UBAM CONVERTIBLES EUROPE

Quarterly Comment | Q3 2017

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

As of September 29th, 2017, UBAM Convertibles Europe became a Feeder fund of FCP Convertibles Europe Responsable ("the Master").

Market Comment

- Q3 saw some turbulence on equity markets, generated by escalating geopolitical tensions on the one hand – especially between North Korea and the US – and central banks' communication on the other. Elections were also in the spotlight in Germany and Japan. This, however, did not prevent global equity markets to demonstrate resilience and to post additional gains over Q3, backed by positive signs for global growth, good corporate earnings and overall positive sentiment indicators. In Europe in particular, the Stoxx Europe 50 NR added 2.2% q/q and the Euro Stoxx 50 NR jumped 4.7% q/q.
- Late-September, the US central bank formally announced it would begin unwinding its balance sheet in October. The majority of FOMC participants still forecast at least 4 hikes by end of 2018, including one in December this year. In Europe, the ECB maintained a cautious tone, divided between a strong euro and low inflation, and postponed the announcement of any decision regarding the calendar and terms of exit of its QE program to October.
- Apart from some peaks caused by geopolitical tensions during the summer months, and although at already ultra-low levels, volatility indices closed the quarter even further below their end-June level. Thus, in the Eurozone, the V2X declined by 5pts q/q, down to 12pts at September-end.
- Convertible bonds' optional feature saw some cheapening in Q3 as revealed by the evolution of their implied volatility across the main markets – with the exception of the US where it slightly increased.
- This overall evolution can be partly explained by the persistent low realised volatility environment, which has maintained downward pressure on options valuation, as well as by the primary activity dynamism. In Europe in particular, the strong month of June (which saw USD 5.3bn of new issuance coming the market – the highest level recorded in the region since June 2014) triggered some cheapening in the secondary market during the summer months.
- A total of USD 18.1bn was added to the global convertible bond supply in Q3. The US market remained the main provider of new papers this quarter (USD 8.3bn), followed by Europe (USD 5.6bn). Japan contributed USD 2.2bn and Asia-Pacific USD 1.5bn. YTD, global convertible primary issuance now amounts to USD 60.4bn including USD 30.8bn in the US, USD 19.1bn in Europe, USD 5.3bn in Japan and USD 3.4bn in Asia-Pacific.

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 progressed by 0.57% after fees in Q3, bringing its performance since the beginning of the year to 0.47%. As way of illustration, the Thomson Reuters Europe Focus Convertible Bond EUR Hedged index ended the quarter down -0.02%; YTD, this index is up 2.31%.
- In Q3, the performance of the strategy was primarily driven by its equity sensitivity component (+1.44%). The fixed income bucket was slightly positive on aggregate (+5bps). The portfolio's optional features, however, had a negative impact (-0.61%) due to detracting "vega" – reflect of the cheapening we saw during the quarter in European convertible bonds' implied volatility.
- At industry level, exposure to the Technology sector was the main contributor to the strategy's Q3 performance (+63bps) thanks to our position in STM (+62bps). The Industrial sector was also a strong contributor (+44bps), through names such as Deutsche Post (+22bps) and Prysmian (+16bps). In the Financial sector (+30bps), our positions in Eurazeo (+13bps) and Deutsche Wohnen (+11bps) particularly stood out.
- To the contrary, the portfolio suffered from its allocation to Consumer Non-cyclicals (-31bps) due to the negative contribution of names such as Gedeon Richter (-15bps), Qiagen (-10bps) and Fresenius (-10bps). Exposure to the Consumer Cyclical sector was also detracting overall (-23bps), due to the negative performance of Steinhoff (-50bps) which offset the positive impacts of Adidas (+14bps) and Valeo (+6bps), among others.
- In relative terms, the outperformance of the strategy vs. its index in Q3 (+0.59%) came primarily from positive stock picking and from the supportive (relative) contribution of optional features. The fixed income component, in contrast, had a negative relative impact.
- Top relative contributors in Q3 include our overweight exposure to STM (+38bps) as well as several off-index choices (Deutsche Post +22bps; Adidas +14bps; Eurazeo +13bps). In contrast, top relative detractors include: LVMH (-13bps, underweight); Fresenius (-8bps, overweight at beginning of period); Evonik Industries (-7bps, underweight); Qiagen (-5bps, overweight).

Portfolio Activity

- The average equity sensitivity of the portfolio declined by 14pts q/q, from 50.1% end-June (vs. 33.7% for its reference index) down to 35.9% end-September (vs. 34.3%). This was primarily the result of active investment choices, leading to reposition the portfolio towards more balanced convertible bonds to reach an average equity exposure more in line with the universe.
- This was notably implemented by taking advantage of primary activity dynamics, with existing convertible issuers managing actively their debt – calling back outstanding papers and issuing new convertibles. This particularly led us to arbitrate our positions in STM and Deutsche Wohnen, selling the relative high equity-sensitive profiles in favor of more balanced tranches.
- Certain of the portfolio's large weights came to maturity during the quarter (e.g. Siemens 2017, Parpublica/Galp 2017). Proceeds were reinvested in convertible bonds which we find attractive from a bottom-up standpoint. Thus, we notably initiated new positions in Telecom companies to benefit from the ongoing supportive momentum we see in the sector, through names with solid credit quality, relative attractive YTM levels and overall defensive equity profiles: Telecom Italia 2022, America Movil/KPN 2020 and Orange/BT 2021.
- Certain positions we had in portfolio were closed in the latter part of the period in anticipation of the transformation of UBAM Convertibles Europe into a feeder fund of our European SRI convertible strategy (effective September 29th), with regard to applicable SRI criteria (e.g. Airbus/Dassault Aviation 2021, Rag Stiftung/Evonik 2018, Bayer/Covestro 2020).

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Outlook

- Although we acknowledge that markets at global level have already priced in a lot of positives thus far, we remain constructive on equity markets for the months ahead. Sustained and synchronised growth remains in place and should continue to support global stock markets going into year-end.
- Looking at current equity valuations, we believe that the European market is well positioned to benefit from this overall healthy environment. The ongoing positive earnings momentum in the region should in our view be further supported by a sound economic expansion. P/E ratios suggest that there is room for further rally: at September-end, forward P/E 18 settled at 14.7x for the MSCI Europe vs. 16.3x for the MSCI World (developed markets) and 17.5x for the MSCI North America.
- On convertibles' optional feature valuation too, we believe that the European market continues to offer attractive convex potential, with convertibles' IV in the region still below its mid-term average level at September-end.
- In spite of the overall healthy economic background, the scenario of a correction should not be completely set aside. The strong rebound already achieved by equity markets thus far, combined with rising geopolitical risks and policy concerns, could translate in a reversal from current ultra-low volatility regime.
- In such a scenario, we believe that the benefits of convertible bonds are twofold. Their convex nature, first, grants them exposure to equity upside potential and at the same time, effective cushion on the downside, thanks to their bond-floor component. Besides, a rise in volatility usually triggers a positive revaluation of options. As such, investors can expect convertible bonds' embedded call option to somehow benefit from a trend reversal in volatility levels – hence partly making up for the induced detracting impact on their underlying equity component.
- On the rate front, with the ECB expected to adopt progressively a more neutral monetary policy, we remain defensive on duration. In this regard, convertible bonds offer strong competitive edge relative to traditional fixed income instruments, by embedding much lower sensitivity to interest rate moves at similar duration. This comes from their embedded option, which benefits from a rise in interest rates and hence, partially offsets the loss on the bond component.

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