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Opinion

Convertible bonds: solid foundations are needed when reaching for the upside

Tuesday, 21 May 2013 | Joseph Fekete

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Clearway Capital believes conservative management approaches, relying upon deep credit skills, may encourage investors to reconsider an asset sector that has been out of favour for some time.

The global financial crisis (GFC) prompted Australian institutional investors to have a closer look at non-investment grade credit. Initially, this was on an opportunistic basis, as spreads widened dramatically compared to historical averages. Then latterly, on a more strategic and possibly permanent basis, as investors recognised longer-term value and the diversifying benefits of an exposure to this asset class.

However, one sub-sector of this asset class that has perhaps generated less attention than it deserves is the convertible bond ('convert') market. Although converts have been attracting considerable attention amongst US and European investors, few Australian institutional investors have allocated to converts as a stand-alone asset class (retail investors have dominated local hybrid markets).

Although Australian issuers have tended to be major banks and household names, complicated structures and limited protections have not always been well understood, and retail investors have fared poorly in a number of instances. Consequently, the Australian regulator, Australian Securities and Investments Commission (ASIC), has become increasingly involved in seeking greater protections for retail investors.

While this has largely impacted retail investors, the problems identified and the taint of several notable failures has not encouraged institutional investors to look more closely. It should be noted though, that the structure of many overseas convertible issues offer greater standardisation, more protection and the option to convert generally rests with the holder rather than the issuer of the security (which has not generally been the case in Australia).

Most US converts include a bond floor (a coupon stream, plus principle at maturity), plus the right to convert the investment to the issuer's common shares at a predetermined price at the bondholders' discretion. Converts can be issued (or subsequently traded) with a conversion price that can lie on a continuum from out-of-the-money to in-the-money. Recent new issuance has tended to have a conversion price closer to the current market price of the equity (at-the-money).

The bond floor, plus the equity 'option' produce asymmetric pay offs. The equity upside is unlimited, but the downside is protected by the bond floor. A convert that is deeply out-of-the-money can be expected to behave in the short term much like a fixed income security, as the likelihood of conversion to equity is relatively remote. On the other hand, a convert that is in-the-money is likely to behave more like an equity security, as the likelihood of conversion is much greater.

Over time, the risk and return performance of converts can be expected to sit somewhere between bonds and equities. However, in the most recent 20-year period, converts actually outperformed equities with lower risk.

History shows us that converts are much more closely correlated to equities than bonds. Interestingly, but not surprisingly, they have also been shown to capture much more of the upside in an equities bull market than of the downside in a bear market. Consequently, they can be very attractive in a risk/return sense and can be a useful diversifier in an equities portfolio. Additionally, their non-correlated relationship to traditional fixed income can be a useful diversifier for a fixed income portfolio.

One could also argue for a permanent strategic allocation to converts in a balanced portfolio on the basis that in a falling bond market they are likely to outperform bonds, and in a falling equity market they are likely to outperform equities. Tactically, it could make more sense to adjust exposures to traditional fixed income and equities, depending on outlook, and to leave an exposure to converts unchanged.

However, it is important to note that in general, convert issuers are of a lower credit quality than issuers of straight debt. The risk of default is real and, regardless of the protection offered by the debt floor and the potential upside on conversion, if a company is bankrupted an investor will still lose some or all of their investment. Notwithstanding the hybrid nature of this market, strong credit skills are critically important in order to avoid the pitfalls.

Conversion premiums (ratio of conversion price to current market price of equity) have fallen since early 2009 and investment premiums (difference between price of convertible and theoretical value of bond floor)

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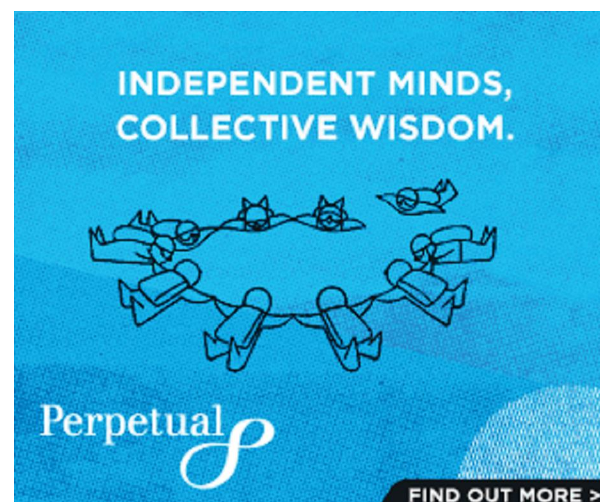

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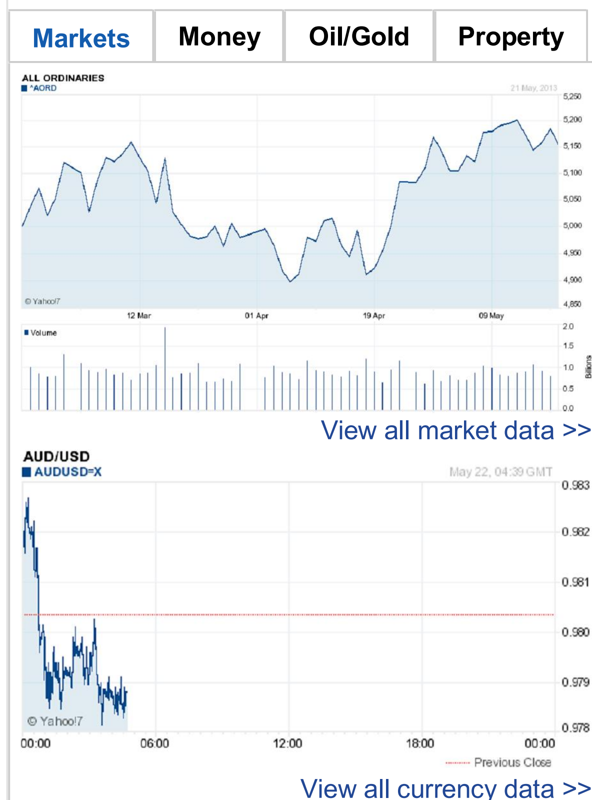

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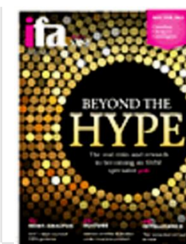
have risen gradually since late 2012. This suggests the market as a whole is behaving more equity-like and the volatility of the asset class could be quite high.

Furthermore, the premiums crossed over in early 2013. Historically, inflection points have foreshadowed premiums diverging for extended periods of time (in this instance, lower conversion premiums relative to investment premiums), suggesting there could be ongoing volatility in the asset class. However, investment managers whose strategies focus on further out-of-the-money entry points and who have a deep understanding of credit and the value of the bond floor may come into their own in these circumstances. A disciplined approach to exiting positions, as individual convertibles become more equity-like, has potential to generate attractive returns above the bond floor, while avoiding the volatility experienced by more traditional approaches of investing closer to at-the-money.

US institutional investors have been rather more prepared to enter or re-enter the market in a significant way than their Australian counterparts. Converts were particularly hard hit by the financial crisis due to the predominance of highly levered convertible arbitrage players, who were forced to reduce leverage in unfavourable circumstances. The clean-out of many highly levered players and the resulting extreme cheapness of these assets (some converts were so unpopular they were trading below their bond floor value – that is, the inbuilt 'option' had a negative value) encouraged more unlevered buyers to enter the market, namely US mutual funds and equity and credit specialists.

A much smaller Australian market, less familiarity with the asset class and some poor outcomes as a result of structural differences in specific domestic issues, may have discouraged local investors from looking more closely at this asset class in the past. However, investors seem more inclined at this stage to seek higher returns where they can find them, as long as the investment thesis is sound. Convertible bonds are an asset class that may warrant further thought.

Joseph Fekete is the managing director of Clearway Capital



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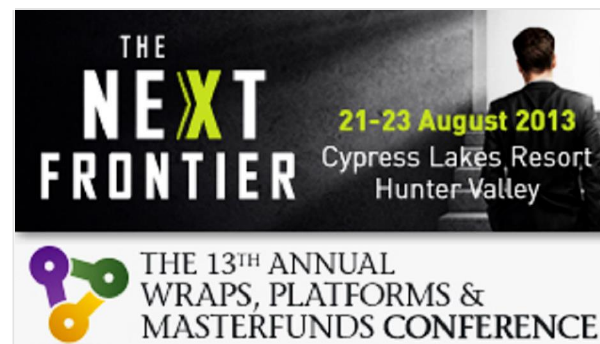

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