Convertible bonds: An income approach yields benefits

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IN BRIEF

Convertibles may provide attractive diversification benefits for both equity and bond investors—but investors aren’t always sure how to use them in a portfolio.

Robin Dunmall talks about the diverse roles that convertibles can play, the appeal of an income-focused strategy and the implications for the asset class if interest rates rise.

WHAT ARE THE MAIN FEATURES OF INVESTING IN CONVERTIBLES?

Convertibles may provide investors with a regular income and participation in equity market returns, combined with downside protection through a fixed income floor. The support of this bond floor means that convertibles typically participate more in equity market gains than they do in falls, giving them the potential to produce attractive returns over a market cycle. This asymmetric return profile also means convertible indices have historically been less volatile than equity indices (Exhibit 1).

EXHIBIT 1: ROLLING 12-MONTH ANNUALISED VOLATILITY

Convertibles have historically been less volatile than equities.

Source: Rolling 12m annualised volatility, Thomson Reuters Global Convertible Index vs. MSCI World, Jan 1994 – June 2016. The performance is not guaranteed and the price and income from the instruments can fall as well as rise.

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Income-oriented convertibles strategies have different drivers of return from traditional balanced strategies

EXHIBIT 2: DRIVERS OF RETURN IN BALANCED AND INCOME-FOCUSED CONVERTIBLE STRATEGIES

WHAT’S DIFFERENT ABOUT YOUR APPROACH?

Most convertibles funds are open-ended, so liquidity is important. As a result, these funds tend to focus on convertibles issued by mid and large cap companies, usually with a “balanced” profile meaning performance is principally driven by equity characteristics, while the fixed income floor limits the downside exposure. These strategies can offer defensive participation in equity upside, but because coupons tend to be low they may struggle to deliver returns in a weak equity environment.

Our closed-ended structure allows us to take a different approach (Exhibit 2). We pursue an income-oriented strategy by focusing on two parts of the convertibles market: convertibles issued by small and mid cap companies that pay higher coupons and convertibles that have lost their equity sensitivity and become more bond-like. This diversification of return streams can lead to lower volatility, and the greater emphasis on the coupon as a source of return means we are less reliant on the performance of equity markets.

HOW DO CONVERTIBLES FIT IN A PORTFOLIO?

Investors who build portfolios by asset class “bucket” are sometimes unsure where convertibles fit—and understandably so, given their mix of equity-, bond- and derivative-like characteristics. Depending on the type of strategy, convertibles can play different roles in a portfolio.

Traditional balanced convertible funds sit more naturally in the equity bucket, perhaps for investors who want to derisk while maintaining exposure to equity upside potential. In contrast, a strategy like ours, which focuses on the bond-like part of the convertible market, might be attractive for investors who want to diversify their exposure to fixed income factors while introducing some limited exposure to equity factors.
HOW IMPORTANT ARE INTEREST RATES?

In part due to their short maturities—typically three to five years—convertibles are driven much more by equity and credit factors than they are by interest rates (Exhibit 3). That’s not to say interest rate rises never matter, but what’s important is the rationale for the increase. A stagflationary environment that forced rates higher could be bad news, but if the economy is improving, the positive equity and credit backdrop can offset any theoretical negative impact from an increase in interest rates.

Convertibles are typically less sensitive than traditional bonds to interest rates

DOES THAT MEAN YOU’RE NOT WORRIED ABOUT THE FEDERAL RESERVE?

Anything that investors perceive as a policy error could have a negative effect on equity markets—and therefore on convertibles—in the short term. Ultimately, though, a US economy that’s strong enough to allow the Fed to raise interest rates should be good news.

History also suggests that rising rates will be positive for the opportunity set. When rates increase, coupons on all newly issued debt—including convertibles—will need to go higher, but issuers can get away with lower coupons on convertibles than on straight bonds, making convertible issuance more appealing.

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EXHIBIT 3: PERFORMANCE OF BOND-LIKE CONVERTIBLES DURING US “TAPER TANTRUM”

Source: Barclays, data as at 30 June 2016.
INVESTMENT INSIGHTS

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