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Convertible Bonds: the better Multi-Asset Class

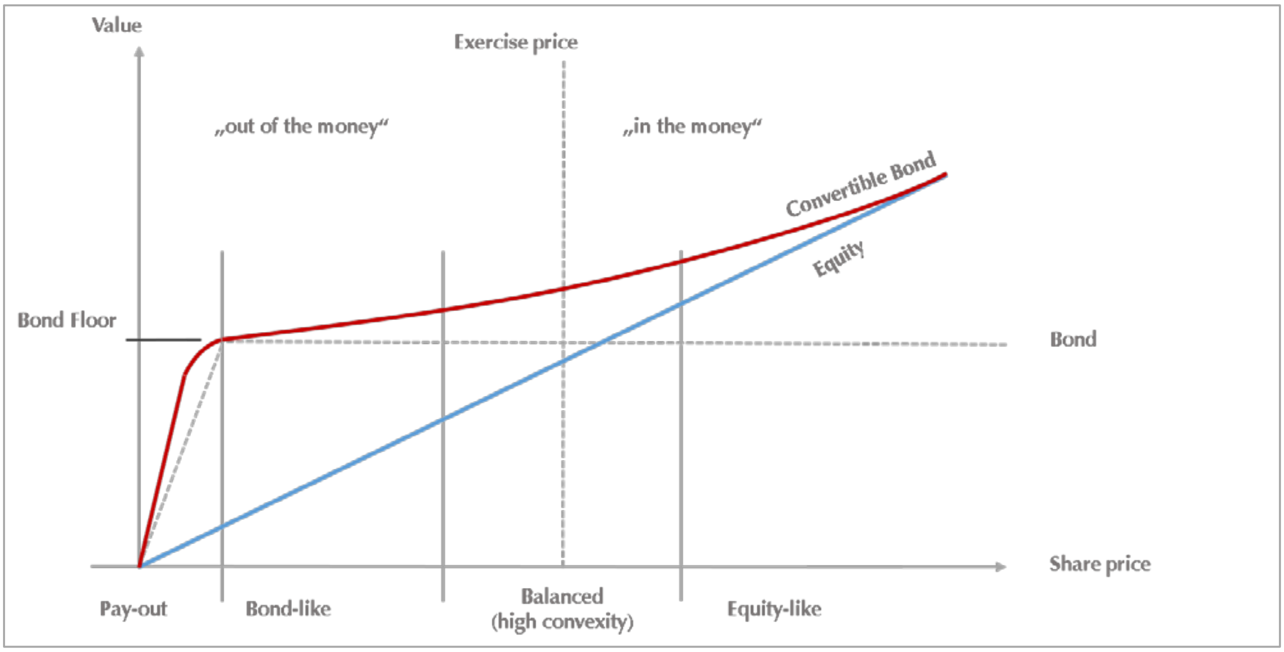
Multi-asset funds have been in high demand over the last few years, attracting record inflows. They have also dominated new business in Europe this year thanks to their product promise using diversification and active allocation, to limit volatility even when markets are in turmoil and to achieve long-term, attractive absolute returns. But this year they really have been tested, with mixed results. In an environment of volatile bond yields, many funds had problems, while others caught themselves on the wrong foot because of the strengthening of the euro. Convertibles, on the other hand, did much better in these unstable markets. This mix of shares and bonds is able to adapt flexibly to the respective market phase thanks to its "build-in" asset allocation. Depending on the development of the equity or bond markets the profile of the Convertibles investment changes.

Convertible bonds combine a corporate bond with a long call-option on the underlying stock, producing an investment that mixes a bond with an equity. The outcome is equity-type revenue but with far less volatility, plus the fixed income and security associated with a bond at redemption. The bond floor pays coupons and ensures redemption at face value—unless the bond has already been converted. Convertibles generally have shorter maturities compared to 'straight' corporate bonds (usually three to five years after issue) and therefore suffer less when interest rates increase. At times of falling and/or volatile capital markets, their hybrid structure makes them an attractive alternative to multi-asset products.

Uncertain market environments especially highlight the advantage convertibles have over multi-asset products: their built-in allocation management. Their asymmetric pay-out profile means convertible bonds almost automatically adjust to their market environment. When share prices rise, their equity component dominates, and when they fall their bond component limits loss. **This relieves the investor of one of the hardest decisions in asset allocation: tactical timing.** In multi-asset funds, the fund manager alone decides upon tactical timing. In terms of asset allocation he has to decide when to switch from equities into bonds, and when to increase or reduce risk. Not an easy task in a challenging market environment.

When equity prices rise, the equity long call-option as part of the convertible bond also rises in value and the pay-out profile becomes increasingly equity-like. When equity prices fall, conversion becomes less likely and the value of the convertible bond moves closer to that of the bond floor (the corporate bond) alone. In this situation, the pay-out profile is more bond-like. Unless the issuer defaults, the overall pay-out profile of a convertible bond is convex—i.e. has an upward curve—especially emphasized in the so-called balanced area.

Graph 1: Convexity of convertible bonds – Upside participation, downside protection



Source: Lupus alpha

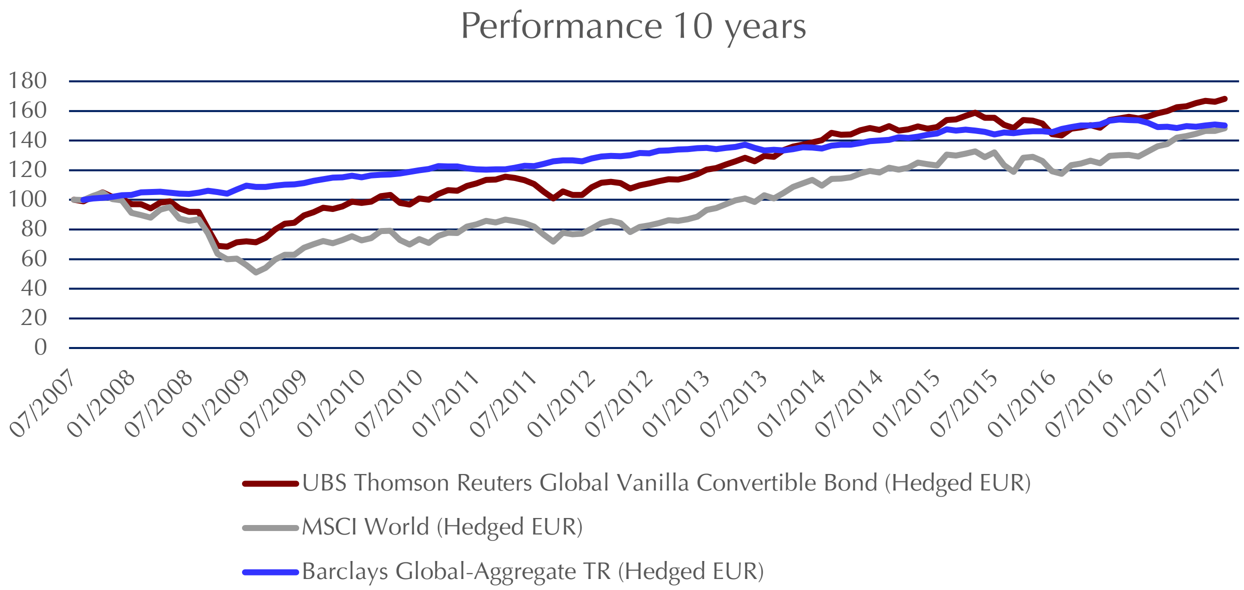
How is participation increased in bull markets? When share price and conversion price are on the same level, equity sensitivity (delta) is 0.5. A delta of 0.5 leads to an appreciation in the price of the convertible bond of 0.5% (at constant terms) when the price of the underlying share rises 1%.

If the share price rises, delta will also go up—to a maximum of 1 (100%). The convertible will become very equity-like and conversion will be very attractive. But increases and decreases of the delta are not linear. If the share price falls below the call price, the participation rate will also decline and the convertible bond at some stage will hardly react to volatility in the share price, becoming very bond-like.

In a balanced area with a delta between 0.3 and 0.7, the reaction of the convertible to changes in the share price will be especially asymmetric, displaying significant convexity. **Convertible bonds with delta in this mid-range are particularly attractive to investors wishing to profit from the "built-in" timing mechanism.**

In addition to their equity and bond features (including credit spread), convertible bonds can also generate return from volatility itself. Equity market corrections generally trigger a significant increase in volatility. Due to the right to convert (an embedded option), convertible bond holders have a long volatility position, accordingly the value of the option will rise. **In very unstable markets the combination of option plus coupon will therefore buffer the bond from the negative delta generated by equity market corrections.**

Graph 2: Long-term equity-like revenue with reduced volatility



Source: Bloomberg, Lupus alpha calculations

A comparison of the long-term performance of global convertible bonds with that of equities and bonds shows that **although convertibles are far less volatile than the equity markets, they offer comparable returns**. The comparison also shows that **temporary rate rises (e.g. at the end of 2016) have hardly a negative effect on convertible bond prices.**

Conclusion

Their hybrid structure and asymmetric pay-out profile means convertibles are able to adapt to the current market environment. **Convertible bonds** with **a balanced equity sensitivity** (delta between 30 and 70%) are particularly well able to cope. A portfolio of convertibles can be more equity or bond-like, depending on its risk/return-profile. As a result, bond investors can use convertibles to enhance returns compared to those offered by a 'standard' bond portfolio, and equity investors can use them to reduce equity risks while continuing to participate in equity performance.

Given their imperfect correlation with straight equity/bond investments, convertible bonds as a stand-alone asset class also offer advantages to asset allocators and **multi-asset class investors** seeking to enhance returns and reduce risk through diversified strategies. Adding convertible bonds to asset allocation as a stand-alone component can help them achieve these aims.

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