Convertibles

A good option to have
Summary

Looking back on the dynamic market environment over the past ten years, one asset class which has successfully managed to keep a pace is convertible bonds. The aim of this paper is to:

- Give an update of our views on convertibles
- Provide a refresher of the fundamental characteristics of a convertible
- Equip clients and consultants with an understanding of how convertible bonds have reacted to changes in the market over the past ten years
Convertibles — a good option to have

Our outlook

The low duration of convertibles stands them in good stead relative to other bond asset classes given our view that bond yields have further to rise, however high demand over recent years has driven up convertible bond prices so that they no longer appear cheap. Equity sensitivity is at an historic high, and therefore convertibles offer less protection now against equity market falls than they have in past.

Implementation

From a strategic point of view, there is no compelling case for convertibles to be singled out as a separate asset class, however we do believe that an allocation to convertibles could play a role in diversifying a credit portfolio given that the alternatives (e.g. high yield and leveraged loans) have seen their attractions diminish. We believe that the best way to access convertibles in this market environment is to ensure that they are part of the opportunity set of equity, bond and diversified growth managers since periodically, certain convertibles will offer attractions. To ensure that the guidelines of your current growth mandate are broad enough to take advantage of opportunistic developments in the convertibles market, please get in touch with the manager research team.

What are convertibles?

Convertible Bonds are an example of a ‘hybrid’ security as they offer both downside protection from their bond component whilst participating in equity upside when stocks rally. The convertible bond investor holds a bond with the option to purchase the underlying stock at a predetermined price. The investor also receives a coupon on the bond which is lower than that for a straight bond because the convertible bond holder has the advantage of being able to convert the bond into equity at their own discretion.

How have convertibles performed?

Over the past ten years, convertible bond returns have been strong in risk adjusted terms versus equities but less compelling compared to high yield bonds. When analysing performance over this period we can see that convertibles have typically captured a significant amount of upside in equity market rallies and had less participation in equity market drawdowns. This rings true with what we would expect to see given the hybrid nature of the security. Given that the average credit rating of the convertible bond universe is BB, it is also appropriate to compare convertibles to high yield bonds which have produced better risk-adjusted returns compared to convertibles over the long term. However, given high yield bonds have benefitted from significant falls in global bond yields, which we anticipate to reverse, we would not expect high yield bonds to continue to perform as strongly going forwards.

Cumulative performance to July 2014

Going forward, we expect high single digit equity returns over a ten year period, with potentially disappointing returns on a risk-reward basis over the medium term. This type of uncertain market environment is exactly why convertibles are a useful option for managers to have discretion to over the long term; in a market where we expect both positive and negative returns, convertibles should be capable of benefitting more from a rising equity market than they will suffer from a falling one.
Convertibles

Performance of convertibles relative to interest rate movements

What has changed in the bond market?
The US Federal reserve have tried to stimulate the economy by buying a great deal of government bonds. This in turn has driven down the return that investors were previously able to get on fixed income securities. Now that the rate at which the US Fed are purchasing bonds has slowed down, the market is generally anticipating that bond yields will finally start to rise, reducing the value of fixed income assets.

Why does this matter?
This scenario has led to a growing concern amongst long term investors that they will need to address the risk of their bonds losing value. Our house view is that short-term rates are anchored at current levels for a while to come, however we do expect a continued gradual uptrend in yields.

Can convertibles provide any help with this?
There are two characteristics associated with convertibles, which could offer downside protection to fixed income investors facing rising yields:

- Convertibles tend to have shorter dated maturities compared to their corporate counterparts, so will have less exposure to movements in interest rates

- In a rising interest rate environment, equities tend to increase in value meaning that the equity call option embedded in the bond will also rise, acting as a hedge against rising rates. Given strong recent performance, we cannot expect equities to continue delivering such high levels of returns going forward, but as long as equities hold up, our view is that rising rates should not be detrimental to convertible performance

Has this happened before?
The chart to the left shows that whilst yields have been trending downwards in recent years, during intermediate periods of rising yields, convertible bonds have performed well. One reason for this is due to strong equity returns on the back of an improving economy. Again, the dynamic nature of how convertibles interact with the market, highlights the benefit of having a manager who can access convertibles at their discretion throughout volatile markets.

Risks
As with all investments there are risks associated with convertibles, most prominently credit, equity, price volatility and to some extent interest rate risk. However, providing a skilled manager access to dynamically allocate to this market should benefit portfolios over the long term.

Next steps
Ultimately no one knows what the market has in store for investors, but we continually strive to help clients look ahead in terms of their investment exposure. By ensuring that convertibles are part of the opportunity set of appropriate equity, bond and diversified growth mandates, managers who have strength in this sector should be able to take advantage of periodic opportunities as they arise. As with all investments, exposure to convertibles is dependent on the risk/return objectives that the client is targeting. If you would like to confirm the scope of your current growth mandates, and to find out our view on your managers capabilities in the convertibles market please get in touch with the manager research team. Together we can ensure that clients are keeping their options open.