche Holding AG, home to the world's largest diagnostics business. If one were to apply a DiaSorin-type valuation (at the time) to the Roche business then the Pharma division looked incredibly cheap. So either DiaSorin was expensive or Roche was undervalued – we believe that the reality probably lied somewhere between the two but most likely skewed towards the side of DiaSorin being expensive.

- Royal Dutch Shell: The last 6-12 months have been particularly difficult for the oil majors, but to Shell in particular. 2019 wrapped up with a ROACE of just 6.9% (2018 8.7%) due to, inter alia, weak LNG prices and low refining/petrochemical margins resulting from poor demand and over-supply. On top of that 2020 delivered a hammer-blow as oil prices collapsed from not only a demand shock but a supply glut as Saudi Arabia and Russia faced off against each other. The culmination was the first dividend cut in over half a century at Shell. Despite re-basing expectations the outlook remains far from certain, with secular demand in conventional oil likely to have peaked whilst considerable reinvestment is required into a portfolio of renewable energy at a time when that market appears flush with capital, potentially compromising returns. During the quarter we used a brief period of share price weakness to reduce the fund's exposure whilst we contemplate the next steps. At this point we feel a ~4% dividend yield is little reward for owning the shares, particularly when we also hold Total and Galp. We continue to review the position pending a decision in the near future.

- KPN NV: As explained above we withdrew some capital from KPN during the quarter in order to increase our position size in Elisa. KPN posted a robust set of Q1 results in April, with mobile ARPU stable for the 5th consecutive quarter and the EBITDAL margin +180bps year-on-year. Further, the new CFO revealed that much greater disclosure on free cash flow (FCF) would be provided going forward alongside a greater focus on ROCE. After a solid report the company saw no reason to change the dividend policy and the payment was made in full. We look forward to seeing what KPN can achieve in the future.

New Positions

- There were no new positions started in the quarter.

Sold Positions

- There were no sold positions during the quarter.

Outlook

- Following up from last quarter’s dividend commentary we wanted to provide an update on where the fund stands both on 2019 dividends and the outlook for 2020. In summary, ~15% of the fund (by gross exposure) have either cancelled the 2019 dividend or 2020 interim dividend. Encouragingly, the entirety of the top 10 holdings (representing ~40%) have paid the 2019 dividend, most in full but in some cases with a slight reduction to the original intention (e.g. LVMH). Within the Financials sector, the fund’s skew towards high quality insurance stocks has helped ensure the flow-through of dividend payments. Whilst many bank holdings have suspended their dividends, we suspect that there may well be catch-up payments made either later this year or early next year.

- Elsewhere, whilst equity market commentators obsessed over the value vs growth trade this year, they (and us to be fair) have missed the real story in town, which is the material outperformance of the technology sector. The only two sectors of the European market to be in positive territory in 2020 thus far are this and Healthcare. Understandably latter can be broadly attributed to the virus and the increased demand placed on the healthcare system in its myriad forms. Technology, however, stands to be a clear longer-term beneficiary in a post COVID-19 world. We are not big believers in the notion that human habits will change wholesale in its aftermath, but our experience leads us to believe that the work-from-home (WTF) 'experiment' has, by and large, proven successful. Employees have shown to employers that not only can they be trusted to work independently but that they can do so productively. Further, company commentary that we have observed suggests that in many cases customer engagement and satisfaction has been enhanced via electronic communication. Clearly human connection is vital for business to prosper longer-term and we would not suggest that WFH becomes the outright norm, but certainly at the margin the concept appears to have been proven and, alongside the obvious acceleration in e-commerce, stands to benefit the technology sector as future investment plans (from consumers, businesses and governments) are likely to be accelerated. How this plays out in a broader context we will need more time to consider but, in the meantime, we intend to redouble our efforts in the Technology area, particularly given that historically it hasn't tended to be a natural home for ‘Income’ investors.

- That being said, our view of the portfolio remains unaltered - we continue to be happy with the positioning and have taken steps to address material stock price dislocations, not only within the portfolio but in areas of our watchlist that hold specific interest. We continue to work particularly hard in this latter area and feel confident that our research is addressing the appropriate segments of the market.

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