

Convertible Bonds

The Revival of an Asset Class

As an asset class, convertible bonds have historically offered investors an attractive source of return

This has been achieved through its mix of equity upside and bond-like protection. As a result of this mix, convertible bonds have historically offered better returns than equities, but with fewer and less severe drawdowns, leading to far better risk-adjusted returns. However, their use by private wealth managers has diminished over the last 15 years. Hedge funds and proprietary trading desks at investment banks dominated the market, especially the new issues and, by doing so, diluted much of the **value and income** that had attracted so many private clients to the asset class in the 1970s and 1980s.

With companies from a range of industries like Sainsbury's, British Airways, WPP and Anglo American now issuing new convertible bonds on very attractive terms, we believe private wealth managers should take a serious look at this alternative and under-owned asset class.

What is a Convertible Bond?

In its standard form, a convertible bond (CB) is simply a bond that gives the holder the right, in certain defined circumstances, to exchange it for cash or for a predetermined number of shares in the company. At maturity, convertibles are worth either their cash redemption value (usually 100) or the market value of the shares into which they are convertible, whichever is greater.

The convertible bond *premium* refers to the percentage that the shares must rise for an investor to choose to exchange the bond(s) for shares (where the combined value of the shares exceeds the redemption value of the bonds). Once the shares have achieved that percentage rise, and so reached the 'parity price', the convertible is said to be 'in the money'. Once convertibles are in the money, they begin to trade like an equity and therefore their correlation to the underlying shares will be high. If a convertible is 'out of the money', they will trade more like a traditional corporate bond.

“We believe private wealth managers should take a serious look at this alternative and under-owned asset”

The Convertible Bond Market

With more than 1,500 issues worldwide, the total market capitalisation of the convertible bond market is large and currently stands at approximately \$500 billion. As of 31 August, there have been more than 27 new CB issues in Europe so far this year, with \$45 billion raised worldwide.

While convertibles may seem like a new form of debt, the reality is that they have been around since the 1800s. In order to renew interest

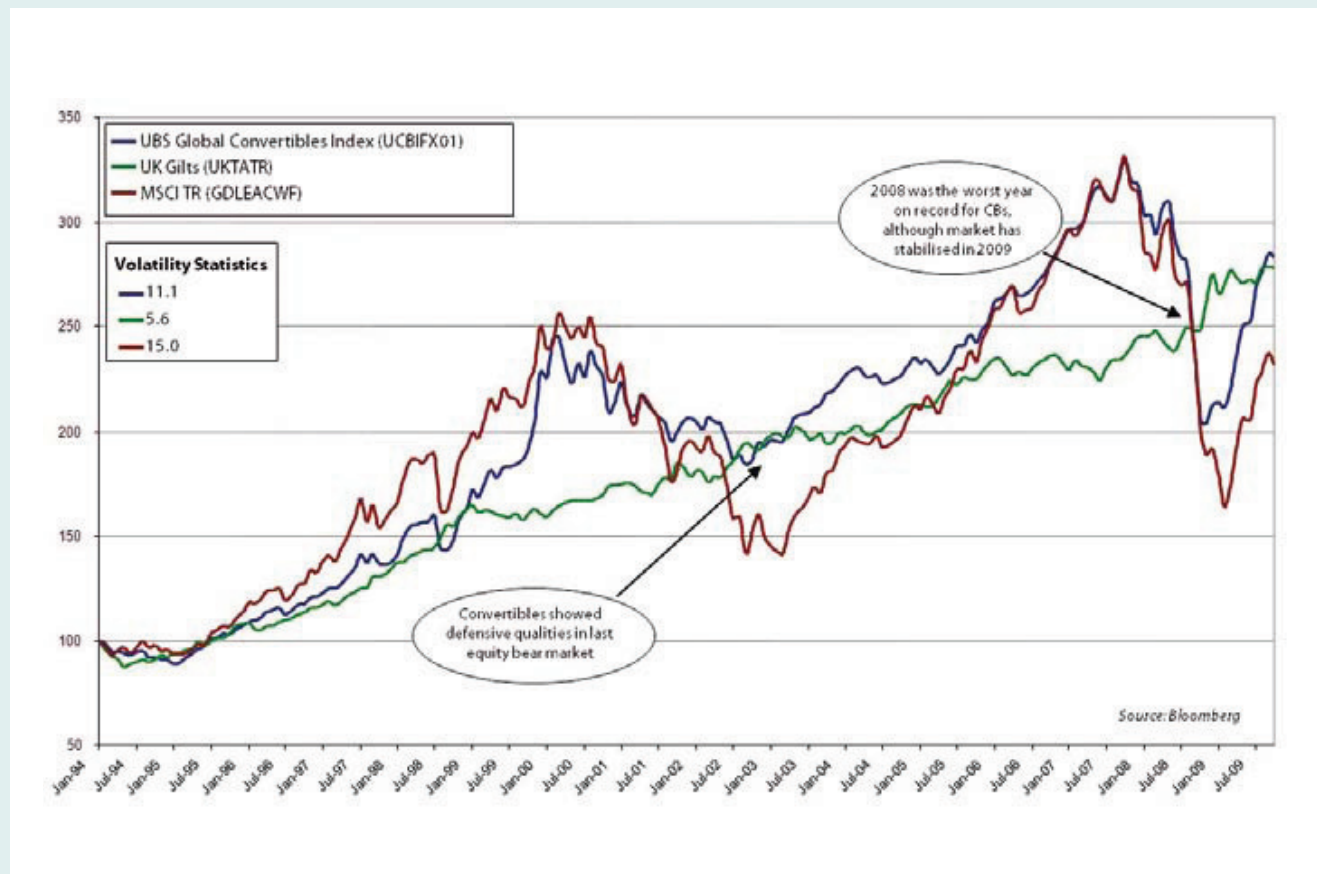
in the bond market that had been hampered during the American Civil war in the 1860s, the US South began issuing cotton-backed bonds to provide holders with guaranteed collateral in case of default. In London, Sterling Bonds too were being issued at very attractive terms: these would be issued with a 7% coupon and a maturity of 20 years, which could be converted into cotton at the pre-war price of six pence a pound. Companies too were issuing convertibles to finance growth, particularly corporations such as Railroad companies.

In the mid 1990s the convertibles market was dominated by hedge funds that sought to exploit arbitrage opportunities in the different elements (i.e. bond or equity option) of a convertible. As these opportunities typically provided a tight margin of return, funds were required to leverage substantially (200-400% of gross exposure) in order to generate such attractive returns. During this period the convertible bond market, therefore, traded very close to its theoretical fair value.

2008: The Perfect Storm for Convertibles

As the credit crisis intensified in 2008, a number of factors conspired to create the perfect storm for convertibles, leading to a sell-off on a scale not seen before (as shown on the graph opposite). Some of the factors that caused this are listed below:

Long-term returns of convertible bonds (UBS Global Convertibles Index)



Convertible bonds have historically provided equity-like returns, but with fewer and less severe drawdowns, leading to less volatile returns than equities. In addition, convertibles rank higher than equities in the capital structure and are sometimes the only form of debt.

- Mass hedge fund redemptions led to forced selling in less liquid and more volatile markets
- Forced de-leveraging by hedge funds and investment banks' proprietary trading desks
- Dramatic widening of corporate credit spreads combined with a severe equity bear market
- The collapse of investment banks Bear Stearns, Lehman Brothers and a ban on short selling

The Opportunity Set

The large concentration of distressed sellers in convertibles has created substantial value opportunities. In light of this, we believe the greatest potential for return lies in a simple, long-only investment in convertible bonds:

- Many convertible bonds now offer a yield to maturity higher than the issuing company's straight bond
- Investors can potentially benefit from

“The large concentration of distressed sellers in convertibles has created substantial value opportunities”

- equity market upside through the attached equity option
- CBs have a fixed life and redemption price and therefore prices cannot trade at discounts in perpetuity (assuming they do not default)
- Should they default, however, convertible bonds rank higher up the capital structure than equities
- Due to their coupon payments, convertibles offer an attractive deflationary hedge
- They also provide a hedge against inflation because of the upside potential offered by the equity option

2009 has seen the UBS Global Convertible index rally by +37.1%. This has been driven predominantly by an improvement in credit but also by a recovery in world equities, with the MSCI World up +25.2% over the same period.

With credit conditions improving and an influx of fundamentally driven and long-only capital entering the convertibles market, we expect returns to continue to improve over the short and medium term. More importantly, even after the rally seen this year, convertibles remain at historically attractive levels from a value perspective. For private clients they offer a unique opportunity to earn a high level of income at a time when companies are slashing dividends, while retaining the potential for considerable capital growth in a sustained equity market recovery. There has rarely been a more attractive time to buy convertibles. ■