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INVESTMENT MANAGERS

Investment viewpoint

Using convertible bonds to navigate an uncertain horizon

For professional investor use only • Convertible Bonds

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Executive summary

- By combining the characteristics of a corporate bond and the option to convert that bond into shares, convertible bonds offer investors an asymmetric risk and return profile
- A focus on balanced convertible bonds[1] allows investment strategies to navigate a range of economic scenarios, in our view
- Over the long term, the convex nature of convertible bonds has enabled them to offer equity-like returns but with much lower volatility and reduced drawdowns
- Today, we believe the case for investing in actively managed global convertible bonds is particularly compelling:
  - Historically, convertible bonds have outperformed bonds in rising interest rate environments
  - Over the second half of 2018, we expect convertible bonds to benefit from rising-but-volatile equity markets
  - Increasing concerns over inflation, asset valuations, central bank decisions or the impact of rising trade protectionism are likely to make risk-conscious investment approaches increasingly attractive to investors

Convertible bonds, the basics

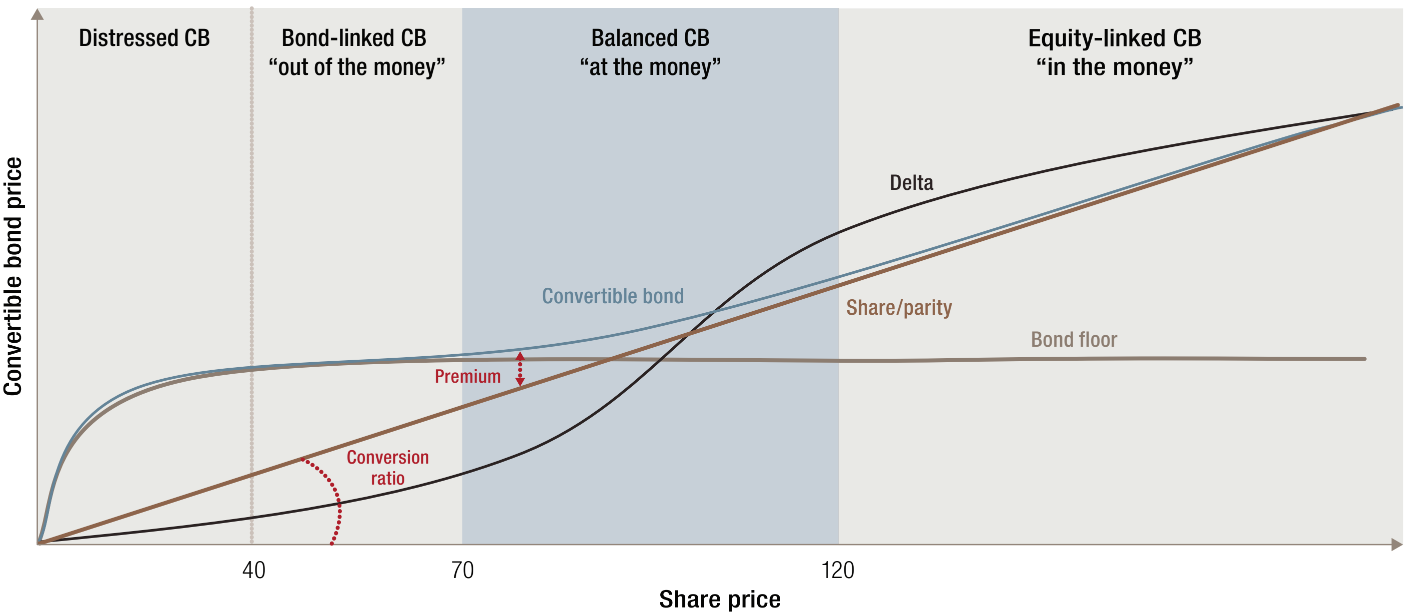
A convertible bond is a corporate bond (with a coupon and a fixed-maturity date) with an option that allows the holder to convert the bond into the common stock of the issuing company (or the stock of another entity in the case of exchangeable convertible bonds) at some point in the future. The number of shares into which each bond can be converted and the conversion price are set at the time of issuance.

[1] Convertible bonds are described as "balanced" when they combine a relatively large bond component (or "bond floor") and meaningful equity sensitivity (or "delta").

Although there are different types of bond structures, convertible bonds generally exhibit both equity and fixed income characteristics. Depending on valuations and market conditions, a convertible bond may act more like a stock or more like a bond at any given time. Convertible bonds are described as "balanced" when they combine a relatively large bond component (or "bond floor") and meaningful equity sensitivity (or "delta") – as shown in Fig. 1. These balanced convertible bonds are particularly attractive to investors, such as the LOIM convertible bond team, who aim to maximise the asymmetrical return profile of their portfolio.

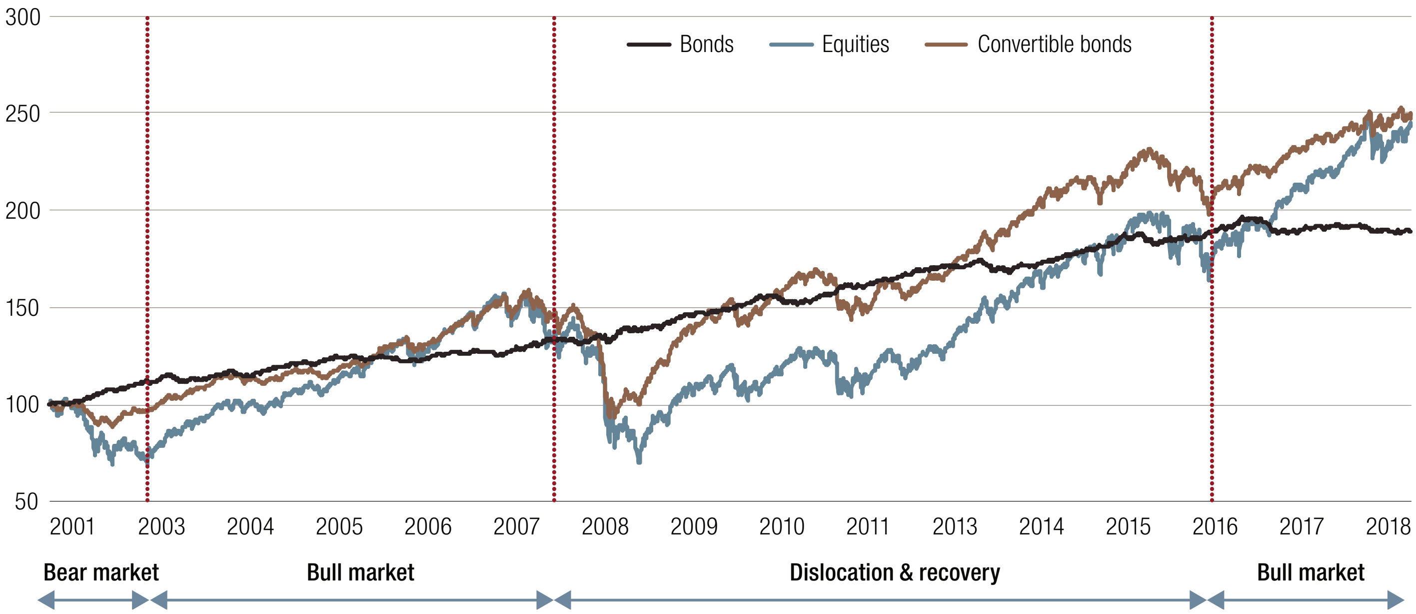
Since convertible bonds can be exchanged for equity, they offer investors the potential to participate in the upside of equities. However, if the underlying equity fails to increase in value, the convertible bond maintains the investment value of the bond floor (or the theoretical value at which a straight bond with the same coupon, maturity and credit quality would trade).

FIG. 1 THE PROFILE OF A CONVERTIBLE BOND CHANGES WITH THE PRICE OF ITS ISSUER'S EQUITY



Source: LOIM. For illustrative purposes only.

FIG. 2 CONVERTIBLE BONDS HAVE OUTPERFORMED AGGREGATE BONDS AND WORLD EQUITIES OVER THE LONG TERM



Source: Bloomberg, LOIM. Performance rebased to 100 and based on: Equities: MSCI World NR (EUR hdg) – MXWOHEUR Index. Convertible Bonds: TR Global Index (EUR hdg) – UCBIFX13 Index. Bonds: Barcap Global Aggregate (EUR hdg) – LEGATREH Index. Past performance is not a guarantee of future results.

In our view, **it is particularly important to include a substantial portion of investment grade instruments in a convertible bond portfolio because they will strengthen the bond floor, which should help to protect the portfolio at times of equity downturn**.[2] This is particularly important given the strong correlation between high-yield corporate credit and equities during downturns.

It is this unique structure, combining participation in rising equities but protection when equity markets are declining, which has led to very attractive risk-adjusted returns for convertible bonds over the long term.

An attractive alternative to straight debt at times of heightened duration risk

As central banks, starting with the US Federal Reserve, begin to normalise monetary policies after a decade of non-conventional measures, investors may face sharp changes in market conditions. The clear trend of rising bond yields is an obvious example; with US 10-year bond yields growing from 2.4% at the beginning of the year to more than 3% today.

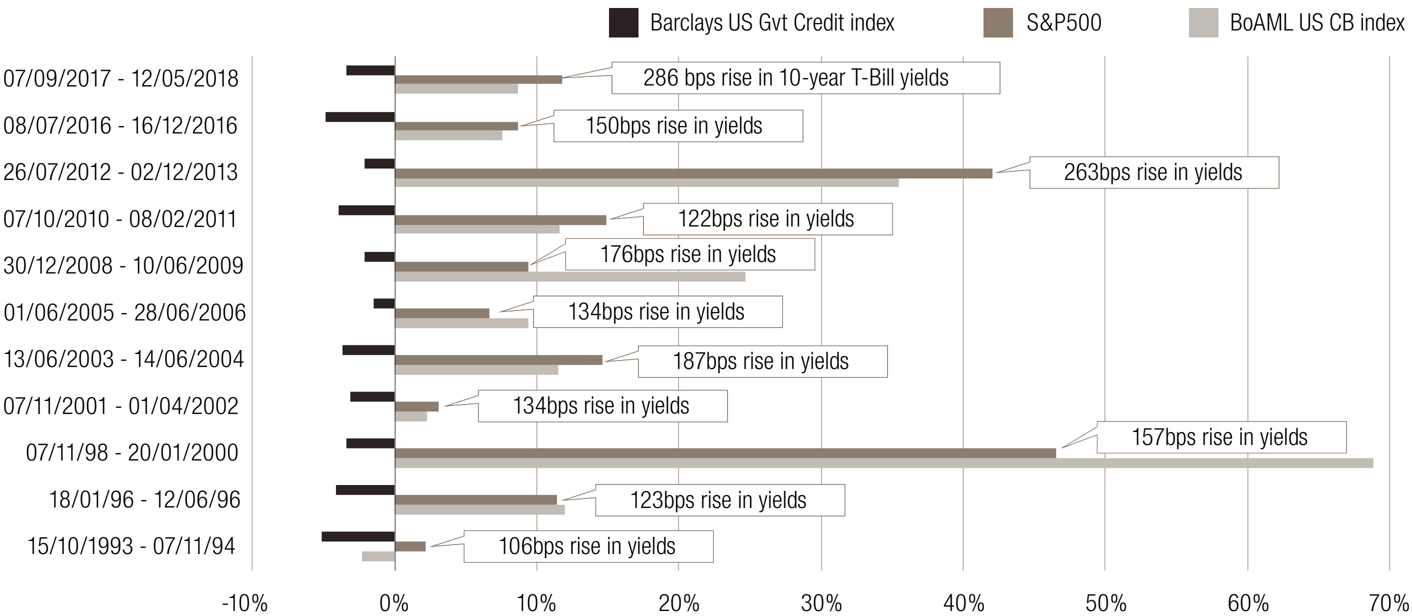
Investors might expect convertible bonds to suffer from such rising rate environments, given their fixed income nature, yet the asset class has outperformed bonds during such periods in the past. In every period where the 10-year bund yield (German base rate) has increased by 120bps or more, European convertible bonds have generated positive returns, while in the US there have been 11 periods when the 10-year yield has risen by 100bps or more over the past 25 years, and during every one of these periods convertibles outperformed bonds, as shown in Fig. 3.

The fact that convertible bonds are much less sensitive to interest rates than all other types of bonds is due in part to their shorter maturities (averaging four years), but mostly to their option component, which generally gains value in times of rising interest rates.

The importance of convertible bonds in asset allocation

Although convertible bonds are often seen as difficult to fit into traditional asset allocation “boxes”, we believe they can play a valuable role in a portfolio for investors looking to either diversify their bond allocation, protect their portfolio during times of rising rates or maintain exposure to the upside of the equity market while seeking to contain volatility.

FIG. 3 RETURNS IN RISING RATE ENVIRONMENTS



Source: Bloomberg, Barclays and BoAML. For illustrative purposes only. Past performance is not a guarantee of future results.

2 Capital protection/Capital preservation represents a portfolio construction goal and cannot be guaranteed.

Convertible bonds have multiple performance engines, which can develop in different ways depending on the market context.

- First, the bond component, which will evolve on the basis of credit quality, carry, yield and curve effects
- Second, the equity component, which will be driven by the underlying stock price, and
- Third the pricing of the option itself

Such diversity of performance drivers within one asset class is unique and gives investors the potential to generate value in a variety of market conditions.

From a fixed income point of view, adding convertible bonds to a diversified portfolio can provide diversification benefits, while lowering the interest rate sensitivity of the overall allocation. As was outlined above, convertible bonds have historically had a negative correlation with interest rates and a close to zero correlation with aggregate bond indices.

Convertible bonds do have a positive correlation to equities, though this correlation is far from perfect and varies over time. Over the long-term, convertible bonds have generated similar returns to equities but have done so with lower volatility, resulting in higher risk-adjusted returns (as measured by the Sharpe ratio) over the trailing 10-, 15-, and 20-year periods (see Fig. 4). **We believe this asymmetrical return profile makes convertible bonds attractive to investors in need of the growth potential of the equity market, but wanting to reduce their exposure to equity-market volatility.**

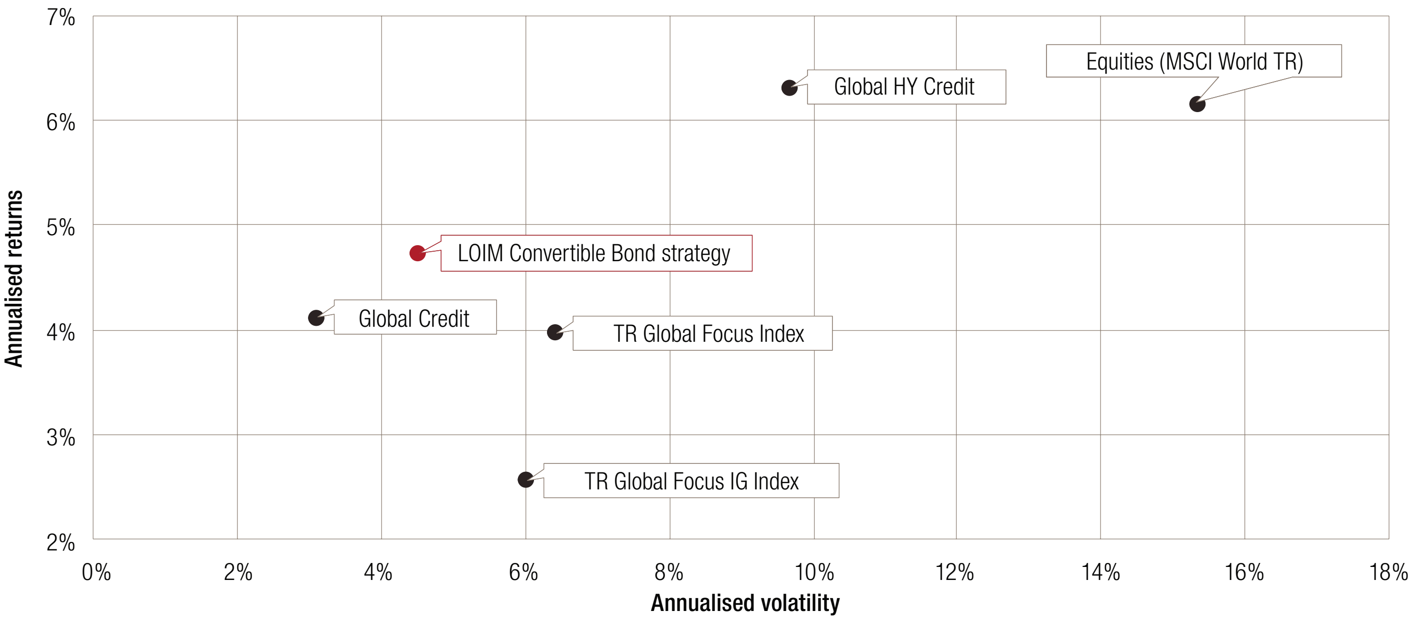
In addition, adding convertible bonds to a diversified portfolio **may broaden the exposure to parts of the market that might be underrepresented in an investor's portfolio**. Although the convertible bond market contains issues from companies of all sectors, regions and market capitalisations, the asset class has a heavier weighting to growth and mid-cap companies than most traditional equity and bond strategies. With significant allocations to sectors such as Technology or Industrials, convertible strategies may be particularly attractive to complement a traditional dividend strategy focused on large-cap value stocks, for example.

Finally, **a key feature of the global convertible bond market is the fact that it contains almost no passive ETF products**. This is due to the complexity of this asset class and the differences between regional markets. The spectacular growth of passive equity and straight credit ETFs has made them vulnerable to technically triggered sell-offs in the event of a downturn in market sentiment, in our view. This near-absence of passive ETF products in the convertible bond space means such risk is extremely limited for the convertible bond asset class.

The primary market

For investors focused on balanced convertible bonds, it is essential that the primary market maintain a healthy flow of issuance. Indeed, new (or recently issued) convertible bonds tend to be the primary source of balanced profiles (paper offering both strong bond protection and meaningful equity sensitivity).

FIG. 4 ASSET CLASS RETURNS AND VOLATILITY



Note: Analysis period 31 December 2004 to 31 July 2018. Sources: Equities: MSCI World TR (EUR-hedged); LOIM Convertible Bonds Strategy (gross); Global HY Credit: Barclays index: Barclays Global High Yield Corporate index (EUR-hedged); Global Credit: Barclays index: Barclays Global Credit Corporate index (EUR-hedged); TR Global Focus Index: Thomson Reuters index (EUR-hedged); TR Global Focus IG Index: Thomson Reuters index (EUR-hedged). Past performance is not a guarantee of future results.

The current market environment is favourable to new issues, as equities at relatively high levels of valuation and interest rates on an upwards trajectory convince issuers to turn to convertible bonds in their funding strategies. This has been particularly evident in recent months as a substantial portion of issues came from newcomers to the asset class (particularly in the US). This has had the welcome consequence of increasing the diversification of the convertible bond universe.

During the first half of 2018, global issuance reached USD 57 billion, according to BoAML – the fastest pace in a decade (see Fig. 5). The US has provided the bulk of this volume (USD 34 billion) while we witnessed a notable rise in Asian issuance (USD 12 billion from Asia ex-Japan). Analysts expect this dynamism to continue in the second half of the year, with BoAML forecasting the highest level of issuance since 2006.

Conclusion: an asset class inherently suited to uncertain times

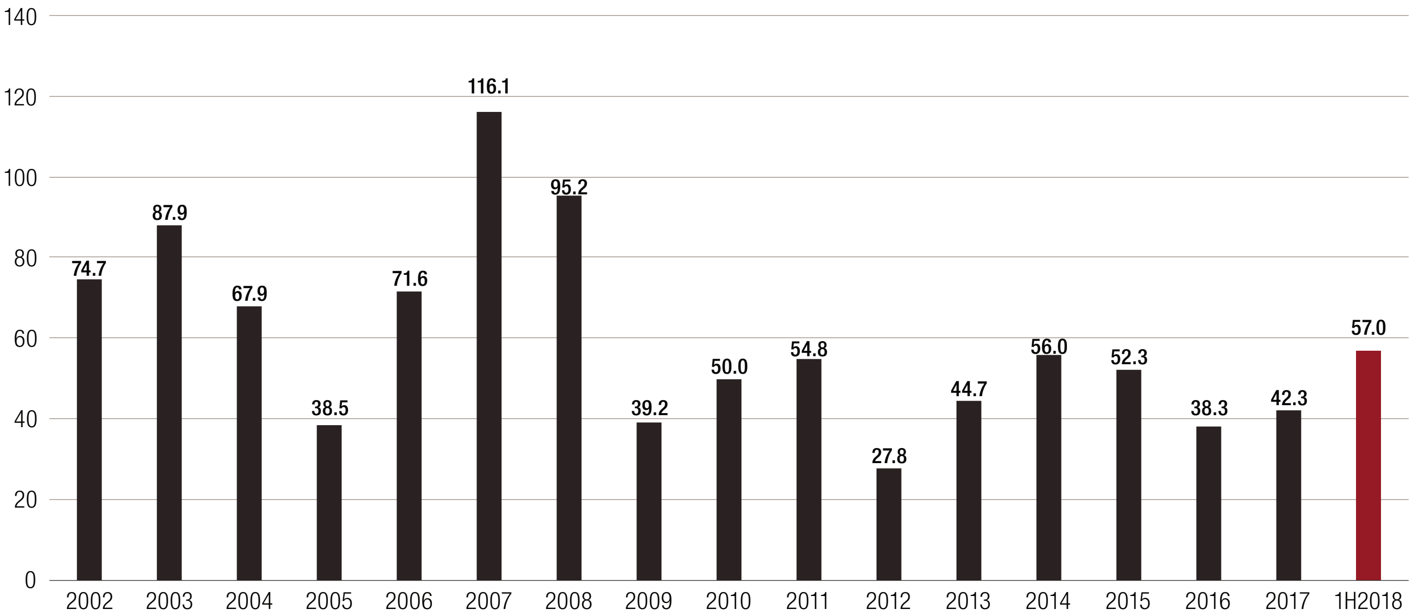
Overall, we believe that strategies focused on balanced convertible bonds with a strong bond floor are well positioned for many scenarios in this time of uncertainty:

- If an investor requires income but expects higher interest rates, spread-widening and rising equity volatility, the equity options and lower interest-rate sensitivity make convertible bonds an attractive alternative to straight debt
- If an investor expects interest rates to remain low but is concerned about equity valuations and the potential for politics to upset sentiment, convertibles are an attractive alternative to straight equity
- If both scenarios as regarded as equally probable, convertible bonds remove the imperative to bet either way

Finally, investors that rely on income from their investments and now find that their portfolio yield is too low and their portfolio duration is too long, can turn to convertibles to reduce interest rate sensitivity and boost expected returns potential with equity optionality. Furthermore, we believe the fact that equity optionality is currently available at an attractive price adds to the investment case. Investors should not forget that convertible bonds are the unique way to gain exposure to liquid and long-term optionality (typically 5 years at issue).

When times are as uncertain as they are today – both tactically and strategically – we would argue that convertible bonds come into their own.

FIG. 5 1H 2018 ISSUANCE STATISTICS (IN USD BILLION)



Source: BoAML.

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