BEYOND THE UNCERTAINTIES

Written on
18 | 03 | 2020

Revaluating our strategy today, to prepare the post – crisis

As in previous crises, the current environment is not necessarily conducive to risk taking. However, we believe in dedicating our efforts to calmly evaluate current valuations and identify the opportunities which, as we all know, when adequately seized in these troubled times, often constitute the drivers of tomorrow's performances.

Certain markets are showing signs of capitulation: hence the current valuations of Additional Tier 1 and HY seem low relative to their fundamentals.

Without underestimating the major economic impacts of this crisis, the stimulus programs announced by governments and the measures put in place by the European Central Bank are likely to reassure. The ECB's March 18 announcements are further proof of this. interventionism rather than ''laissez faire'' is now being advocated to revive the economy as quickly as possible, and the banking sector clearly constitutes an essential transmission channel to the real economy which will have to be preserved at all costs. European banks have been evolving for more than a decade in an environment characterised by heightened prudential regulation, which has substantially favoured the strength of balance sheets to the detriment of shareholders. With very favourable capital levels, they also evidence very cautious risk management which will leave no room to the infamous "moral hazard" concern, if the institutions were to strengthen the accommodative measures.
Therefore, the financial subordinated debt market clearly constitutes a strong conviction for us on the credit market because of current valuations and extremely low levels of credit risk on the sector.

Jean-Luc HIVERT
Chief Investment Officer

SUBORDINATED DEBT MARKETS

The distortion of valuations in the credit market has continued in recent days, exacerbated by the scarcity of liquidity, whether on subordinated debt, High Yield or even Investment Grade, where prices have not always been able to reflect market reality. Regarding subordinated debts, we are reaching **unprecedented levels** that are **detached from any economic meaning**, either in absolute or relative value within the segments. Indeed, prices have fallen often indistinctly, regardless of the durations of the bonds, their ratings or the fundamentals of the underlying issuers, **some securities having been sold more quickly because considered "less risky" or more liquid theoretically.**

As of March 18, the Markit iBoxx subordinated debt indices show very high spreads and yields. The iBoxx EUR Contingent Convertible Index (CoCos AT1) thus shows an average Z-spread of 1509 bps for an annualized return of 14.5% according to the most conservative assumptions *(yield to worst)*, while that figure had never exceeded 10% since the creation of the index in January 2014 and was still at 4.1% at the end of February 2020. If we consider the iBoxx EUR Financials Subordinated index, which is now made up only of Tier 2 debts, but which also used to contain Tier 1 (non-CoCos), we have to go back to April 2009 to find such yields, in a banking sector that was significantly different from today.

The current health crisis coupled with the sharp drop in oil prices will evidently have **significant economic consequences**, especially on non-financial companies in our view, but we observe that **the market does not seem to be yet responding to the various accommodative measures** conducted by governments and central banks around the world. Among these, we highlight the measures announced to the benefit of the European banking sector by the ECB, which aim to temporarily ease capital constraints and promote access to wider and cheaper liquidity. Banks have significantly increased their capital ratios in recent years and have significantly improved the quality of their balance sheets, notably by reducing outstanding bad debts. **We are a long way from the systemic risks** that still prevailed at the beginning of 2016, when the Italian banks and Deutsche Bank were adversely impacting the sector as a whole.

CoCo MARKETS

If we focus on the market of CoCos denominated in EUR, most of the issues now trade at prices between 50% and 70%, some securities having lost more than 40% in just a few weeks. Let us consider the Dutch bank ''ABN Amro'', rated A1/A by Moody's and S.P., which benefits from very strong fundamentals and comfortable solvency ratios, since its core capital ratio (Common Equity Tier 1) was 18.1% at the end of December 2019, which allowed it to display a regulatory capital cushion of 6.6 billion euros, making any potential defaults on its CoCos and any intervention of the regulator rather unlikely. Following the various derogations decided in recent days (exemption from complying with the Capital Conservation Buffer, reduction to 0% of the countercyclical cushion and lowering of the systemic cushion to 1.5% against 3% previously), ABN Amro's distance from its regulatory requirements increases to 11.1 billion euros, everything else being equal. However, the spread of ABN Amro's CoCo segment with a coupon of 4.75% now shows a Z-Spread of around 970bps, a yield of 9.9% for a theoretical refund in 2027, while this stock is rated Ba1/BB+ by Moody's and Fitch. The price of this bond has collapsed by 39 points in just one month, and now incorporates considerable levels of risk, whether in terms of extension or even default risks, although the latter still seems relatively low.

OUR CONVICTIONS

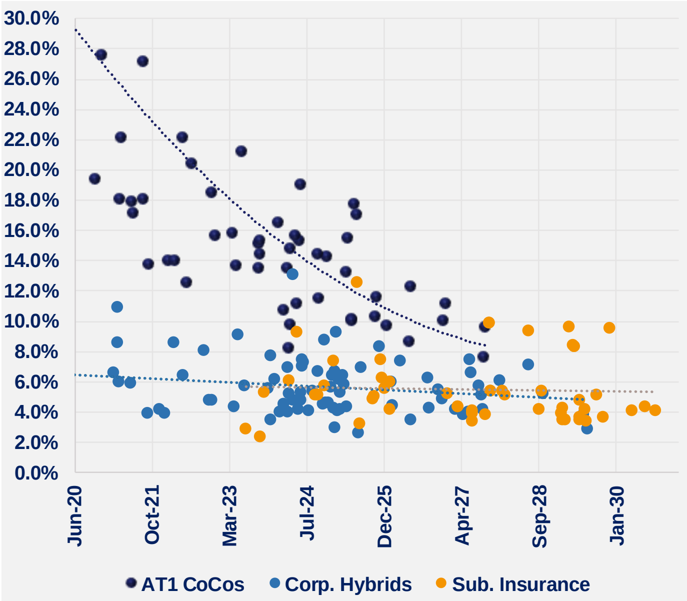
Despite the deteriorating macroeconomic environment, still unable to fully evaluate the impact of the Covid-19 crisis, we consider that current levels of European subordinated debt, and in particular of CoCos, offer attractive entry points. This is due to the various accommodative measures announced (and potentially still upcoming) by governments and central banks, particularly the launch of the ECB's new 750 billion euro bond-buying program (named PEPP), coupled with an additional EUR 120 billion purchase for the existing QE. We see opportunities for low-priced securities (between 50% and 70%) because they incorporate probabilities of call on the first repayment date that are relatively low, even though they are rather far into the future (in most cases 4 to 7 years from now), a time horizon within which we can infer that the impact of the virus will have been alleviated. Moreover, extreme market conditions have not prevented ING Group and SEB AB from announcing this week that they will repay their USD-denominated CoCos with close maturities, which shows that repayment issues are depending on the issuer's economic interest, but also on its regulatory or refinancing constraints.

OUR EXPERIENCE NAVIGATING THE SUBORDINATED DEBT MARKET AT LA FRANÇAISE

We have been managing subordinated debts since 2008 and we have navigated numerous storms and experienced multiple segment changes (birth of CoCos and Restricted Tier 1 insurance, development of Corporate Hybrids...). Throughout these eras, we have chosen (and will continue) to favour liquid assets from quality issuers as well as granularity within our portfolios. Thus, the average issuer ratings of La Française Sub Debt and La Française Global CoCo are "A-" and "A" respectively, while the funds contain 134 and 100 bonds respectively, 86% and 74% on bonds with outstanding assets greater than 500m EUR (often called ''benchmark''), which usually gives them better liquidity than smaller bonds.

Throughout the previous crises, the financial subordinated debt market offered several windows of opportunities. **Thus, we identified in 2016 misvaluations on the CoCo market, a sector that La Française Sub Debt consequently overweighed.** Today, we believe that the valuations of our two specialized funds on the subordinated debt asset class **offer attractive yields.** The average YTW[2] of La Française Sub Debt is 10.5% according to the most conservative assumptions, while that of La Française Global CoCo in EUR is 12.6%[3], which represents historical levels in absolute terms., and therefore, in our view, meaningful market opportunities. Assuming an ability to withstand additional weeks of volatility, we believe that the current valuation of this asset class already constitutes an investment opportunity, although we understand that this crisis is not over.

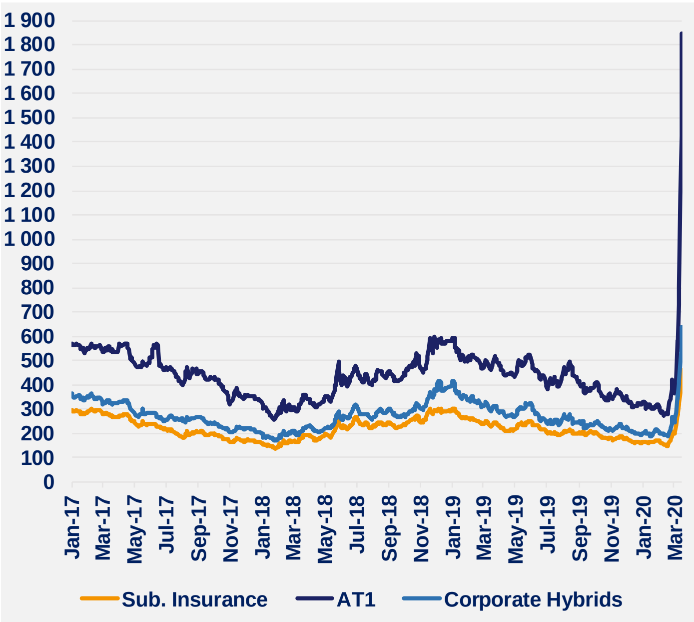
Yields on the first repayment dates of a selection of euro-benchmark subordinated bonds based on their asset class (indicative rate curves dotted)



---

[2] *Yield to* worst, defined according to *Bloomberg as "The lowest yield (based on Mid price) to all possible redemption date scenarios''. This figure is expressed gross of fees. As of 30/06/2019, the ongoing charges of the Institutional share class of LF Global CoCo and LF Sub Debt are 0.76% and 0.63% retrospectively.*
[3] *Indicative: Bloomberg as of March 18, 2020 taking into account the theoretical 3-month hedging costs of USD-denominated bonds and GBP for France's Global CoCo.*

Evolution of spreads against benchmark of subordinated debt indexes denominated in euro (in bps, Credit Suisse indexes)



Sources : La Française AM, Bloomberg, Credit Suisse. Data as of 18 March 2020. Past performance is not a reliable indicator of future results.

Past performance is not a reliable indicator of future performance.

The objective of La Française Sub Debt is to achieve a performance higher than 7 % p.a , over a recommended investment horizon of over 10 years, by gaining exposure to subordinated debt, with specific risk profile different from standard bonds. Creation of the sub-fund: 10/12/2018. The sub-fund originates from the merger by absorption of the La Française Sub Debt mutual fund created on 20 October 2008, with an identical strategy and absorbed on 10/12/2018.Investors are informed that their capital is not guaranteed and that it may not be returned in full. **Main risks are: interest rate risk, credit rate risk, counterparty risk, convertible bond risks, equity risks, potential risk of a conflict of interests. SRRI = 4 – please note that this calculation in based on historical data and may not be a good indication of future risk profiles. Before any investment, and for further information related to risks, please refer to the prospectus, available in French and English, on our website: https://www.la-francaise.com/en-fr/what-we-do/our-products/**

La Française Sub Debt is suitable for professional investors as defined below. Execution only services can only be provided to professional investors. Retail investors are excluded from the positive target market. Professional Investors have the following characteristics: Good knowledge of relevant financial products and transactions; financial industry experience. La Française Sub Debt is not suitable for retail investors unless they have professional investment advice AND the investment in La Française Sub Debt is for diversification purposes only or have signed a discretionary portfolio mandate. Before any investment, and for further information related to risks, please refer to the prospectus, available in French and English, on our website: https://www.la-francaise.com/en-fr/what-we-do/our-products/

The objective of La Française Global Coco is to achieve a net of fees performance superior to its benchmark, the ICE BofA Merrill Lynch Contingent Capital EUR Hedged Total Return Index, over a recommended investment horizon of over 5 years, by gaining exposure to subordinated debt. The SICAV has been registered as at 14/08/2018. It was created by merger absorption of the La Française Moderate Multibonds FCP, created on the 18 January 2001 (It became La Française Global Floating Rates as at 13/08/2019). The La Française Global Coco component has been created as of 07/12/2018, following a merger absorption of the La Française Global Coco FCP (created as of 18/01/2017). **Main risks are: discretionary risk, credit risk, counterparty risk, convertible bonds, contingent bonds, liquidity risk, derivatives, interest rate risk, risk of overexposure, volatility risk, speculative securities, countries not part of the OECD, counterparty risk, preferred shares, potential conflict of interests, legal risk. SRRI = 4 – please note that this calculation in based on historical data and may not be a good indication of future risk profiles.**

Before any investment, and for further information related to risks, please refer to the prospectus, available in French and English, on our website: https://www.la-francaise.com/en-fr/what-we-do/our-products/

La Française Global CoCo is suitable for professional investors as defined below. Execution only services can only be provided to professional investors. Retail investors are excluded from the positive target market. Professional Investors have the following characteristics: Good knowledge of relevant financial products and transactions; financial industry experience. La Française Global CoCo is not suitable for retail investors unless they have professional investment advice AND the investment in La Française Global CoCo is for diversification purposes only or have signed a discretionary portfolio mandate. Before any investment, and for further information related to risks, please refer to the prospectus, available in French and English, on our website: https://www.la-francaise.com/en-fr/what-we-do/our-products/

The information contained in this document does not constitute investment advice, an investment proposal or any type of recommendation whatsoever to invest in the financial markets. The assessments contained herein reflect the opinions of their authors at the time of publication and are subject to change at a later date. Under no circumstances may La Française Group be held liable for any direct or indirect losses resulting from the use of this document or the information contained therein. This document may not be reproduced, transmitted or distributed to third parties, in whole or in part, without the prior written consent of La Française Group. Published by La Française AM Finance Services, located at 128 boulevard Raspail, 75006 Paris, France, a company regulated by the Autorité de Contrôle Prudentiel as an investment services provider, nº 18673 X, subsidiary of La Française. La Française Asset Management is a management company agreed by the AMF under the number GP97076 on July 1, 1997. For more information, check the websites of the authorities: Autorité de Contrôle Prudentiel et de Résolution (ACPR) www.acpr. banque-france.fr, Autorité des Marchés Financiers (AMF) www.amf-france.org. It is provided solely for informational and educational purposes and is not intended to serve as a forecast, research product or investment advice and should not be construed as such. It cannot constitute investment advice or an offer, invitation or recommendation to invest in certain investments or to adopt an investment strategy. The opinions expressed by the La Française Group are based on current market conditions and are subject to change without prior notice. These opinions may differ from those of other investment professionals. Please note that the value of an investment may rise or fall and also that past performance results are no indication of future results. Published by La Française AM Finance Services, located at 128 boulevard Raspail, 75006 Paris, France, a company regulated by the Autorité de Contrôle Prudentiel as an investment services provider, nº 18673 X, subsidiary of La Française. La Française Asset Management is a management company agreed by the AMF under the number GP97076 on July 1, 1997. For more information, check the websites of the authorities: Autorité de Contrôle Prudentiel et de Résolution (ACPR) www.acpr. banque-france.fr, Autorité des Marchés Financiers (AMF) www.amf-france.org.

Address of the local distributors:
Italy: La Française AM International Italian Branch, Milan: Via Dante 14 20121 Milano
Germany: La Française Asset Management GmbH: mainBuilding, Taunusanlage 18
60325 Frankfurt am Main
Spain: La Française AM Iberia, Spain: Paseo de la Castellana 92, 28006 Madrid
UK: La Française Real Estate Partners International : 78 Brook Street W1K 5EF London

LA FRANÇAISE
investing together

128, bd Raspail 75006 Paris - France
Tél. +33 (0)1 44 56 10 00
Fax +33 (0)1 44 56 11 00

www.la-francaise.com