THE DRIVE YOU DEMAND

UBAM CONVERTIBLES EUROPE 10-40

Quarterly Comment | Q4 2019

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

Market Comment

- The prospect of an agreement between the US and China, the clear result in the UK elections and a healthy macroeconomic environment helped restore confidence and supported risk assets in Q4.
- In the US, the S&P 500 TR progressed by +9.1% q/q; in Europe, the Stoxx Europe 600 NR climbed +6.1%; in Japan, the Nikkei 225 TR ended up +8.9% and the Hong Kong HSI (TR) finished up +8.9% q/q. Performance was even stronger in Emerging markets, with the MSCI Emerging Markets equities index up +12.2%.
- Sector-wise, the rotation that had hit the market end-Q3 continued in Q4. Backed by sound GDP growth prospects, cyclical names outperformed growth and defensive ones. In this context, the healthcare and technology sectors yet managed to rebound from their Q3 weaknesses.
- Volatility slightly decreased over the quarter – whilst remaining quite sustained. At December-end, the fear-gauge index (VIX) settled at 14pts (from 16pts at the end of September); in Europe, the V2X index closed at 14pts (from 16pts at September-end).
- On the sovereign bond side, the 10-year yields closed higher: by +25bps q/q in the US, up to 1.92%, and by +39bps in Germany (at -0.18%).
- The high yield segment and, though to a lesser extent, investment grade corporate debt in the US, benefited from credit spreads tightening. 3-5Y high yield (HY) indices were up +2.61% in the US and up +1.98% in Europe, while 3-5Y investment grade (IG) indices were up +1.08% in the US and slightly down in Europe (-13bps).
- Convertible bonds issuers continued to raise capital opportunistically during the last quarter of the year, with a peak in October. They took advantage of supported volatility, tight credit spreads, and near all-time high stock prices.
- In Q4 2019, global primary issuance amounted to USD 14.2bn, bringing YTD total to USD 85bn. Region-wise, the US market was the main contributor to past quarter's activity, bringing USD 8.7bn of new papers. On their end, Europe, Asia (ex-Japan) and Japan contributed respectively USD 2.7bn, USD 2.2bn and USD 0.6bn.

Sources: UBP, Bloomberg Finance LP, BofA Merrill Lynch.

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

- UBAM Convertibles Europe 10-40 progressed by +1.32% after fees in Q4, outperforming its index* (the Thomson Reuters Convertibles Europe EUR Hedged) by +0.05bps. YTD, the strategy is now up +6.91% net of fees, which compares to a +7.84% return for the index*.
- During the quarter, the underlying equity component was the main driver to performance for the strategy (+1.7%). The optional features and Forex (hedging & implied forex) also contributed positively, adding +25bps and +7bps respectively. In contrast, with risk free rates slightly rebounding, the fixed income bucket cost -45bps and "others" (management & trading fees) -24bps.
- Over the quarter, sectors that contributed the most were Technology (+66bps), Industrial (+38bps) and Consumer Cyclical (+32bps). Only two sectors detracted in Q4, namely Utilities (-11bps) and Consumer Non-cyclical (-14bps).
- At firm-level, major contributors to the strategy's performance in Q4 included STM (+38bps, Semiconductors), Kering (+31bps, Consumer Cyclical) and Worldline (+25bps, Technology). In contrast, our investments in Corestate Capital (-18bps, Financial), Valeo (-14bps, Consumer Cyclical) and Dassault Aviation (-13bps, Industrial) detracted.
- In relative terms, the outperformance of the strategy vs. the index* was primarily driven by our stock picking. Hence, underweights in Wirecard and Siemens proved favourable and added +38bps and +21bps respectively while our overweight in Kering added +18bps. At sector-level, underexposure to Industrial (+26bps) and Energy (+21bps) as well as our overexposure to Consumer Non-Cyclical (+16bps) proved favorable.

Portfolio Activity

- The average equity sensitivity of the portfolio increased over the quarter, from 33.0% to 39.3% at the end of December and the strategy offers more exposure to equity markets than its index* (30.5%). This move was mainly driven by equity market's strong performance and reflects a general increase of equity sensitivity in the European convertibles market.
- At the end of December, the portfolio displays an average interest rate sensitivity of 2.1%, and an average OAS spread of 105bps (vs. 189bps for the index*). This gives strong evidence of our focus on credit quality in our security selection.
- At the end of Q4, the convertible market offers more convexity than at the same time last year. This makes it easier for us to maintain our focus on convertible bonds with enhanced convex features and to build a strategy with asymmetric patterns while applying equity/credit/bond picking through our bottom-up process.
- For example, Worldline and Cellnex are two companies that used the convertible market to raise some financing in 2019. They are well invested in the portfolio as we see significant long-term upside potential through convex instruments.
- Over the quarter, we seized the opportunity offered by high markets' levels to continue taking profits on some of our higher delta and best performing names such as Adidas (Consumer Cyclical), CA Immobilien (Financial) or Safran (Industrial) and reinving in more defensive names such as Orpea (Consumer Non-cyclical).
- Furthermore, this active, convexity-driven management was supported by attractive opportunities in the primary market. We notably participated in the new Atos 2024, exchangeable in Worldline. We favor this instrument over the existing Worldline bond as it has a shorter profile and more equity sensitivity. We have therefore reduced our position on the old stock to favor the newly issued instrument.
- We also participated in the new Neoen 2024. This independent company is a leader in the production of renewable electricity. The strong growth anticipated for the coming years should enable Neoen to meet its balance sheet commitments. We remain cautious in our credit analysis and have therefore granted an internal B rating to this company because of the significant leverage used to finance its growth.

*Index provided for comparison and information purposes only. The fund has no official benchmark.

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Outlook

- With good GDP growth driven by a healthy labor market and consumer spending, low absolute rates, accommodative monetary policy and benign inflation, the global picture remains supportive of risk assets for 2020. Investors are thus expecting a healthy year, backed by earnings growth rather than multiples expansion.
- Even though the broad economic outlook points toward a robust economy, we remain vigilant about some unpriced geopolitical risks such as Middle East tensions, US elections, China/HK conflict or Brexit – to name but a few.
- The bias in favor of value names seen in the market over the past 5 months is likely to remain in play in 2020, backed by more robust manufacturing activity. That said, names in the convertible bonds' "value" space are not necessarily our "top picks" due to a weaker operational and credit profile of the issuers. From a valuation and fundamental point of view, we thus remain comfortable with our constructive stance towards quality and growth names
- In light of the lingering uncertainties that offer potential for sustained volatility in the months to come, we will maintain a disciplined approach in terms of profit-taking.
- Similarly, we remain very selective with respect to the recent primary activity given the opportunistic approach of many issuers. However, we do not shy away from opportunities to rotate away from equity sensitive structures into instruments with more balanced risk-reward profiles.
- While remaining reasonably constructive on equity markets, we expect 2020 to be challenging given the many upcoming events and the lack of visibility on the geopolitical front. This, combined with interest rates at historical lows and tight credit spreads, leads us to believe that convertibles remain an asset class of choice for the year ahead. Historically, the asset class has demonstrated its capacity to benefit from equity markets' rise whilst mitigating their downsides.
- We will maintain a rigorous approach in terms of credit quality and robust risk management in combination with conviction based positioning – a combo that remains in our view particularly suited to current market environment.

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