LOMBARD ODIER
INVESTMENT MANAGERS

STRATEGY INSIGHT
THE PRUDENT SEARCH FOR YIELD IN FIXED INCOME MARKETS

High yield convertible bonds – a compelling diversifier to a global high yield allocation

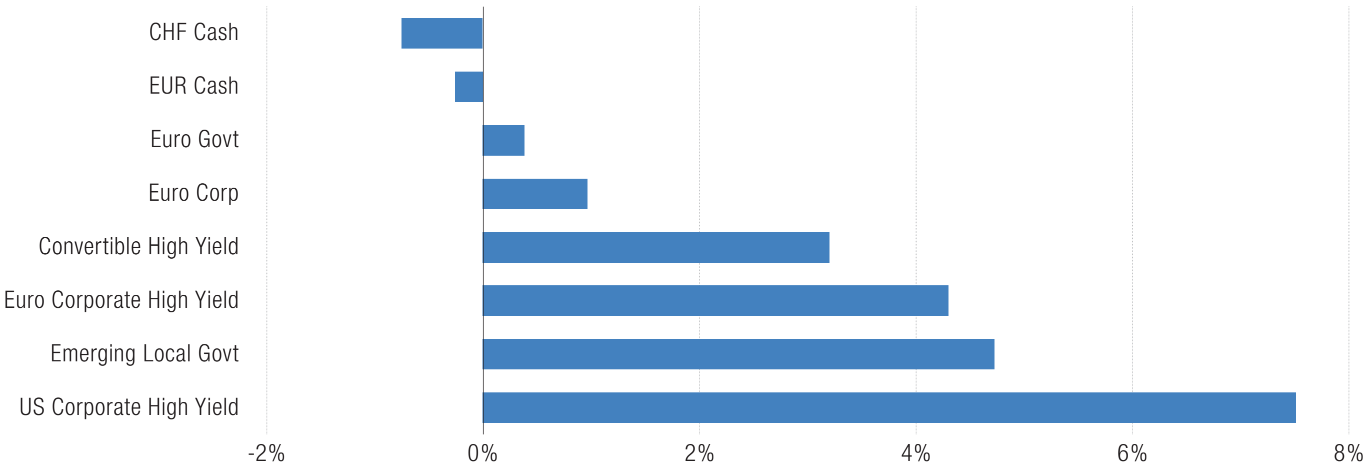
Contents

A tough environment for investors seeking a decent yield

As any fixed income investor will appreciate, the world has changed. Central banks now dominate the landscape. They can be described as policy makers, asset owners and regulators, as well as controlling the money printing press. Central banks now own between 20% and 30% of the global developed bond market. With no prospect of an exit strategy, they are a new permanent player in the bond markets.

Unlike other investors, central banks do not buy bonds to generate an income or return, but rather stimulate growth and inflation. They are insensitive to price. Consequently, investors are being forced to take on more risk in order to gain a decent return on their bond investments. Indeed, with negative interest rates across Europe impacting the returns on cash savings, we find ourselves in a unique situation in history.

FIG. 1 – THE YIELDS ON OFFER IN THE FIXED INCOME MARKET



Source: European Central Bank, Swiss National Bank, Barclays Euro Government Index, Barclays Euro Corporate Index, LO Funds III–High Yield Convertible Bond, Barclays Euro Corporate High Yield Index, Barclays EM Local Currency Government Index, Barclays US Corporate High Yield Index. As at 31 May 2016.

This backdrop is leading investors to increase their exposures to high yield bonds. However, in our view, most traditional high yield strategies are moving too far down the credit spectrum in search of this yield. For investors seeking a more prudent way to generate yield, we believe high yield convertible bonds can offer comparable returns with a lower exposure to credit risk and better diversification.

We analyse the many benefits of high yield convertible bonds in detail later in this paper. However, it is useful to firstly recap the relationship between government and corporate bond yields.

The relationship between government and corporate bond yields

It is important to remember that the yield on any corporate bond has two components:

1. The “risk free” component matches the yield on the relevant government bond
2. The company-specific component – or credit spread – reflects the risk factors that are particular to the issuer and the industry in which it operates.

Conventional wisdom suggests that an increase by a central bank in official rates normally produces a higher yield on benchmark government bonds. This, in turn, implies an increase in the “risk free” component and, therefore, of the overall yield on the corporate bond.

In fact, the truth is more complex. The relationship undoubtedly holds true for larger moves in official interest rates. However, smaller moves in official rates do not necessarily lead to the equivalent change in corporate bond yields. Indeed, the behaviour of fixed income markets over the last 15 years or so indicates that credit spreads and government bond yields are actually negatively correlated. This suggests that a rise in government bond yields should be accompanied by a compression in credit spreads, and vice versa.

The reason for this is that corporate bond yields are “stickier” than yields on government bonds. A given move – in either direction – in government bond yields is normally accompanied by a smaller move in yields on corporate bonds. “Stickier” corporate bond yields provide investors with some protection against a general rise in inflation expectations – at least over relatively short time periods. Over longer time periods (e.g., two years and longer) the negative correlation declines. In other words, over the longer term, the relationship between government bond yields and corporate bond yields is much less clear.

Credit spreads and interest rate volatility

The most important driver of credit spreads is, in fact, interest rate volatility. This is because credit spreads are driven by investors’ view of corporate credit risk and of uncertainty in the macroeconomic outlook. Increasing uncertainty about macroeconomic prospects usually leads to greater volatility in interest rates and to increased credit spreads. Conversely, greater certainty usually produces greater stability in interest rates and reduced credit spreads.

As most economists agree, the causes of rate moves are more important than are their effects. Suppose that yields on benchmark government bonds are rising in response to a strengthening economy, for example. In this case, credit spreads – and the spread on high yield bonds in particular – should narrow as a result of lower default risk. US fixed income markets provided a good example of this between June 2003 and January 2007. Yields on benchmark US Treasury bonds rose by 2.3%, but yields on high yield corporate bonds actually fell. Over this period, core inflation in the United States rose by 0.6%. Most crucially, the high yield default rate fell by 2.7%.

Conversely, if yields on benchmark government bonds are rising for a reason other than a strengthening economy, the default risk – and credit spreads – may rise. This is what happened in the United States, for instance, between January 1999 and June 2000. Yields on benchmark US Treasury bonds increased by 1.9%. Yields on high yield corporate bonds rose by between 2.0% and 2.6% (depending on the rating). Core inflation in the United States rose by 0.7%. However, the default rate jumped by 3.0%.

For most investment grade corporate bonds, the “risk free” component accounts for the (vast) majority of the overall yield on the bond. By contrast, for high yield corporate bonds, the credit spread is typically greater than the “risk free” component. Over the very long term, the median spread on US high yield corporate bonds is 5.0%. This means that, for any high yield corporate bond, movement in the credit spread is likely to be the most important driver of volatility in the price of the bond.

Convertible bonds: an asset class with attractive characteristics

Greater diversification of return sources is one of the attractive features of convertible bonds when compared to traditional bonds.

Like all credits, performance is generated from:
- **The carry trade:** how much interest is carried over the course of an investment
- **The tightening of the spread:** as the likelihood of reimbursement of the original investment rises, the credit spread will tighten and so produce a return for the holder.

Convertible bonds, however, also offer a potential return from the **embedded option**. The option will increases in value if the underlying share price rises or experiences heightened volatility.

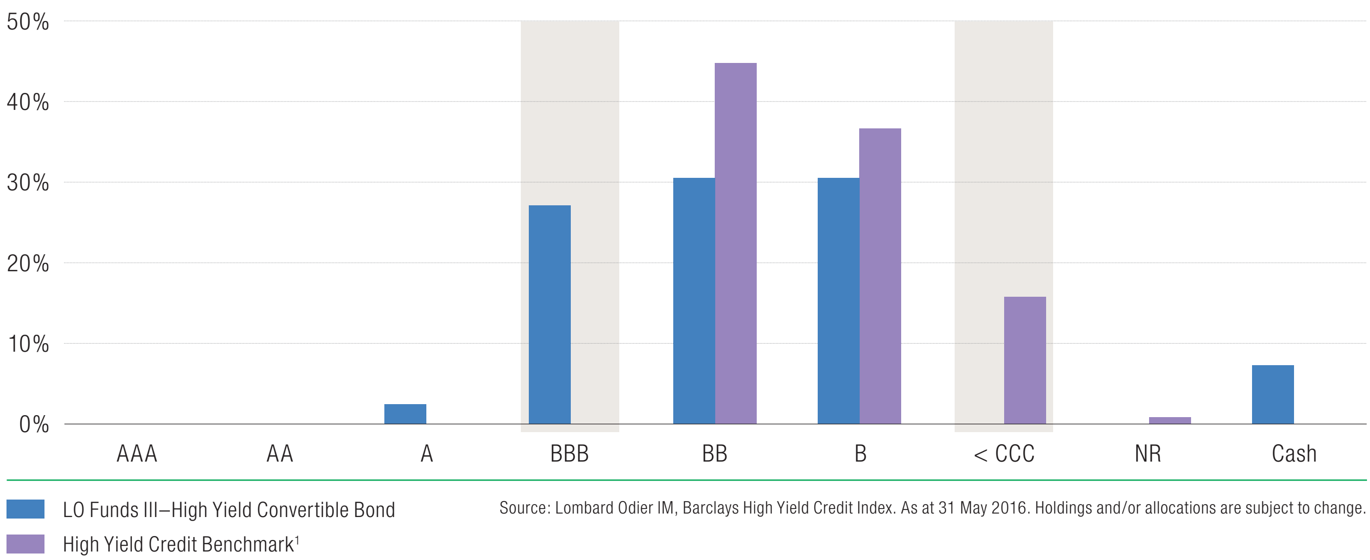
High yield convertible bonds: a way to generate yield with less credit risk
We believe a well-diversified high yield convertible bond allocation typically comes with much lower credit risk than a traditional high yield bond strategy. This is for three key reasons:

REDUCED CREDIT RISK

Using the portfolio of LO Funds III-High Yield Convertible Bond as an example, the allocation to "speculative"1 credit – bonds rated CCC and below – is negligible (in fact, the current allocation for our fund is zero). This compares to 16% for the Barclays Global Corporate High Yield Index, a common benchmark for high yield bond funds. The lower credit-risk nature of our fund is also demonstrated by Lombard Odier IM's bias towards to top end of the high yield spectrum.

Holdings and/or allocations are subject to change.[1] "Speculative" is the term used by S&P to describe the segment of bonds rated CCC and below.

FIG. 2 – NO EXPOSURE TO "SPECULATIVE"[1] CREDIT



Source: Lombard Odier IM, Barclays High Yield Credit Index. As at 31 May 2016. Holdings and/or allocations are subject to change.

[1] As described by Standard & Poors.

Analysing the average weighted credit spread of LO Funds III–High Yield Convertible Bond further enhances this point. Credit spreads in Lombard Odier IM's High Yield Convertible Bond Fund are just 323 basis points compared to 543 basis points for the Barclays Global Corporate High Yield Index.

TABLE 1 – A LOWER AVERAGE WEIGHTED CREDIT SPREAD

PORTFOLIO CHARACTERISTICS	LO FUNDS III–HY CB	HY CREDIT BENCHMARK[1]
Credit Spread (OAS)	**323 bps**	**543 bps**
Maturiy	4.6 years	5.0 years
Duration (OAD)	2.5 years	3.9 years
Yield-to-maturity	3.2%	7.0%
Yield-to-worst	3.2%	6.8%

Source: Lombard Odier IM, Barclays Global Corporate High Yield Index. As at 31 May 2016.For illustrative purposes only.

GREATER REGIONAL DIVERSIFICATION

We believe regional diversification has an important role to play in risk reduction. Despite this, traditional high yield bond funds, which tend to be managed to one of the two main high yield benchmarks, are typically heavily skewed towards the US market. The US accounts for approximately 62% of both the Barclays Global Corporate High Yield and Merrill Lynch Global High Yield indices. In contrast, Lombard Odier IM's high yield convertible bond offering has a 44% exposure to the US. Of course, a high exposure to the US can work very well but it can also lead to very disappointing performance when the US high yield market underperforms.

LO Funds–High Yield Convertible Bond Fund is also much more regionally diversified, particularly in Asia when comparing to a traditional high yield credit index.

TABLE 2 – A TRULY GLOBAL EXPOSURE

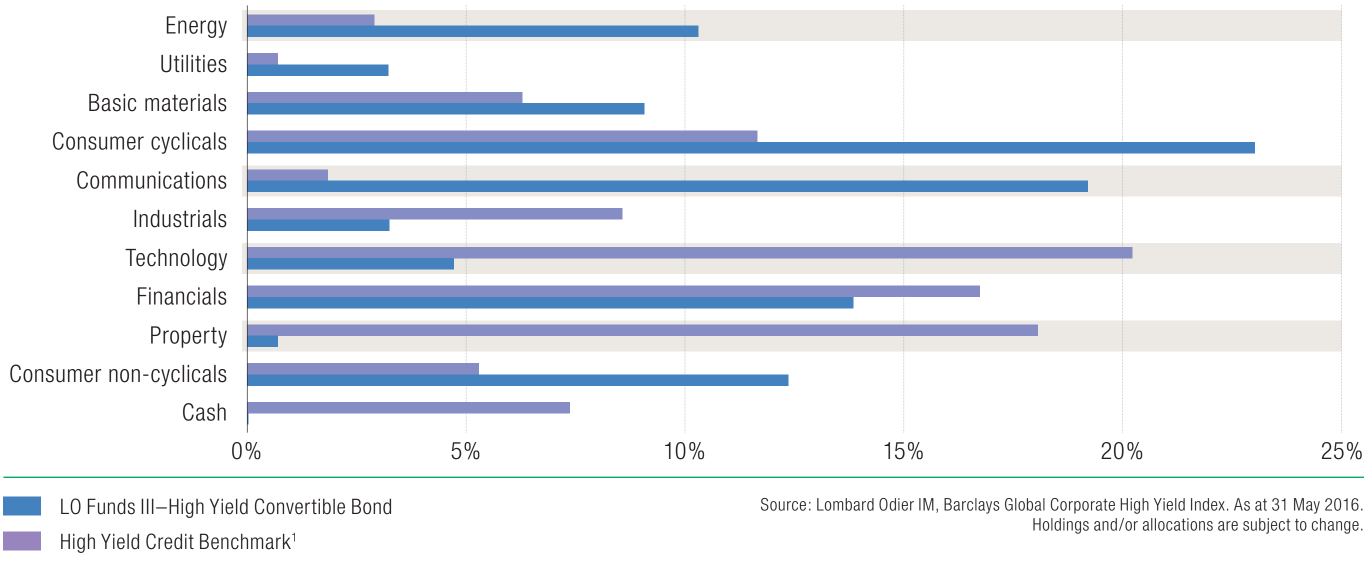
REGIONS	LO FUNDS III–HY CB	HY CREDIT BENCHMARK[1]
US	**49.1%**	**62.2%**
Europe	25.9%	30.9%
Asia	15.1%	3.1%
Japan	2.5%	0.3%
Others	0.0%	3.5%
Cash	7.4%	–

Source: Lombard Odier IM, Barclays Global Corporate High Yield Index. As at 31 May 2016.
Holdings and/or allocations are subject to change.

EXPOSURE TO LOWER-RISK SECTORS

Traditional high yield portfolios – both funds and indices – are highly concentrated in the most leveraged industries – Telecoms, Financials and Energy. In contrast, our high yield convertible bond strategy is far more centred around lower leveraged sectors such as Technology . It also has substantial allocations to other traditionally high growth sectors, namely Property and the consumer sectors.

FIG. 3 – EXPOSURE TO LESS LEVERAGED SECTORS



Source: Lombard Odier IM, Barclays Global Corporate High Yield Index. As at 31 May 2016.
Holdings and/or allocations are subject to change.

Diversifying performance

Performance and volatility over the past seven years (since the inception of our high yield convertible bond strategy) provides yet another compelling reason to use these instruments as a complement to a high yield credit allocation. The table below shows the decorrelation of the performance and the volatility between our portfolio and the two main high yield bond indices.

TABLE 3 – [...]

	HY CB	HY STRAIGHT	HY STRAIGHT
	LO FUNDS III–HY CB	BARCAP GLOBAL CORP HY	MERRILL LYNCH GLOBAL HY
2016 YTD	3.0%	6.6%	6.8%
2015	2.6%	-3.3%	-2.5%
2014	3.2%	2.7%	2.3%
2013	6.3%	7.2%	6.8%
2012	17.3%	17.9%	18.2%
2011	-4.4%	3.0%	3.1%
2010	13.3%	14.3%	14.5%
2009[1]	13.2%	22.6%	22.4%
Perf (ann.)[2]	7.4%	9.1%	9.2%
Vol (ann.)[2]	5.2%	7.0%	7.0%
Perf/Vol	**1.43**	**1.30**	**1.32**

Source: Lombard Odier IM. As at 31 May 2016.

2015 is an excellent example, with our strategy delivering positive returns of 2.6%,compared to -3.3% and -2.5% for the Barclays and Merrill Lynch indices respectively. The primary driver of this performance was the volatility of the underlying shares, which helped compensate for the unspectacular return on the bond portfolio to some extent. The high yield indices have rebounded this year due to their high exposure to the energy sector and tightening spreads in the US high yield market.

Why add convertible high yield bonds to your fixed income portfolio?

In a low return world where a strong yield is increasingly difficult to find, we believe high yield convertible bonds can offer many compelling benefits. As they are high yield debt instruments, investors tap into all the advantages of the high yield credit market. We believe high yield convertible bonds, as managed by Lombard Odier Investment Managers, have the potential to offer investors (in normal market conditions or all?):

- A higher average credit quality than a traditional high yield allocation
- Added diversification benefits, with lower exposure to highly-leveraged sectors and risk spread more evenly around the world
- An added source of return – an equity option is included at little cost
- Consistent yield with a shorter duration.

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