Lupus alpha

Themes and Markets Q4/2023

alpha insights

New year, old challenges

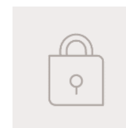
Dr. Götz Albert, CFA
Partner and Chief Investment Officer

Despite all the crises, the difficult stock market year 2023 ended on a positive note. The DAX rose by a good 20% and the S&P 500 by more than 26%. However, it is questionable whether the interest rate cut rally on the stock markets will continue in the new year, as the economic situation remains difficult, economic growth - at least in Europe - is more than meagre and geopolitical uncertainties have not diminished, on the contrary. However, leaving the stock market is of course not an option. Investors should diversify their portfolio with alternative, high-yield investment strategies.

Small & Mid Caps
Back on the growth track **p. 2**

Volatililty strategies
Current yield expectations higher than ever before **p.5**

Convertible Bonds
Increasing momentum on the primary market p. **3**



Value protection strategies
Intelligent combination of security and performance participation **p.6**

CLO
Attractive real returns with manageable risk **p.4**

Risk-Overlay
Sensitivity needed **p.7**

Small & Mid Caps
Back on the growth track

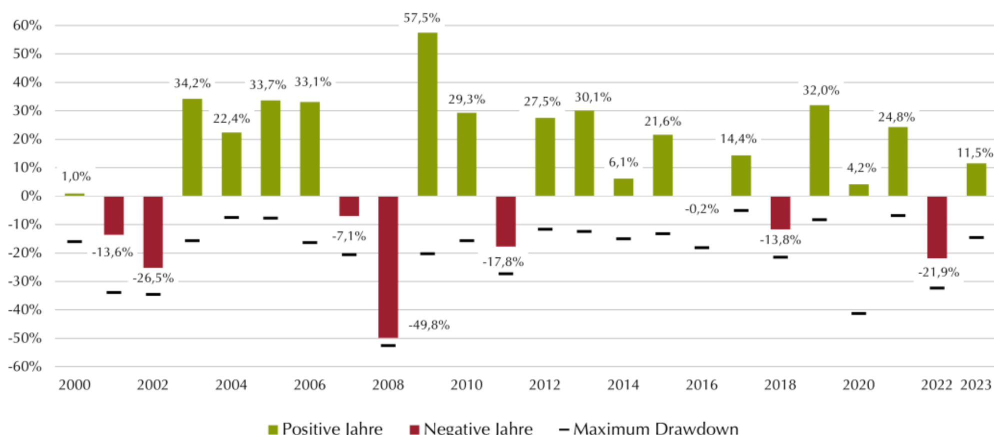
Marcus Ratz
Portfolio Manager, Small & Mid Caps

The European stock market is currently experiencing a remarkable development: After an unusually long period of weakness - with the horror year of 2022 and the first ten months of 2023 - European small & mid caps now appear to be reversing the trend towards a long-term upward trend. Since the low point at the end of October 2023 alone, the prices of European small & mid caps have recovered by a strong 18%.

The current trend makes it clear that equity investors, particularly in the small & mid cap segment, should have staying power despite interim drawdowns. A look at historical share price performance also shows that such periods do not necessarily have to end with negative annual results. While the return on European small & mid caps was still in negative territory last year until the end of October, the segment has now recorded an increase of over 11% for the year as a whole. The chart below underlines that this is not an isolated case in history: year-end values rarely fall to the lowest level of the year as a whole; 2020 was also an impressive example of this. So if you remain prudent, you can avoid selling at the low point - the worst possible scenario for investors.

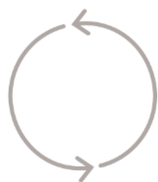
Instead, long-term investors should use the inevitable setbacks on the stock markets as favorable buying opportunities and the chance for future gains. Irrespective of short-term, tactical opportunities, small & mid caps have earned a firm place in the strategic asset allocation of investors, as they can make a significant contribution to the overall performance of the portfolio despite possible volatility. After the past difficult years for small caps, they now appear to be back on their long-term growth path.

Setbacks open up favorable buying opportunities for long-term investors



Source: Bloomberg, own calculations; as at: 29.12.2023

Past performance is no guarantee for future performance.



Convertible Bonds
Increasing momentum in the primary market

Marc-Alexander Knieß
Portfolio Manager, Convertible Bonds

Stefan Schauer
Portfolio Manager, Convertible Bonds

Manuel Zell
Portfolio Manager, Convertible Bonds

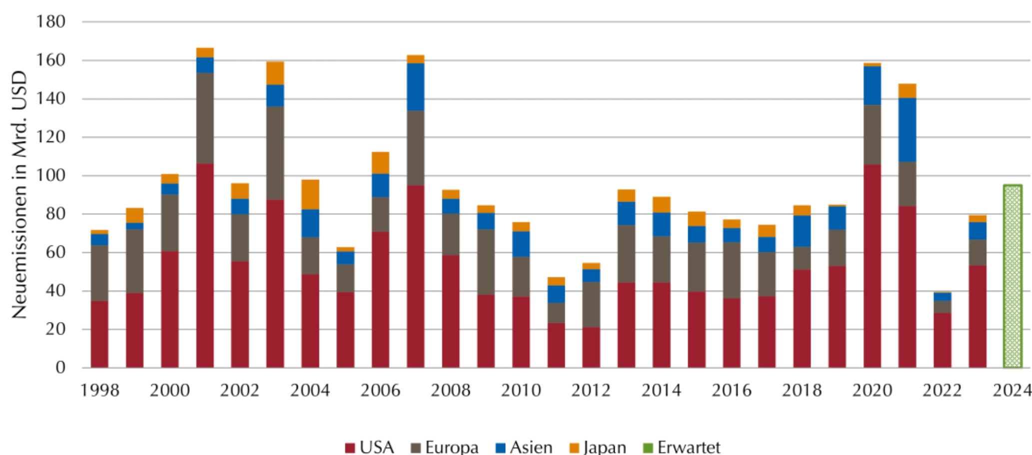
The convertible bond market is currently experiencing a renaissance. The rise in interest rates last year led to increased issuance and thus to a noticeable revival of the market, making this form of investment increasingly attractive again for both issuers and investors.

The increase in primary market activity in the fourth quarter, especially in November, was particularly noticeable and was significantly higher than in the previous year. This development can be partly explained by the so-called "maturity wall" in the convertible bond and high-yield bond segments. Due to the necessary refinancing, expectations for the primary market in 2024 are high and are likely to increase further in the following two years, which indicates continued momentum in this segment (see chart).

This development opens interesting investment opportunities for investors on the convertible bond market. Among the new issues in the fourth quarter of 2023 were securities from well-known companies such as Bechtle, RAG/Evonik, Sibanye Stillwater, Uber, Rivian, Ubisoft and Schneider Electric as well as various Japanese companies such as Sanrio, Sosei and Kobe Steel. It is noteworthy that not only growth and technology companies are entering the market, but also many from the utilities, industrial and cyclical consumer sectors. This expansion of the universe enables broader diversification within the asset class.

Another advantage for investors is the so-called new issue premium, which averages 1% on the first day of issue, but is sometimes significantly higher. In addition, the increased activity in the primary market also promotes liquidity in the secondary market, which is an advantage for both new and existing convertible bonds. Overall, this results in an extremely attractive environment for investors, characterized by greater diversification, attractive new issues and improved liquidity.

Global convertible bonds new issues



Source: BofA Global Research, as at: 29.12.2023
Past performance is no guarantee for future performance.

CLO
Attractive real returns with manageable risks

Dr. Klaus Ripper
Portfolio Manager,
Fixed Income Credit

Norbert Adam
Portfolio Manager,
Fixed Income Credit

Following the end of interest rate hikes, many market participants are expecting the first interest rate cuts in the course of the new year. However, inflation and interest rates remain at a higher plateau than in previous years - a sign that the days of ultra-low interest rates are over for the time being.

Although classic bonds are once again offering positive nominal interest rates, the joy of this is overshadowed by high inflation. With inflation rates averaging 3.2% over the last five years, real yields on government bonds have been a non-starter. Even under the optimistic assumption of an inflation rate of 2.25% over the next five years, the segment remains a long way from generating an adequate real return, let alone making a significant contribution to asset accumulation. In addition, the persistently low coupon level - a relic of the low interest rate policy - makes it difficult to generate predictable income streams.

Investors looking to generate real returns in the bond segment are therefore being forced to turn their attention to higher-risk corporate and high-yield bonds. However, with a recession looming, this is not an appealing option for many, as higher gross yields offer little comfort in such times should defaults occur.

This is where CLOs come into their own, as they offer attractive real returns with manageable risks even in difficult economic times. For a euro investment grade CLO strategy, for example, we forecast an annual return of 6-7% p.a. in the medium term. Three main drivers are strengthening investor confidence in this strategy: firstly, the higher coupons due to higher market interest rates, even for issuers with high credit ratings. Secondly, the higher coupons due to attractive credit spreads in a long-term comparison. Thirdly, the "pull-to-par" effect results in further price potential, as the prices of CLOs and their underlying loans continue to trade below par.

Yield potential in the bond market 5 years

	Erw. Rendite p.a. in %	Kupon in %*	Spread in bps*
Bund 5 Jahre	2,19	1,61	-42
Aaa Pfandbriefe 5 Jahre	3,06	1,14	19
IG EU Corporates (BBB+)	3,74	2,05	88
CLO Neuemission (AAA)	5,71	5,00	175
CLO Strategie (IG)	6,54	6,96	393
HY EU Corporates (BB-)	6,61	4,24	373

Source: Bloomberg, own calculations, *as at: 15.12.2023
Past performance is no guarantee for future performance.

Volatility strategies
Current yield expectations higher than ever before

Mark Ritter, CFA, CAIA
Portfolio Manager,
Derivative Solutions

Alexander Raviol
Head of Derivative Solutions

Volatility strategies closed 2023 with outstanding performance and very low volatility, underlining their positive contribution to a portfolio's overall return.

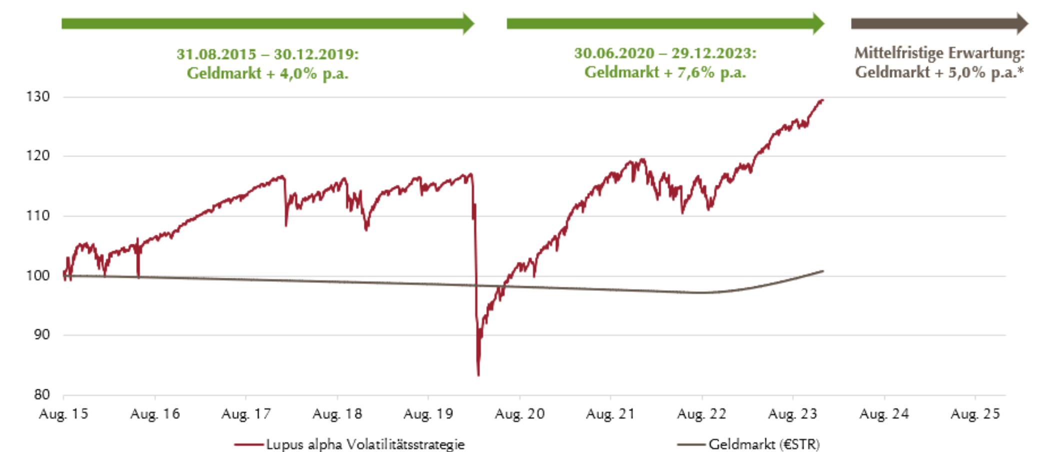
Volatility is one of the most established and stable alternative risk premia that has been observed in the liquid space for more than 30 years. A clear and comprehensible mechanism, which is similar to a classic insurance policy, enables a very attractive risk premium to be collected in absolute and risk-adjusted terms.

Since the sharp drawdown in 2020, volatility strategies have shown an impressive performance (see chart). Even the end of the low-interest phase last year has not affected this positive development, on the contrary. The key to this success lies in the high volatility risk premium ("VRP"), driven by increased demand for hedging. Interestingly, many providers of hedging strategies disappeared from the market after the coronavirus pandemic, opening up additional opportunities for the remaining investors in volatility strategies.

Currently, the medium-term total return expectation for volatility strategies is higher than ever before. But why is that? For one thing, the VRP remains at a high level. Even if it declines from the record levels after the coronavirus crisis, it remains higher than before the pandemic for the structural reasons mentioned above. On the other hand, volatility strategies are implemented using derivatives, based on a core portfolio of short-term bonds with good credit ratings. As interest rates have risen, the expected return from the underlying portfolio has also increased.

This results in an impressive absolute return expectation of 8.0 to 8.5% in total, which is made up of around 3.5% (money market) interest and 5.0% risk premium. These figures show once again why volatility strategies should have a permanent place in every portfolio.

A high risk premium leads to high returns on the volatility strategy



Source: Bloomberg, own calculations, as at: 29.12.2023
Past performance is no guarantee for future performance.

Value protection strategies
Intelligent combination of security and performance participation

Stephan Steiger, CFA, CAIA
Portfolio Manager,
Derivative Solutions

Alexander Raviol
Head of Derivative Solutions

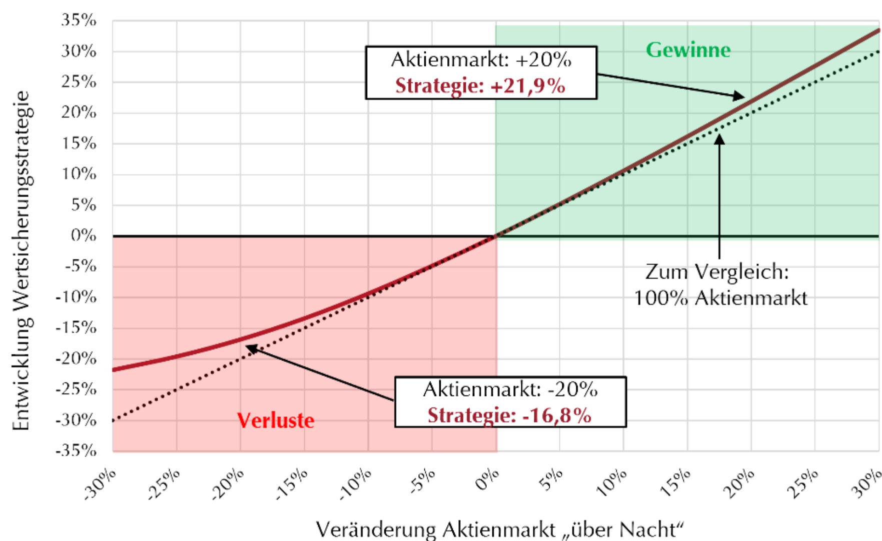
When constructing a portfolio, investors have always been faced with the question of finding the right balance between expected risk and expected return. While many investors - rightly - relied on a high equity allocation in times of zero interest rate policy, this was associated with high losses in the interim due to the crisis. The horror year of 2022 showed that traditional diversification through bonds hardly offers any security, as bonds also suffered heavy price losses.

So are investors with return expectations above the inflation rate at the mercy of fluctuations on the equity and bond markets? Do they have to believe in the promise of so-called "crash prophets" to avoid high drawdowns, who have been able to cushion losses in the past but have not been able to generate any significant returns in normal market phases? No. Intelligent, option-based capital preservation strategies can preserve participation opportunities and limit drawdowns at the same time.

The risk/reward ratio of capital preservation concepts can be adapted to the investor's individual risk appetite. Depending on the structure of the equity market delta, both conservative profiles (with a low fall and moderate participation in returns) and more offensive variants (with a moderate risk of loss and higher participation) can be presented. The chart below shows an example of the performance of the stock market and an option-based capital preservation strategy under the assumption of an overnight shock.

Specifically, the use of options makes it possible to manage potential losses ex ante without having to risk a so-called "cash lock". In the worst-case scenario, purchased call options expire worthless. At the same time, the use of options across different maturities and strike prices offers the opportunity to participate in price gains on the global equity markets, which was most recently impressively achieved in the 2023 year-end rally.

Simulation: Overnight shock on the stock market



Source: Bloomberg, own calculations, as at: 29.12.2023

Past performance is no guarantee for future performance.

Risk Overlay
Sensitivity required

Marvin Labod
Head of Quantitative Analysis

Alexander Raviol
Head of Derivative Solutions

In contrast to the hectic year of 2022, overlay managers had less to do overall in 2023. Nevertheless, the past year has also shown that it is wise to think outside the box and view the portfolio, including all sub-segments, as one big puzzle whose pieces fit together.

But how do you identify the risks in the portfolio that are suitable for an overlay? The first step is a detailed analysis of the asset allocation. This is done using benchmarks provided by the investor. Interestingly, it is not necessary to transmit individual positions. Instead, the portfolio is analyzed according to various criteria: The focus is on asset classes, countries, regions, and sectors. It is like a geographical grid that is placed over the investment spectrum in order to uncover hidden risks.

Once this analysis has been completed, the proportion of the portfolio that can be hedged is determined. This is done by identifying the underlying risk and the relevant risk drivers. Appropriate hedging positions are then built up for the areas of the portfolio that can be hedged. The trick is to choose the right hedging mechanisms and determine their intensity appropriately - almost like balancing a sailing boat in stormy seas.

But what happens to the risk classes that cannot be hedged? These risks are either considered in reporting or a portion of the risk budget is reserved for them. If possible, so-called "proxy hedges" are used. In any case, it is important to always keep an eye on all risks.

Overall, 2023 proves that a clever, holistic approach and careful handling of risks are crucial in overlay management. It is a complex game with many variables that requires a sure instinct, good craftsmanship and foresight.

Identification and analysis of risk drivers in the master fund

Analyse des Kundenportfolios **über alle Teilfonds** zur Identifikation der Risikotreiber ermöglicht **effiziente und transparente Risikosteuerung auf aggregierter Ebene**

Source: Lupus alpha, schematic illustration

This fund information is provided for general information purposes only. This information is not designed to replace the investor's own market research, financial analysis, nor any other legal, tax or financial information or advice. The information presented does not constitute in any manner a solicitation activity, an invitation to buy or sell, nor an ancillary investment service such as investment research or financial analysis within the meaning of Section B(5) of Annex II, nor does it qualify as investment advice within the meaning of Section A(5) of Annex I of MiFID II (as it does not amount to an objective and independent explanation of a recommendation within the meaning of article 36,1.a) of the Delegated Regulation (EU) 2017/565 of 25 April 2016) and should not be treated by recipients as such. It does not contain any key information enabling to make important economic decisions and may differ from information and estimates provided by other sources or market participants. We accept no liability for the accuracy, completeness or topicality of this information. All statements are based on our assessment of the present legal and tax situation. All opinions reflect the current views of the portfolio manager and can be changed without prior notice. Full details of our funds and their licenses of distribution can be found in the relevant current sales prospectus and, where appropriate, Key Information Document, supplemented by the latest audited annual report and/or half-year report. The relevant sales prospectus and Key Information Documents prepared in German are the sole legally-binding basis for the purchase of funds managed by Lupus alpha Investment GmbH. You can obtain these documents free of charge from Lupus alpha Investment GmbH, P.O. Box 1112 62, 60047 Frankfurt am Main, Germany, upon request by calling +49 69 365058-7000, by e-mailing info@lupusalpha.de or via our website www.lupusalpha.de. If funds are licensed for distribution in Austria the respective sales prospectus, Key Information Document and the latest audited annual report or half-year report are available from the Austrian paying and information agent UniCredit Bank Austria AG based in Rothschildplatz 1, 1020 Vienna, Austria. Fund units can be obtained from banks, savings banks and independent financial advisors.

This document is directed at professional investors only. Therefore, neither this document nor the information made available thereon shall be construed as a distribution in or from France to any person other than professional.

Neither this fund information nor its contents or a copy thereof may be amended, reproduced or transmitted to third parties in any way without the prior written consent of Lupus alpha Investment GmbH. By accepting this document, you declare your consent to comply with the aforementioned provisions. Subject to change without notice.

Lupus alpha Investment GmbH

Speicherstraße 49–51

D-60327 Frankfurt am Main