THE DRIVE YOU DEMAND

UBAM CONVERTIBLES GLOBAL

Quarterly Comment | Q2 2019

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

Market Comment

- The second quarter was marked by "V-shape" moves on global markets, driven by central banks' rhetoric and developments on the US-China trade conflict. Eventually though, most major equity indices ended the quarter in the green, adding to the strong gains achieved in Q1. In the US, the S&P 500 TR progressed by +4.3% q/q; cross-Atlantic, the Stoxx Europe 600 NR climbed +3.0%; in Japan, the Nikkei 225 TR ended slightly up (+0.5%). On the negative side, the Hong Kong HSI (TR) finished slightly down -8bps q/q.
- Corporate credit spreads, on their hand, broadly tightened over the quarter, across regions and credit grade segments: -14bps for the 5Y investment grade (IG) index and -18bps for the 5Y high yield (HY) index in Europe; -10bps for the 5Y IG index, and -25bps for the 5Y HY index in the US.
- Aside from the spikes witnessed in May, markets' volatility remained fairly contained on a quarter-to-quarter basis – and still well below the levels seen in Q4 2018. At the end of June, the fear-gauge index (VIX) settles at 15pts (from 14pts at the end of March); in Europe, the V2X index even slightly declined q/q, from 15pts down to 14pts.
- In the past weeks, government bond holders generally benefited from the prospect of interest rate cuts with the latter triggering a falling trend in long yields. Thus, 10-year yields fell by 40bps q/q in the US, down to 2%, and by 26bps q/q in Germany, down to a historic low of -0.33%.
- Q2 19 saw a robust volume of USD 18 billion of new convertible bond issuance globally, bringing YTD total to USD 40bn. Region-wise, the US market was the main contributor to the past quarter activity, with USD 11.8bn; Europe added USD 3.1bn; Asia (ex-Japan) brought USD 2.9bn of new papers and lastly, Japan contributed for USD 0.3bn.
- The falling trend witnessed in interest rates, combined with the US government shutdown and trade tensions have been headwinds to primary activity dynamism, and explain the relative slowdown in comparison to last year's strong issuance pace. However, new convertible deals' terms – initial premiums in particular – have been less aggressive in comparison to what prevailed last year, which should prove favourable to the asset class' performance going forward.

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

Performance Review

- UBAM Convertibles Global ended the quarter up 2.15% after fees (+25bps above the Thomson Reuters Convertibles Global EUR Hedged index*), bringing its performance year-to-date up to 9.10% (vs. 9.85% for the index*).
- During the quarter, the strategy benefited from positive contributions of both its fixed income (+2.3%) and equity sensitivity buckets (+1.6%). In contrast, the portfolio's optional feature detracted -0.9%. Forex (hedging and implied forex) cost 52bps and "others" (management & trading fees) -32bps.
- Region-wise, the portfolio's exposure to the US market was the main driver to performance in Q2 (+2.2%), due primarily to positive contributions of the Consumer Non-cyclical and Tech sectors. Europe contributed +77bps, Asia ex-Japan +17bps while Japan detracted -16bps.
- At firm-level, major contributors to performance this quarter were Exact Sciences (+27bps, US Biotech), Sarepta (+19bps, US Pharma) and Okta (+17bps, US Internet Services). On the negative side, main detractors were Alibaba (-12bps, Asia Internet), Ubisoft (-10bps, Europe Software) and Nutanix (-10bps, US Computers).
- In comparison to the index*, the outperformance of the strategy over the quarter was driven by favourable stock picking, and positive relative contribution of the option component. At companies level, overweighs to Exact Sciences (+16bps) and Adidas (+11bps, Europe Textiles & Apparel) proved favourable, alongside our absence from Weatherford International (+12bps, US Energy Equipment & Services). In contrast, our absence from Dish Network (-17bps, US Media) and Bayer (-12bps, Europe Pharmaceuticals), for credit reasons, came at a cost.

Portfolio Activity

- The average equity sensitivity of the portfolio slightly decreased over the quarter, from 47.7% to 46.3% at the end of June (+2pts vs. the index*). This was explained by arbitrages from higher delta names to more balanced instruments, as well as by the gamma effect which played out in response to equity markets' correction in May.
- Region-wise, at June-end, the portfolio's equity exposure is split as follow: US 29.3% (+0.6pt q/q); Europe 12.1% (-0.3pt q/q); Asia 3.3% (-0.6pt q/q); Japan 1.6% (-1pt q/q).
- The average interest rate sensitivity of the portfolio remained fairly stable quarter-on-quarter, at 2% for an average duration of 4 years. At June-end, the average OAS spread of the portfolio settles at 197bps, which compares to 309bps for the index*. This gives strong evidence of the importance we place on the credit analysis as part of our security selection.
- With near-term risks still at play, we maintained a disciplined approach in terms of profit-taking and rebalancing of our portfolio towards convertible bonds with more balanced equity profiles. This was done whilst keeping core attention to the credit quality. This should remain at the core of our approach in the coming months. Although volatility remains contained at overall market level, at single stock level, large moves are not uncommon, and offer opportunities for bottom-up managers to capture convexity.
- Although convertible primary activity has been more contained so far in 2019 in comparison to last year, deal terms have been fairly attractive overall, providing interesting new opportunities to invest in. In the European market, we notably participated in the new GN Store Nord 2024 (communication solutions) as well as in the new Cellnex Telecom 2028 (leading European telecom tower group) – both instruments which offer attractive convex profile on underlying equity with solid fundamentals and growth prospects.
- Also in the European bucket, we initiated a new position in the Iberdrola 2022 (electricity generation and distribution), on fundamental conviction. From very defensive entering into 2019, the convertible has evolved to a much more convex profile, along with the supportive performance achieved by the underlying stock YTD. Other major moves last quarter include additions of JPM/Siemens 2022 and Link 2024 (largest Asian real estate company with strong management and steady growth).

* For information and comparison purposes only. The fund has no official benchmark.

Outlook

- As we head into the second half of 2019, we remain reasonably constructive on equity markets for the months ahead. Central banks' dovish rhetoric, combined with resilient global growth, could fuel additional upside in global equities. However, "May-like" short-term corrections are to be expected considering lingering uncertainties (outcome of the US/China trade negotiations; developments in "Brexit"; etc.).
- With short-term correction risk in equity markets and yields in the fixed income space that remain too low to deliver attractive long-term returns on a standalone basis, the traditional "Equity-Bond" asset allocation is put to the test. In this context, we believe that a meaningful allocation to financial instruments combining equity upside potential and downside mitigation benefits makes sense.
- Throughout 2018 until end of June this year, global convertible bonds lived up to their long-term benefits. Last year, amid challenging market conditions, the asset class demonstrated solid resilience during the shocks that affected financial markets, outperforming global equities with lower volatility, and significantly reduced drawdowns. In addition to these downside mitigation benefits, global convertible bonds posted solid performance during the H1 2019 rally, capturing a significant proportion of equity markets' overall rebound past semester.
- In today's advanced phase of the cycle, the convertible market additionally provides investors with a risk-controlled exposure to stocks for which the growth potential is linked to favourable secular trends (e.g. digitalisation of the economy, middle class consumption in Asia, healthcare, etc.) and thus, less exposed to the overall softening economic activity.
- Looking ahead, amid accommodative central banks, resilient global growth, and the stabilization we expect in global activity (on the back of favorable base effect, reduction in inventory overhang and increased liquidity in all key regions), we believe it is too early to reposition the portfolios with a more defensive bias. However, uncertainties remain and call for cautiousness. Against this backdrop, we believe that regular and disciplined profit taking will remain key to manage the robustness of the portfolio, whilst maintaining a constructive positioning in terms of overall exposure.
- On the credit side, concerns have diminished in the short-term on the back of central banks' policy shift. Nonetheless, and in line with our historic DNA, we remain particularly attentive on credit metrics in our investment decisions.
- In H1 2019, convertible bonds saw some richening from their Q4 2018 lows, driven by rebound in global stock markets. At current levels however, valuations are far from the highs we witnessed in recent years (e.g. during the 2016 rally), and the primary activity – although slightly down in comparison to last year – continues to bring new investment opportunities with attractive technical and pricing terms. At the end of June, valuations in the asset class stand in line or below their mid-term average levels, giving access to convex opportunities under reasonable to attractive conditions.
- In current market environment, we believe the asset class offers compelling advantages in the context of portfolio allocation, by allowing investors to remain exposed to equity markets whilst lowering their portfolio's overall risk profile.

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.

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