

Commentary from the Investment Management Team at Boussard & Gavaudan

Diverging Markets and Sector Rotation: A Case for Structural Convexity

February was characterised by a distinct divergence between European and US equity markets, alongside complex underlying sector rotations.

- The EuroStoxx 50[®] Total Return advanced by +3.31%, while the S&P 500[®] Total Return declined by -0.76%.
- European implied volatility (VStoxx[®]) settled lower at 19.7%.
- Credit risk premiums expanded, with the iTraxx Crossover[®] (S43) widening to 233bps.

We remain market-neutral with a structurally long-convexity profile, enabling us to capture dislocations in the volatility market while maintaining controlled and limited net delta exposure.

Convertible Bond Arbitrage

US 5-year Treasury yields fell from 3.78% to 3.50%, while HY CDX spreads widened from 296bps to 332bps. In aggregate, these moves largely offset any valuation changes, but beneath this calm surface, sector rotation was fierce with year-to-date performance spread between tech hardware and software reaching close to 50%.

As underlying software equities sold off, implied volatilities and conversion premiums surged. We capitalised on this by strategically exiting nearly all our software convertible bonds, which had transitioned to lower-delta, higher-credit-risk profiles. We recycled this capital into industrial, healthcare, and utility CBs, maintaining our US exposure while upgrading our opportunity set ahead of an anticipated surge in March primary issuance.

Europe is still characterised by a low level of primary activity. European secondary markets appear expensive, with the market overestimating implied volatility and M&A probability in names like Qiagen,

On the M&A front, our successful position in Alphawave has now settled enabling us to monetise the implied put on Qualcomm. By strategically electing to take cash instead of Qualcomm shares, which dropped significantly during the month, we effectively captured the gamma by buying back our short shares.

Looking to the months ahead, we have positioned the portfolio to benefit from potential volatility on certain names, such as Lufthansa. We established a delta-neutral position in their convertible bonds while hedging the credit risk through CDS. With the outbreak of conflict in the Middle East, the implications for airlines are considerable, and our long convexity positioning allows us to efficiently capture the elevated volatility while maintaining strictly defined downside risk.

In contrast to Europe, the Asian primary market, especially in Hong Kong and Japan, continues to provide a strong pipeline of new issuances. A standout example was Nippon Steel that issued the equivalent of \$3.5bn designed to replace a bridge loan used to finance the acquisition of US Steel.

As a widely anticipated transaction, it priced reasonably and offered an attractive implied volatility profile. We participated in this deal, tactically hedging the credit risk component with CDS.

Our broader Asian portfolio is well-positioned to benefit from current geopolitical volatility, anchored by fully hedged, high-delta convertibles and conservative, investment-grade credit profiles.

Volatility Trading

The market environment remained somewhat unusual. Equity indices, particularly the S&P 500, traded within an exceptionally tight range, compressing index realised volatility. Despite this subdued realised backdrop, implied volatility remained relatively well supported.

Two main factors appear to have sustained this bid for optionality. Firstly, persistent geopolitical uncertainty kept investors cautious. Secondly, the AI narrative increasingly dominated market discussions during the month, with growing debate around the disruptive potential of artificial intelligence in the traditional software industry.

This configuration of low index realised volatility combined with sustained demand for single-stock optionality proved supportive for our defensive dispersion strategies. Our approach is intentionally designed to provide long-tail protection through our weighting framework, which involves paying some theta and provides resilience in more stressed environments.

At the same time, significant idiosyncratic dispersion across equities generated by the earnings season supported the strategy's performance.

Although the implied volatility spread between single stocks and indices already appeared relatively rich in absolute terms, reflecting historically low implied correlations, the strategy continued to generate positive carry as well as favourable mark-to-market dynamics.

Overall, we maintain a disciplined and cautious stance as current market conditions continue to create a somewhat fragile volatility regime.

Equity Strategies

Our equity portfolio benefited significantly from strategic M&A positioning and disciplined sector avoidance. Standout contributors included Beazley PLC, which received a firm acquisition offer from Zurich Insurance in early March, and InPost, following a consortium takeover bid led by FedEx and Advent.

Crucially, we recognised the risks of AI-related disruption early and maintained zero exposure to the software sector. This strategic foresight shielded the portfolio from steep sector rotation losses. Instead, our structural long convexity profile allowed us to actively profit from heightened market movements, a stance that continues to bear fruit following the recent outbreak of conflict in the Middle East.

Trading Strategies

In our Macro trading strategy we effectively managed the late-January gold drawdown by actively adjusting our exposure during the volatility spike. We subsequently rebuilt the position at the start of the month, taking advantage of better entry levels. As gold performed strongly throughout February, we reduced the position again towards month-end, as we believe the metal may need time to reach new highs following the recent volatility shock. More broadly, the macro trading book generated gains across asset classes. Notably, we initiated a relative rates position of long UK government bonds versus short Eurozone bonds, based on our view that UK yields are

excessively high relative to domestic economic fundamentals. At the same time, we prefer to avoid outright directional exposure in rates, given the backdrop of rising oil prices and still-robust global activity.

The Equity long-short thematic trading strategy thrived by rotating into positions in “old economy” sectors such as Defence, Utilities, and Oil which outperformed during the software sell-off. The Systematic Trend Following strategy capitalised on continuing trends from January. While falling interest rates challenged our short futures positions, we captured gains from the upward trajectory of European equities, precious metals, and energy contracts. Positive momentum in our long Brazilian real and short New Zealand dollar positions, alongside strong performance in market-neutral utilities and mining, rounded out a disciplined and diversified month.

Outlook

Looking ahead, we expect the current fragile volatility regime and geopolitical uncertainty to continue driving significant equity dispersion and sector rotation. An expected resurgence in primary convertible bond issuance this spring should provide attractive new opportunities for capital deployment. By maintaining a disciplined, market-neutral stance with a structurally long-convexity profile, we remain optimally positioned to protect capital against sudden shocks and actively capture pricing dislocations as the market navigates shifting macroeconomic realities.

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