LOMBARD ODIER
INVESTMENT MANAGERS

Investment viewpoint

The weather forecast for 2023

For professional investor use only • Convertible bonds

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There has been significant volatility in returns for both bonds and equities since early 2020. The convertible bond market has also seen some major changes.

In 2020 convertibles benefited significantly from equities moving up, rates falling and credit spreads tightening. All the possible performance drivers worked.

2021 was the year of giving back some gains after the exuberance of 2020. Over the 2 years, convertibles did what they were supposed to do as balanced convertibles have participated in 50% of the equity market performance.

2022 has been a difficult year where most traditional asset classes have so far generated double-digit negative returns. There have been many factors, which have caused volatility spikes. Record levels of global inflation have led to rising rates in all major economies except in China where the central bank has remained highly accommodative in the face of a possible slowdown in growth.

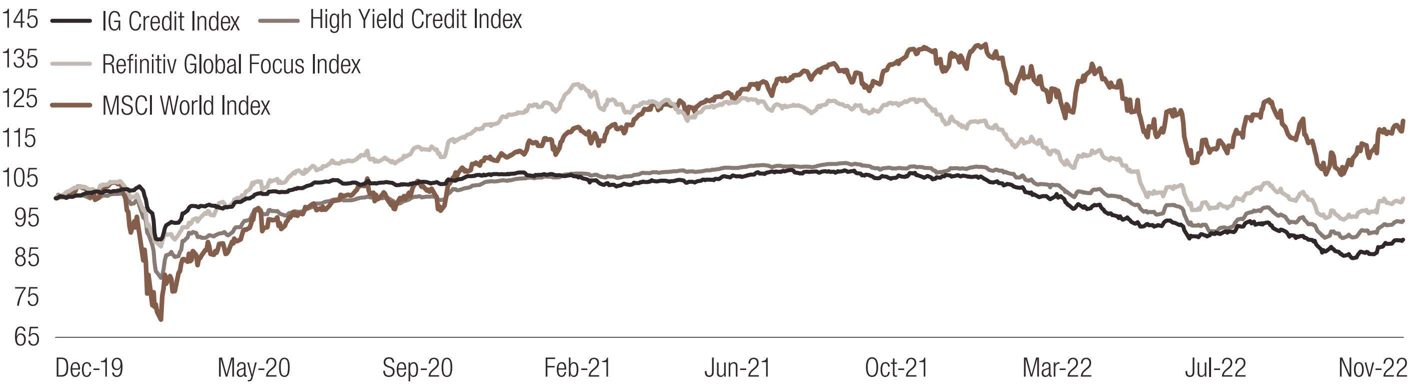
For convertibles, 2022 is the year of dispersion in performance between investment styles. Managers have needed to understand a very different environment where Central Banks have been withdrawing liquidity. It has been a challenge – there has been nowhere to hide - but we forecast in late 2021 that the investment environment would be “different” – that has helped us outperform the peer group and better protect returns. At Lombard Odier, we have been defensively positioned and have outperformed both equities and bonds year-to-date.

Over the past two years, the optionality embedded in the asset class, has helped returns and has acted as a cushion in the face of falling equity markets. The value of the option rises as volatility rises. Since 2020, we believe that this effect has added approximately 5 points to returns.

The universe today benefits from a high level of convexity due to good credit quality and inexpensive valuations. A high percentage of convertible bonds currently have a balanced profile and we expect the primary market to be a source of value. If the equity markets continue to perform into the New Year, convertible bonds will automatically participate with the equity upside, whilst still offering downside protection if the market corrects. This is one of the main attractions of investing in the asset class when the macroeconomic backdrop is as uncertain as it is today.

FIG. 1 CONVERTIBLE BOND COMPARATIVE PERFORMANCE

GLOBAL CONVERTIBLES VERSUS CREDIT AND EQUITIES SINCE LATE 2019



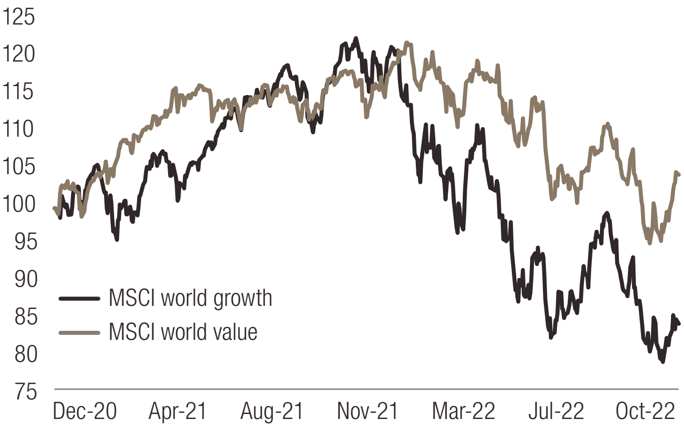
Source: LOIM. For illustrative purposes only.

In 2020, growth companies, which make up a large part of the investable universe performed well. In 2021 and 2022 they performed poorly. However, there are reasons to believe that certain Growth companies can recover from current levels.

Historically growth companies have been big issuers of convertibles. Often they have no other outstanding debt and can generate healthy returns. Some early convertible growth issuers have become household names like Tesla, which issued several convertibles over the past 10 years to finance expansion. In fact, convertibles are the ideal way to invest in this type of sector – you get a large part of the equity upside but with much lower volatility due to the protection from the bond floor.

FIG. 2 THERE HAVE BEEN SEVERAL ROTATIONS IN EQUITY STYLE

VALUE STOCKS HAVE OUTPERFORMED GROWTH BY ALMOST 14.5% SINCE JANUARY 2021

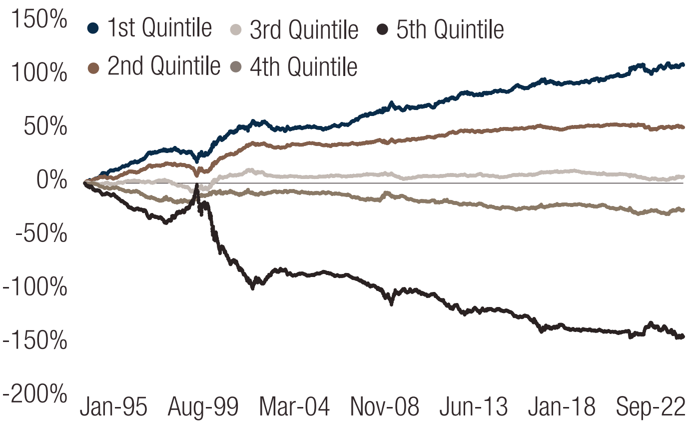


Source: LOIM. For illustrative purposes only. MSCI World Growth and Value Equity Indices (€) as at 31 August 2022.

The periodic Growth to Value rotations since the onset of the pandemic, have made it difficult for investors to navigate a clear path and negatively affected the performance of the asset class from early 2021 onwards. There were two style rotations last year and now again in 2022. Fears of rising interest rates and inflation pushed investors towards Value names with lower growth prospects but which felt defensive.

Nevertheless, the rate rises this year in the US and Europe led investors to rethink this positioning and start looking at growth names that have significantly underperformed.

FIG. 3 HIGHER QUALITY COMPANIES OUTPERFORM OTHER SEGMENTS OVER TIME

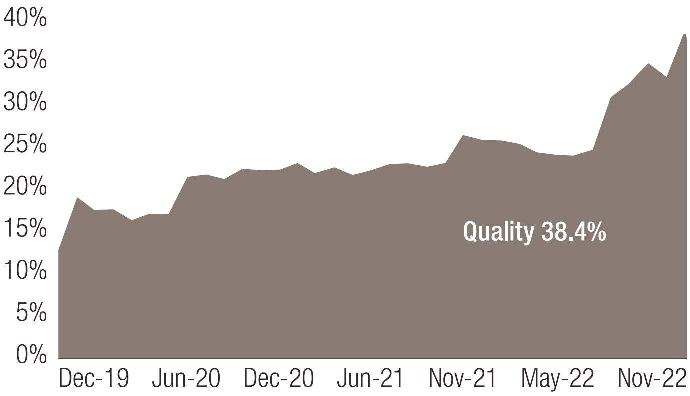


Source: LOIM. For illustrative purposes only. MSCI All Country Equity Index as at 31 August 2022. Quality – Excess Economic Return (EER) >60%

That said, we do not think that the entire growth complex will recover. We differentiate between "quality growth" and "unfunded growth". We expect companies with strong balance sheets and sustainable, stable business models to do well whilst more leveraged high growth names will struggle due to a higher cost of capital. Thus, we expect quality growth to outperform unfunded growth in a recessionary environment. The proportion of high quality companies basket of shares underlying the LO Funds – Convertible Bond fund has increased significantly.

FIG. 4 THE WEIGHT OF QUALITY COMPANIES HAS INCREASED

EXCESS ECONOMIC RETURN (EER) >60%



Source: LOIM. Basket of shares underlying the LO Funds – Convertible Bond (€) fund. For illustrative purposes only.

Historically convertibles have done well when rates rise, but in 2022 rates went up and convertibles didn't.

Convertibles are bonds but with one key difference versus straight debt. In simple terms, as an investor you have an instrument, which is less sensitive to rate moves because of the embedded equity option. That is what makes convertibles unique.

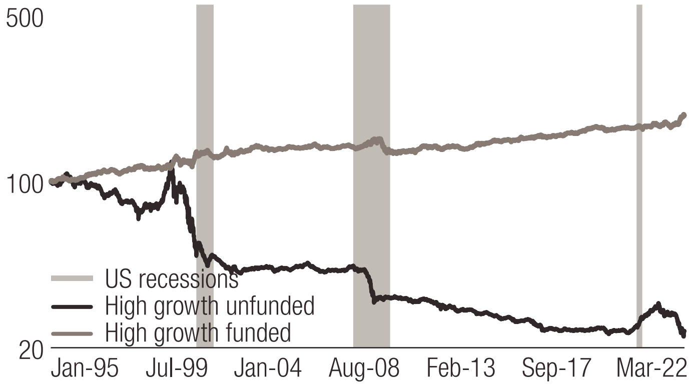
In periods when central banks raise interest rates against a backdrop of growth and moderate inflation, equity markets rise too. Convertibles have also historically done well – they benefit from the momentum in underlying share prices and as they have lower average duration than straight bonds they are less affected than longer-dated paper by higher rates.

Today, rates are rising to curb exceptional levels of inflation. Rises are steeper than in a standard hiking cycle. In order to bring inflation under control, policy makers are willing to sacrifice the growth, which would normally drive equities higher.

The concept of indirect duration became important in 2021. High growth companies, trading on expensive multiples and with profitability forecast several years out, suffered from rising rates, leading to a steep market correction. The asset class started 2021 with a high proportion of weaker growth names that did not do well as the year progressed.

FIG. 5 INDIRECT DURATION – BEING ADEQUATELY CAPITALISED WILL BE CRITICAL

LEVERAGED COMPANIES COULD STRUGGLE AS THE COST OF CAPITAL RISES SHARPLY AND GROWTH SLOWS

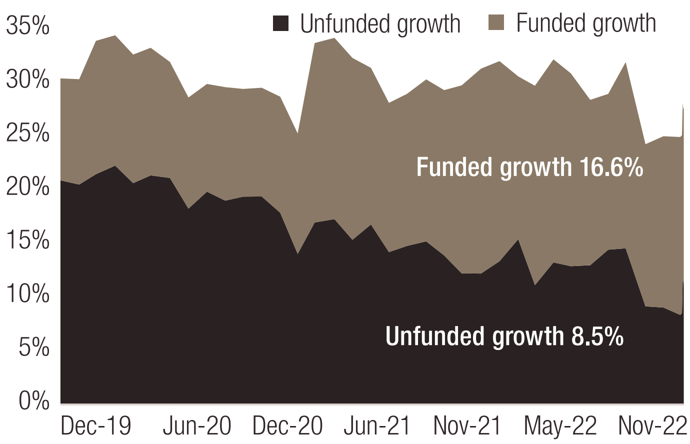


Source: LOIM. For illustrative purposes only.

In early 2021, the asset class had a large proportion of high growth issuers, which weighed on performance in the months which followed. We actively sold unprofitable companies last year and it proved to be a good decision. There are now fewer in our universe – many have lost equity sensitivity and no longer have balanced profiles.

FIG. 6 ADEQUATELY VERSUS LESS WELL CAPITALISED COMPANIES

THE PROPORTION OF WELL CAPITALISED COMPANIES HAS RISEN



Source: LOIM. Basket of shares underlying the LO Funds – Convertible Bond (€) fund. For illustrative purposes only.

The convertibles market grew by USD 300 million to USD 550 million in 2 years but there was less issuance in 2022 and the market has subsequently contracted.

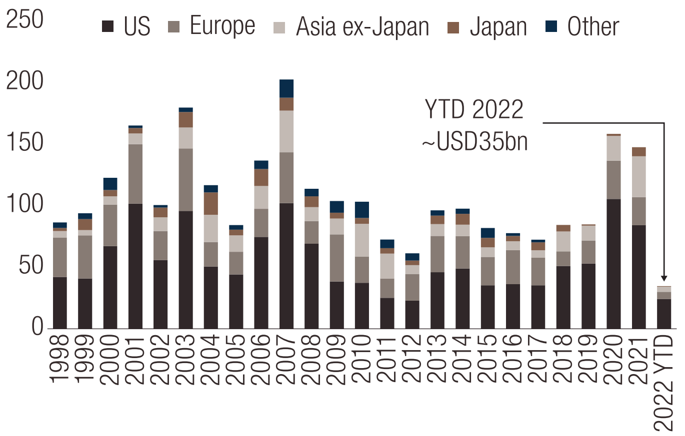
If you look at issuance over a number of market cycles, you can see that market capitalisation fluctuates. The asset class becomes the preferred means of financing when certain conditions become aligned – usually periods of rising equity markets and rising rates. We are not overly concerned – for at least the past three decades, the asset class has seen periods of substantial issuance and others where the primary market was quieter. When the broader backdrop is difficult, such as in the immediate aftermath of the Global Financial Crisis or during the early stages of the pandemic, deals were priced to attract investors. Ultimately pricing becomes tighter with less on the table for buyers until the process comes full circle and new issue terms again become attractive.

FIG. 7 TOTAL MARKET SIZE SINCE 1998 (USD MILLION)

Source: BoAML. For illustrative purposes only.

Although 2020 and 2021 were record years, issuance has been much lower in 2022. The primary market in 2020 was partially about issuance by high-growth companies fitting the working and consuming from home theme but also about rescue capital for issuers severely affected by the pandemic. There was a spike in issuance early in 2021. A large number of deals came to market very rapidly and caused indigestion. The asset class cheapened. There was a second wave later in the year from more opportunistic issuers, companies with weaker balance sheets or challenged valuations. We believed that the macro environment was deteriorating and did not participate in any of these transactions.

FIG. 8 ANNUAL ISSUANCE SINCE 1998 (USD BILLION)



Source: UBS to 2017, BoAML from 2018. For illustrative purposes only. As at 30 November 2022.

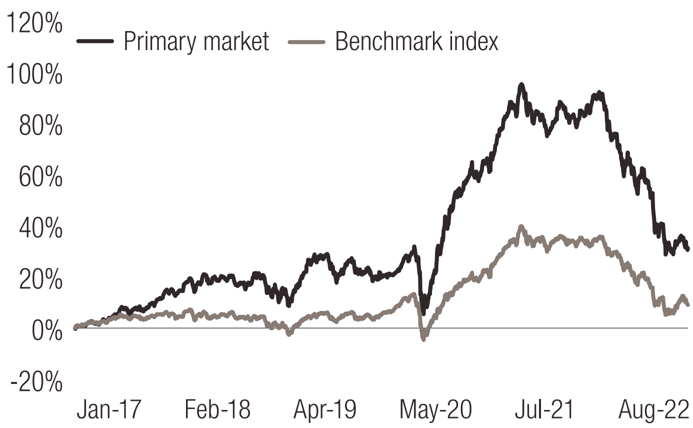
In 2022, higher financing costs, low refinancing needs and equity price volatility have led to a much quieter primary market.

Primary activity started to pick up in August and the issuance pipeline is gradually being converted in Q4, with deals especially from mid-size issuers. There are a number of reasons for this – some companies are looking to strengthen their balance sheet or lengthen their debt maturity profile, others for M&A to take advantage of some very cheap absolute valuations.

Issuance adds convexity and liquidity but we do not feel that the universe has especially suffered from the lack of deals this year. The other added value of the primary market is derived from the initial valuation of new paper. New paper is often placed at a discount. The new convertibles tend to outperform the secondary market and richen in the first three months post-issue. Larger deals will enter the benchmark and this also supports valuations.

The key to making money from the primary market is to be discerning – do the analysis, choose well and understand the underlying dynamics of investor behaviour.

FIG. 9 THE PRIMARY MARKET USUALLY OUTPERFORMS THE BENCHMARK INDEX



Past performance is not a guarantee of future results. For illustrative purposes only. Source LOIM. Benchmark: Bloomberg. Refinitiv Global Convertible Bond Index (€). As at 31 August 2022.

The broader opportunity set against a backdrop which remains complex but where valuations are attractive.

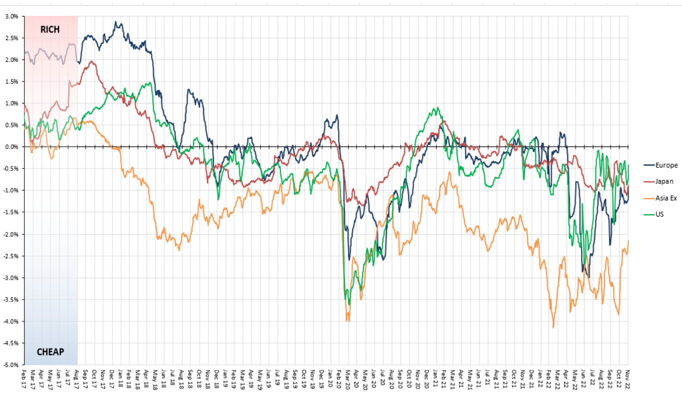
We currently consider the universe to be inexpensive. In addition, after the poor performance of many underlying equities, numerous convertibles now offer attractive yield and are trading at a discount to straight fixed income.

An opportunity has emerged. Many convertibles are now trading on or very close to their bond floor with what is technically a free equity option. Part of the market has become dislocated and it is possible to construct an interesting portfolio of these names.

There are two main performance drivers – firstly the pull to par and secondly the return of convexity (option value) in a rising equity market. As credit spreads tighten and equities rise, the two main performance drivers act in concert to produce equity-type returns from fixed income instruments.

FIG.10 THERE REMAINS UPSIDE POTENTIAL FOR CONVERTIBLE BOND VALUATIONS

MUCH OF THE UNIVERSE IS STILL INEXPENSIVE VERSUS THEORETICAL FAIR VALUE



Source: Jefferies. Past performance is not a guarantee of future results. For illustrative purposes only. As at 30 November 2022.

The compelling feature of the asset class is that at any point in the cycle, several strategies can make sense for investors. There will always be a place for a broad, well-diversified, global product, which carefully manages equity exposure. A classic vehicle for all weather conditions. Our flagship strategy has been in existence longer than almost any other global convertible product with a successful long-term track-record. It invests in instruments displaying asymmetry to the equity market that can help navigate periods of volatility.

In 2022, an even more defensive bias has worked; a strong credit profile and convexity have protected returns. Our LO Funds – Convertible Bond Defensive Delta strategy has been a useful addition to a broader investment portfolio.

Turning to Asia, recent government announcements have helped improve investor sentiment. Valuations look compelling and the Peoples' Bank of China is one of the few main central banks not raising rates. Stimulus is ongoing and growth looks set to top 4% next year. Additionally, the recent willingness from Beijing to begin a progressive loosening in the zero-Covid policy could remove a major hurdle in 2023. Investing in the real estate sector is still difficult but property is so systemically important in China that we believe it will eventually stabilise. It has been an important political year and if you believe, as we do, that the current risks can become an opportunity, then our dedicated Asia convertible fund is worth considering.

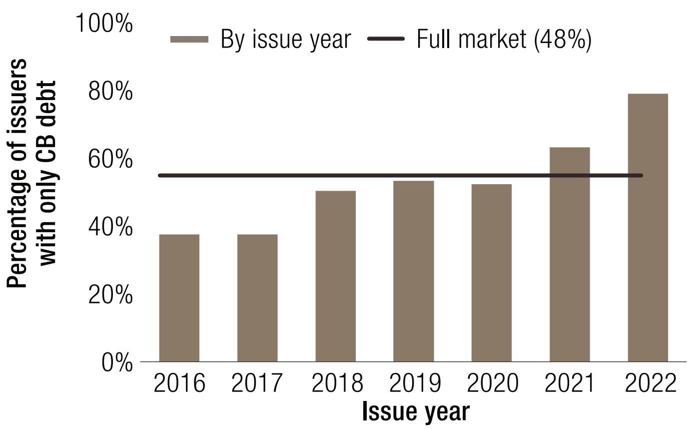
In volatile markets, convertibles are an ideal way to be positioned. Investors are paid to wait and will participate when the equity market recovers. Although China makes up more than half of the outstanding Asian convertibles universe, there are a substantial number of issues from South Korea, India, Taiwan and Singapore.

An allocation to convertible bonds today versus a balanced portfolio of equities and bonds.

In our view, investors are not obliged to follow one path or the other. A diverse portfolio of investments can be complementary but there are some strong arguments in favour of convertible bonds. An investment in convertibles can add diversification to a traditional equity + bond allocation. The convertibles universe has a different set of issuers and a different sector bias with, for example, a greater weighting in consumer discretionary, technology and communications versus financials and consumer staples in standard indices. These names tend to have a higher Beta and perform well in a recovery but the downside protection provided by the convertible structure helps mitigate volatility.

A large number of convertible borrowers have no other outstanding debt so it is the only way for a fixed income investor to gain exposure. For an equity investor, convertibles provide a low-volatility alternative in a difficult macro environment. Owning a bond fund plus an equity fund is also not a true replication as you are combining volatility and duration rather than mitigating both.

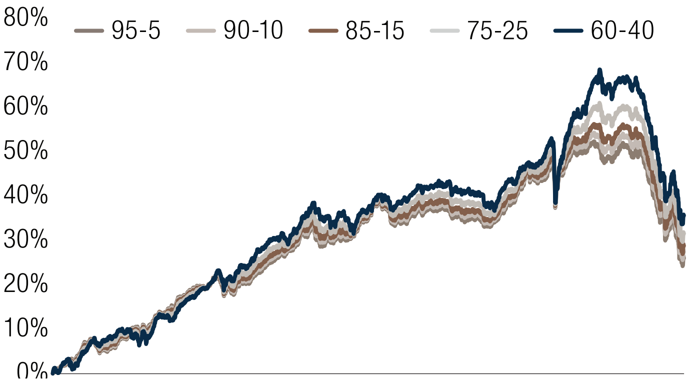
FIG.11 CONVERTIBLE ISSUERS TYPICALLY HAVE LITTLE/NO OTHER PUBLICLY TRADED DEBT



Source: BoAML as at 31 May 2022.

The correlation between bonds and equities is usually negative, so it makes sense to buy a balanced portfolio. This year bonds and equities both fell so a balanced portfolio did not work. Our global portfolio had lower equity sensitivity and lower duration this year, therefore did better. When the correlation turns negative again, this will boost returns as long as we avoid indirect duration. Our asset class has its own technicals and the performance drivers are different.

FIG. 12 GRADUALLY ADDING CONVERTIBLES TO A BOND PORTFOLIO CAN ENHANCE RETURNS



BONDS (%)	CONVERTIBLE BONDS (%)	ANNUALISED PERFORMANCE (%)	VOLATILITY (%)	SHARPE RATIO
95%	5%	**1.78%**	**3.00%**	**0.60**
90%	10%	**1.87%**	**2.90%**	**0.65**
85%	15%	**1.95%**	**2.80%**	**0.70**
75%	25%	**2.12%**	**2.80%**	**0.75**
60%	40%	**2.35%**	**3.10%**	**0.76**

Source: LOIM data from 1 January 2010 to 7 September 2022. Bloomberg Global Aggregate Corporate Bond Index (€) Refinitiv Global Focus (€) Convertible Bond Index. For illustrative purposes only. As at 31 August 2022.

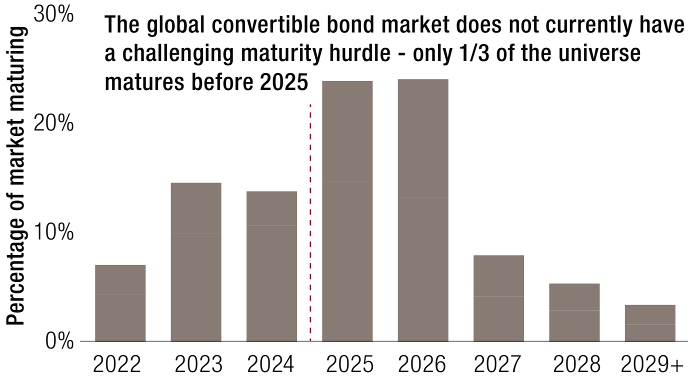
Portfolio positioning and performance drivers for 2023.

We came into 2022 defensively positioned with a relatively bearish view on equities and credit given the macro backdrop of slowing growth and a looming liquidity withdrawal in all the major economies (except China). That helped us navigate the market correction in the first half of the year well. Specifically we deliberately avoided unprofitable high growth names and have no credit exposure to Chinese real estate.

Looking into 2023, we expect equity markets to remain volatile with limited upside in H1 from here, given valuations after the recent rally. The Jackson Hole summit and the recent hawkish comments from the Chairman of the Federal Reserve post the weaker-than expected CPI reading in November, reinforced our conviction that the economy could enter a slowdown. Rates are likely to remain higher for longer. It is hard to predict the effect of more restrictive central bank policy on the real economy and convertible bonds could be an effective way to navigate 2023.

FIG. 13 THE CONVERTIBLES UNIVERSE CURRENTLY HAS AN EXTENDED MATURITY HURDLE

WE DO NOT SEE AN IMMINENT PICK-UP IN DEFAULTS



Source: BoAML as at 31 May 2022.

In credit, we do not foresee a significant pick-up in defaults because the redemption schedule up to 2025 is light. In fact, we think there could be opportunities. Yield and coupon income should provide a source of return. We prefer to focus on companies with sound credits as rates rise and spreads widen.

As we look ahead, we believe that the US, as the result of Federal Reserve policy, will remain on the trajectory of monetary tightening against a backdrop of strong employment data and rising wages. The Federal Reserve is already well on the path of reaching a neutral policy rate and recent data appear to show a moderation in inflation. In Europe, the tone is considerably more optimistic in early 2023 than in late 2022. Following the recent spate of clement weather and the high level of gas storage, energy price worries have receded for now but remain a concern for winter 2023/2024. In reducing its dependence on Russian gas supplies, the region is committed to developing alternative, sustainable energy sources. The weak Euro is providing some support for exporters and most of our exposure is via companies with a global footprint. We believe these companies should prove more resilient if there is a downturn.

Investing in Asia is highly dependent on the outlook for China. Slowing growth, periodic Covid lockdowns and uncertainty around expectations for the property sector made investing in China complex until Q4 2022, in spite of compelling equity market valuations. Tensions remain with the US and stimulus measures to support the real estate sector have yet to make a material difference. China has now radically overhauled measures to optimize epidemic prevention, ending the zero-Covid policy with no u-turn likely. The shift in policy to boost growth has improved investor sentiment. Recovery in Asia will be gradual in our view, not a v-shaped rebound. We are positioned in names where we see growth (selected consumer cyclicals, technology and reopening exposure such as airlines) and also in themes aligned to government policy such as the green transition (electric vehicle manufacturers).

- We believe that convertible valuations could continue to improve from here.
- We expect the Primary Market to add value as deals should be priced attractively for investors.

FIG. 14 PORTFOLIO POSITIONING AND POTENTIAL PERFORMANCE DRIVERS FOR 2023

USA

- Federal Reserve still hawkish
- Unemployment low and wage growth significant
- High uncertainty around the lag effect of tighter financial conditions
- Financing costs could impact the real economy and create volatility

Europe

- More optimism than in Q4-22
- Energy prices have peaked
- Some additional energy capacity secured
- Limited wage pressure despite low unemployment
- Weak € and saving rates still supportive
- Global companies most resilient
- Equity market valuations inexpensive vs. historical and US

Japan

- Corporate profitability high
- Wage growth under control

But

- Higher inflation could drive further yield curve policy changes
- ¥ appreciation could become a headwind

Common themes for US and Europe

- The majority bulk of the rate hike cycle is behind us but…
- We expect higher rates for longer
- PMI numbers show continued weakness in activity in all regions
- Activity indicators consistent with a shallow recession
- Historically low unemployment rate in both regions

Asia Pacific

- Faster than anticipated end to zero-Covid policy
- No potential reopening u-turn
- Pro-growth policy shift (fiscal and monetary)
- Real estate remains the elephant in the room but…
- Increasing government support and recent relaxation of rules positive
- Some geopolitical tail risks (Taiwan, US-China tension) will keep market volatility and the discount vs. DM high
- We expect a gradual recovery (not V-shaped)
- Focus on Consumer Cyclicals, Reopening names and themes aligned with government policy

Source: LOIM. For illustrative purposes only.

Given the macro environment, there are a number of investment themes which we believe to be an efficient way to be positioned in the New Year.

In the aftermath of the pandemic and against a very different backdrop, there are four themes in our view, where convertibles today offer investors a broad range of opportunities.

Pricing Power – best in class names with strong end demand in the luxury and software sectors but also companies which are leaders in their specific niche.

Security – especially, cybersecurity as geopolitical tensions remain high and IT budgets continue to grow. Also food security, guaranteed supply of basic resources and energy independence.

Defensive names with growth, which provide relative protection in case of a recession such as telecoms.

Insourcing – bringing production back home, especially relevant to strategic industries such as semiconductors.

As well as the investment themes listed above, there are important generational trends, which are gradually seeing issuance through convertible bonds.

Scarcity of resources – this is an increasingly important topic, but is so far underrepresented in our universe. We would actively welcome more issuance from, for example, producers of rare metals used by renewable energy providers.

The Climate Transition is possibly the most important investment theme – electric vehicles, renewable energy and solution providers which will benefit from growing secular demand and government support. Here at Lombard Odier, we have developed a range of funds for clients wishing to reduce the climate impact of their investments. In November 2021, we launched the Target Net Zero Convertible Bond strategy, which invests in companies already engaged in the climate transition but also in solution providers who will increasingly benefit from investment in lower emission businesses. The product is a concentrated portfolio with a more flexible risk budget than our existing strategies.

Convertible bonds are an all-weather instrument. We believe the asset class to be well-placed to outperform other traditional asset classes in the current volatile macroeconomic environment. At Lombard Odier we offer a broad range of strategies which allow convertible bond investors to select their preferred level of equity exposure, regional focus or themes which will benefit from longer-term secular growth.

FIG. 15 INVESTMENT THEMES FOR 2023

Pricing Power	Security	Defensive Growth	Infrastructure & Capex Spend	Resource Scarcity	Climate Transition
Best-in-class Strong end demand Real pricing power Luxury Quality software Niche leaders	Themes becoming embedded in daily life Cybersecurity Energy independence Food security	Names with growth and downside protection Telecoms	Automation Digitalisation Strengthening of the Supply Chain Semiconductors	Under-represented in convertibles e.g. metals for renewable energy solutions	The biggest secular theme of our generation Growing demand and government support Renewable energy Electric vehicles Solution providers
LVMH Microsoft Mercedes Benz Remy Cointreau Booking	Akamai Cyberark Software Palo Alto	Deutsche Telekom KPN Bharti Airtel	Siemens Cellnex Rohm DMG Mori	MP Materials Nippon Steel Wilmar	Ford Prysmian Schneider Enphase Veolia

Source: LOIM. For illustrative purposes only.

IMPORTANT INFORMATION

RISK AND REWARD PROFILE

SRRI score: 6 (1 : Lower risk - potentially lower rewards; 7 : Higher risk-potentially higher rewards).

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