BNP PARIBAS WEALTH MANAGEMENT

2021 Investment Themes

Half-Year Update

June 2021

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world

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Achieve real returns without 100% equity risk

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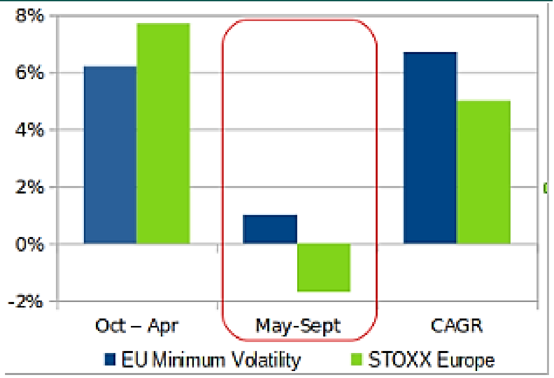
Real returns without 100% equity risk

MEDIUM-TERM, MEDIUM RISK

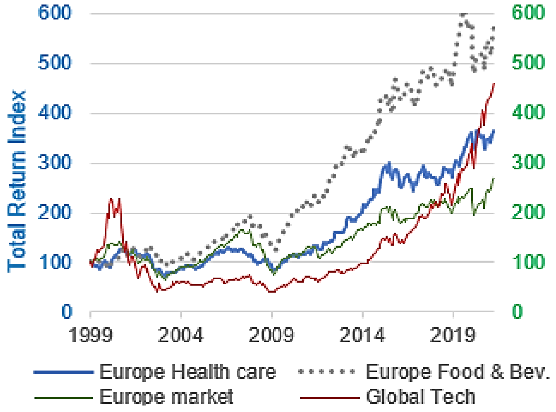
- We believe the medium-term equity market outlook remains positive, so we do not advise investors to sell their stock market exposure despite accumulating outsized gains since early 2020.
- However, over the summer months, some rotation of equity exposure out of riskier cyclical sectors and stocks into more defensive factors and sectors, such as Low Volatility and Health Care, has historically achieved superior results. Low volatility and quality income dividend strategies are an attractive option for income-oriented investors who are seeking positive real returns, not available in cash, sovereign bonds or IG credit.

Low volatility factor wins over the summer



Note: Average returns over 1997-2020
Source: BNP Paribas, Bloomberg

Health Care, Food & Bev., Global Tech have all beaten the European benchmark over time



Source: Bloomberg

Nervous investors seek to dial down their equity risk

"Sell in May and Go Away" (until the end of September). This year there are a host of reasons for even calm and rational investors to heed to this old stock market adage:

Strong stock market returns: the global stock market has risen 84% in USD terms since the March 2020 market low, and 27% since the beginning of November. Stock market valuations are on the high side, particularly in the US (end-2022 P/E of 22.3x for the S&P 500 index). We know that high valuations today generally lead to lower future long-term returns.

Negative seasonality: equity returns have historically been far worse over the summer (May-September inclusive) than over October-April, suggesting that investors should take a more defensive approach at this point in time.

There are some strategies that still deliver positive returns on average over the summer months. These are **Low Volatility and Defensive equity strategies in Europe**. Low and minimum volatility factors have generated small, albeit positive, returns (1.0%) on average over the May-September period, at a time when the benchmark STOXX Europe index has typically declined by 1.7%. Looking at defensive stocks (companies that are not economically sensitive in general, including Health Care, Utilities and Food & Beverages), we see a similar pattern emerging. Since 2005, European defensive stocks have gained 2.4% over the summer, while cyclical stocks have delivered only a flat return on average over the same period.

Low volatility, quality dividend strategies make a come-back: low volatility and quality dividend strategies are starting to perform well once again, after a long period of underperformance for equity dividend strategies in general. Dividends are at last making a comeback in Europe, with banks now able to pay 2021 dividends (after generally being banned by financial regulators from paying dividends in 2020). While there is still very little yield on offer from cash, sovereign or even Investment Grade corporate bonds, the Euro STOXX Select Dividend 30 index offers a 5%+ dividend yield on end-2021 estimates.

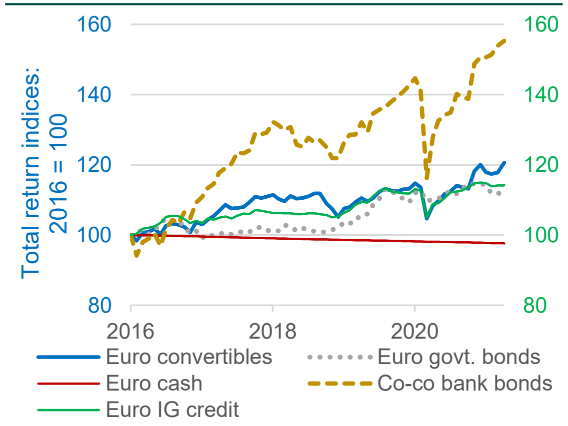
We prefer not to have an exposure to a pure high dividend index like the Select 30, but rather to a dividend growth or quality dividend strategy that may have a slightly lower (but still appealing) dividend yield, combined with a reasonable payout ratio, strong profitability and future dividend growth potential. This gives a far better chance both of maintaining and/or growing the dividend over time, and also generally gives a better total return to the patient investor.

Note too that academic research has highlighted the risk-adjusted outperformance over time of a low-volatility, high dividend equity portfolio strategy, which correlates well with the quality and dividend growth approaches to equity income investing. In Europe, since 2016 Low Volatility and Quality Dividend stock indices have returned between 6% and 13% on average annually, at a lower level of risk than for the STOXX Europe benchmark index.

Hybrid income, real return solutions

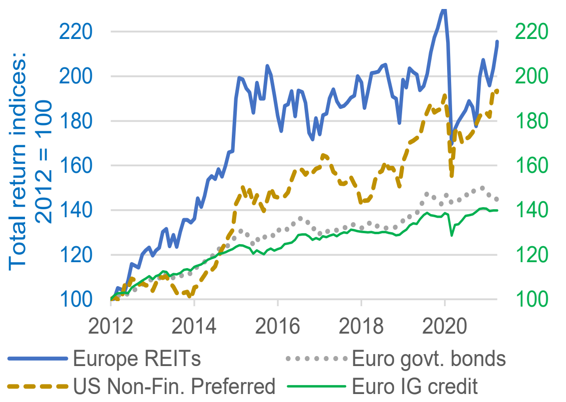
- Hybrid asset classes sit in between risky stocks and ultra-low yield bonds, with a potential positive real return on offer but at lower-than-stock market risk.
- We favour hybrid asset exposure for income and real returns: convertible bonds, contingent convertible (co-co) bonds, and preferred shares.
- Listed and private real estate funds continue to offer attractive valuations, solid yields and the potential for both capital and rental growth over time. The reopening of European economies should be a catalyst to spur recovery in office and retail sectors.
- Lower-volatility forms of investment in equities can also be achieved via structured products and alternative UCITS funds.

Co-Co bonds, convertibles beat bonds, credit



Source: BNP Paribas, Bloomberg

Real Estate, Preferreds outperform bonds + credit



Source: Bloomberg

Seeking less risky solutions than equities, but yielding more than bonds

Looking for positive after-inflation returns, but not from stocks? Without accepting the negative after-inflation returns from government bonds or cash, there are several hybrid asset classes which have historically been less risky than stocks, but have beaten bonds and credit returns. **Convertible bonds**: these are hybrid fixed-income corporate bonds that yield interest payments, but can also be converted into a predetermined number of equity shares. The conversion from the bond to stock can be done at certain times during the bond's life and is usually at the discretion of the bondholder. Since 2016, Euro convertibles have returned 3.6% on average per year, beating Euro Investment Grade credit and government bonds by over 1%. **Contingent convertible (AT1) bonds**: these are corporate bonds issued by European banks. They offer a higher yield than traditional bonds given the higher risk involved. Also known as “CoCo bonds”, they are perpetual bonds with callable dates and bear a risk of loss absorption. They are converted into shares (at current price i.e. depreciated) once the issuer's equity ratio falls below a predefined level. The issuer can cancel the interest payment. **Preferred shares**: these are shares of a company’s stock with dividends that are paid before common stock dividends are issued, and rank above common shares in the event of insolvency. Most preferred (or “preference”) shares have a fixed dividend, and have returned on average 7+% since 2021.

Real Estate Investment Trusts (REITs) and funds: Listed European real estate companies (REITs) performed strongly up until February last year, and are now staging a strong recovery in values as European economies move towards reopening post-pandemic, led by shopping centre and warehouse real estate assets.

Structured products typically involve the use of sophisticated instruments (futures, options and credit default swaps) to which individual investors usually have limited access. These instruments serve to optimise returns or limit losses while reducing sensitivity to a rise in interest rates or a fall in underlying shares. We focus on equity-based structured products of two types: a) those offering a partial or full capital guarantee plus exposure to any rise in European stock markets; and b) those combining a long exposure to European or global stock markets together with a long volatility or long put option that can act as a hedge against falling stocks.

Alternative UCITS (hedge) funds: these funds can take both a long and short exposure to asset classes like equities, allowing them to reduce the net exposure of a fund to the stock market and thereby reducing the volatility of a fund’s returns over the long term. We focus on three strategies here: Long/Short equity (8.0% average annual return since 2012), Global Macro (4.6%) and Event-Driven (6.7%), all of which have far outpaced credit and government bond returns (albeit at lower volatility) than for equity markets.

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