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In conversation with

Volatility and dispersion: towards a renewal of flexible strategies?

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What impact has monetary tightening had on allocations?

2008 – 2022: EQUITIES AT THE HEART OF ALLOCATION CHOICES

Not long ago, stock markets seemed impervious to bad news. They were immune to the accommodative monetary policies of the major central banks, which, among other factors, led to lower, or even negative interest rates. **Faced with unattractive bond yields, investors were compelled to seek out alternatives, particularly equities**. Following this trend was enough in and of itself to generate financial performance, **leading equity funds to be at the forefront of fundraising dynamics**[1].

2022 – 2024: BOND MARKETS REGAIN THEIR APPEAL

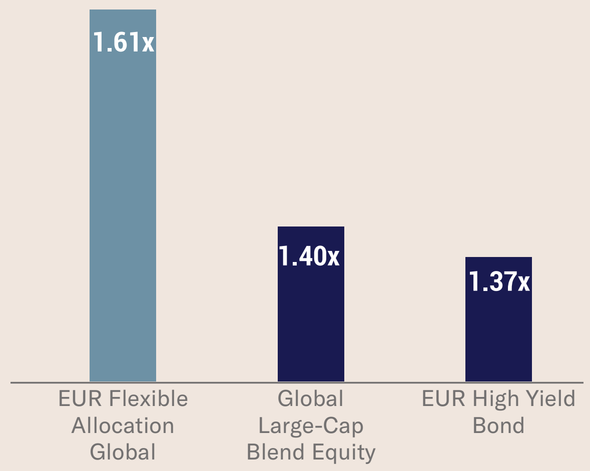
In 2022, central bankers had no choice but to abruptly raise key interest rates, putting an end to a decade of low rates. This opened up an unprecedented chapter in the financial markets, marking a return to favour for the bond market. **This trend called into question the predominance of equities in asset allocations in favour of yield products, especially money market funds**[2]

2024 AND BEYOND: THE GROWING INFLUENCE OF FLEXIBLE STRATEGIES

The gradual central bank pivot is likely to lead to a decline in yields of monetary products as well as certain credit strategies, making them less attractive.

Moreover, in the face of chronic economic and political uncertainty, volatility seems to be returning, and, at such times, flexible strategies tend to prove resilient. Indeed, the graph below shows that **over the last 10 years, flexible funds** (Morningstar category EU Flexible Allocation – Global) **have posted the best risk-adjusted performance, ahead of equity funds** (Morningstar category “Global Large-Cap Blend Equity”) **and High Yield credit funds** (“EUR High Yield Bond”)[3].

PERFORMANCE / MAX DRAWDOWN (RATIO CALMAR)



Source: Morningstar, data from 31/12/2013 to 30/12/2023

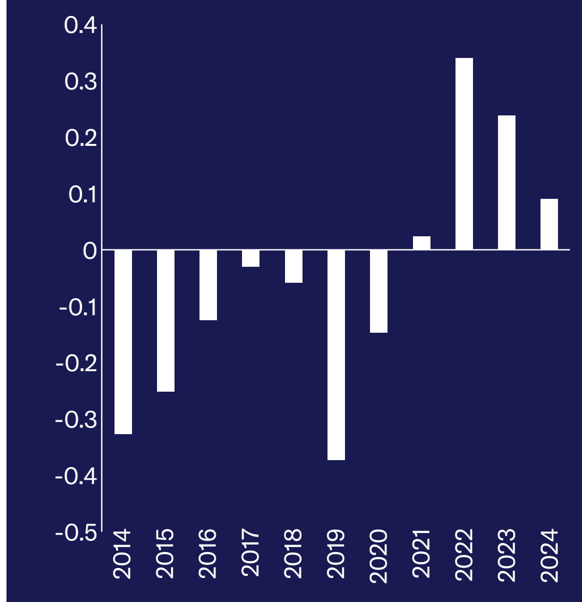
[1] Source: Morningstar, data at 30/08/2024.
[2] Source: Morningstar, data at 30/08/2024.
[3] Source: Morningstar, data at 29/12/2023. The first decile in terms of performance was taken into account. Risk-adjusted performance is the ratio of average performance divided by the max drawdown average for each category.

Is the "traditional" 60/40 allocation model still valid?

Nonetheless, current market conditions require a more agile, flexible fund structure, going beyond the traditional 60/40 allocation model which now proves to be unsuitable. Indeed, this conventional model was designed during a period when government bonds and equities displayed a negative correlation that prevailed until 2022, as shown in the graph on the right[4].

Over the past three years, the shift to a positive correlation between government bonds and stocks marks a turning point. Counterintuitively, sovereign bonds, previously considered a "safe haven" asset, experienced the biggest declines in performance in 2022. For example, the performance of Eurozone government bonds declined by 18.22% in 2022 while European equities lost 9.88% over the same period[5].

The post-pandemic economic environment, marked by increasing deglobalization, rising geopolitical tensions, and governments having to adopt aggressive fiscal policies to create resilience, is expected to shape the next decade.



CORRELATION BETWEEN MSCI WORLD AND ICE GLOBAL GOVIES®

Source: Tikehau IM, data at 24/09/2024.

> Current market conditions require a more agile, flexible fund structure, going beyond the traditional 60/40 allocation model which is now proving to be unsuitable.

In this context, which should be viewed as structurally inflationary, uncertainty surrounding developments in monetary policies is likely to persist and could continue to fuel strong volatility in rates, similar to that observed over the past three years. **Viewed through this lens, the correlation between interest rates and stocks remains totally unpredictable and is insufficiently robust to be used to found allocation decisions: the static 60/40 model thus has its limits.**

To adapt to this new environment, it is now crucial to adopt a more dynamic allocation strategy based on active management.

[4] Source: Bloomberg, MSCI World Index vs. ICE Global Govies® Index, data from 31/12/2013 to 24/09/2024.
[5] Source: Bloomberg, ICE BofA Euro Government Index® performance, 31/12/2021 - 31/12/2022, Stoxx Europe 600 Index for European equities, 31/12/2021 - 31/12/2022.

How can the current market environment be a source of opportunity for managers of flexible funds?

Risk assets have continued to climb upwards, pushing valuations higher. However, in a market characterized by increasing dislocation, segments of opportunity persist within both credit and equities: selectivity will be essential here no matter the asset class.

Do opportunities still exist despite high valuations?

We are cautious overall regarding equities because, given relatively high valuations and perhaps still overly optimistic earnings growth prospects, the risk of an economic slowdown does not seem to be fully priced in.

However, opportunities exist in highly dislocated equities markets, namely in:

Growth stocks exposed to strong megatrends:
- The tech sector
- Europe and the rise of the concepts of sovereignty, autonomy and resilience

Defensive stocks that typically demonstrate resilience in times of market stress.

> Segments of opportunity persist within both credit and equities: selectivity will be essential here no matter the asset class

How to invest in the tech sector?

The tech sector has seen a spectacular rise in recent months, driven largely by the euphoria surrounding artificial intelligence and investors' belief that it will usher in a new era of strong growth. This enthusiasm has led to high valuations, with the MSCI World Information Technology Index trading at 35.3x earnings[6], compared to a price-to-earnings ratio of 21x for the MSCI World Index.[7]

However, this segment represents a major opportunity for expansion according to our analysis, with many companies posting double-digit growth rates,[8] **especially in online advertising and the cloud**, In this sense, the growth bastion of technology remains inevitable, and exposure to it seems essential to us.

At the same time, some companies in this segment continue to display what we consider to be reasonable valuation levels. For example, Alphabet[9] (digital advertising), is trading at 20.6x[10] its earnings, a relatively low level on a historical basis, penalized by regulatory uncertainties.

What about Artificial Intelligence?

Regarding Artificial Intelligence, the certainty of the sector's prospects remains unclear in the face of very optimistic market expectations. **We therefore favour indirect exposure** in order to alleviate any potential deception that might arise in this respect.

Through our investments in the cloud and online advertising, we remain exposed to major US players that generate significant cash flows and are able to invest heavily in AI. These colossal investments are of two-fold interest in our opinion.

Firstly, if a revolutionary application capable of radically transforming our daily lives is developed, it will probably come from one of these major players, making an investment in this player an unprecedented opportunity. Secondly, these efforts allow them to improve their current offering (for example, offering a better online search tool), while maintaining a business model that remains relatively independent of the success of this technology. Microsoft and Amazon.

A second strategy is to turn to companies for which artificial intelligence represents an additional, but not indispensable, source of growth. We can, for example, cite Accenture[11], a company specializing in supporting companies in digital transformation.

> **Regarding artificial intelligence, the certainty of the sector's prospects remains unclear, in the face of very optimistic market expectations. We therefore favour indirect exposure in order to alleviate any potential disappointment that might arise in this respect.**

[6] Source: Bloomberg, data at 10/10/2024.
[7] Source: Bloomberg, data at 10/10/2024.
[8] Source: Publications of the results of the companies we have allocated fund resources to, data at 30/06/2024.
[9] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.
[10] Source: Bloomberg, data at 10/10/2024.
[11] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.

What is your view on European equities and how are you positioned?

The very negative investor sentiment, the obvious under-positioning and the historically significant discount compared to the United States are all signals of a favourable entry point to investing in European stocks.

At the same time, **the notion of European sovereignty is giving rise to new investment opportunities on the old continent**. To this end, the European Commission and Member States have launched various initiatives aimed at investing colossal sums in certain sectors identified as strategic: defence, energy transition and even semiconductors, for example. Supporting European companies that could benefit from these investments, such as ASML[12] or Rheinmetall[13], would, in our opinion, generate performance in the long term.

> **The notion of European sovereignty is giving rise to new investment opportunities on the old continent.**

Are there any other segments that you consider interesting, particularly in a context of persistent uncertainty?

The defensive stocks segment focuses on companies judged to be of high quality and characterized, among other things, by their ability to navigate through different economic cycles. In addition, these companies display valuation levels considered reasonable, very much like the consumer staples sector as a whole, where the MSCI Staples index is trading at a price of 19.7x its earnings[14]. Within this segment we can mention Coca-Cola[15], which reported organic growth that we consider solid in 2024, as well as Unilever[16], a global leader with a portfolio of renowned brands.

In addition, the healthcare sector is experiencing positive dynamics, driven by technological advances, an ageing population and broader access to care in emerging countries, while proving less vulnerable overall to economic slowdown. The animal health industry has also seen attractive growth that we believe will continue over the coming decade.

Finally, listed real estate companies in Europe also present opportunities according to our analysis. On one hand, the sector is rebounding on the prospects of rate cuts after several quarters of notable underperformance. At the same time, the second quarter results generally confirmed strength in the generation of cash flows[17] driven in particular by like-for-like growth in rents (effect of automatic indexation of rents to inflation in many countries). Also noteworthy is the emergence of a firm consensus among many industry leaders announcing the end of the decline in asset values after four consecutive semesters in the red[18]. Finally, the sector continues to display valuations deemed attractive[19] as potential funding/refinancing concerns dissipate, and growth appears to be back on the radar.

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[13] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.
[14] Source: Bloomberg, data at 10/10/2024.
[15] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.
[16] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.
[17] Source: Publications of company results, data at 30/06/2024.
[18] Source: Publications of company results, data at 30/06/2024.
[19] Source: Bloomberg, data at 10/10/2024.

And on credit, how are you positioned?

Credit is now a yield product and no longer a spread product.

Bonds have once again become a key asset for investors. For the first time in more than ten years (excluding Covid), investors have had the opportunity to lock in a yield deemed attractive, whether on Investment Grade or High Yield.

In credit markets, building a portfolio exposed to quality issuers, with leverage levels deemed reasonable and with yields of 4% to 7%[20] is now a core strategy. There is no need to venture into overly complex options subject to refinancing issues to find profitability, since now even quality names offer an attractive yield. This base can be supplemented by other satellite strategies, making it possible to optimize the embedded yields of portfolios while taking advantage of significant market dislocations. Among these, we can mention:

> **Credit is now a yield product and no longer a spread product.**

THE SELECTION OF LOWER-RATED SECURITIES, IN PARTICULAR CCC.

The recent outperformance of the BB segment[21] has made this segment less attractive (BB risk premium ratios are close to their lowest points compared to high yield). **Therefore, moving away from the BB universe by selecting issuers considered to be of high quality but with lower ratings, notably CCC, can generate a higherreturn.** With a yield close to 18%[22] despite default rates of only around 3%[23], this cohort offers an interesting pool of opportunity for rigorous and selective investors.

For example, we can mention a CCC+ bond issued by Biogroup[24], a grouping of medical biology laboratories. The company, rated B-, issued an unsecured instrument, rated CCC+, with a yield of 9.1%, or approximately 3% more than the secured bond[25].

SUBORDINATED FINANCIALS.

The results of the last quarter demonstrate once again the solidity of the European banking sector fundamentals. **Within financial bonds, we favour in particular AT1 subordinated financials which offer a yield considered attractive in absolute and relative terms compared to corporate bonds with the same rating** (with a difference in average spreads estimated at 140 bps between AT1 and corporate bonds of the same rating[26]).

Within banking, we mainly target top-tier European banks that are well capitalised and have healthy solvency levels. **We also remain exposed to peripheral banks, such as Spanish and Portuguese banks, which have made considerable efforts to clean up their balance sheets in recent years.**

How to deal with volatility spikes?

Although the period of turbulence observed in early August 2024 was short-lived, uncertainties persist and could lead to new peaks of volatility in markets. For expert managers capable of implementing derivative strategies, this constitutes an additional potential performance lever, previously sidelined over the last decade of low rates and low volatility.

Like equity and credit investments, derivative strategies must demonstrate agility to protect portfolios and capitalize on gains not only during market decline (or periods of increased volatility), but also when opportunities arise during rebounds (or periods of reduced volatility).

[20] Source: Bloomberg, data at 10/10/2024.
[21] Source: Bloomberg, data at 10/10/2024.
[22] Source: Bloomberg, data at 10/10/2024.
[23] Source: Moody's, Goldman Sachs Global Investment Research, data at 30/06/2024

Conclusion

Today's market environment is more favourable than ever for flexible "2.0" funds. On one hand, the gradual central bank pivot could make certain bond strategies less attractive, notably money market funds. On the other, the return of the positive correlation between rates and stocks puts an end to traditional 60/40 allocation structures, leaving room for flexible funds that are agile and dynamic. Moreover, in a market context where valuations are high, opportunities are becoming increasingly rare. However, the significant market dislocation constitutes an unprecedented occasion for flexible strategies, capable of seizing opportunities in both credit and equity markets. Finally, the potential return of volatility also offers an additional performance lever for flexible fund managers, capable of implementing effective derivative strategies.

In short, **we are currently witnessing the strong resurgence of flexible strategies, which are proving essential to navigating the new paradigm**.

[24] The companies mentioned are used for illustration purposes only and do not constitute an investment recommendation or investment advice.
[25] Source: Bloomberg, TIM, data at 30/09/2024.
[26] Source: Bloomberg, data at 10/10/2024.

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