Investing in a hybrid asset class: Why insurers should consider allocating to convertible bonds

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IN BRIEF

- More insurers are considering adding convertible bonds to their balance sheet, as a way to gain exposure to equities in a capital efficient manner.
- The recent volatility in markets led to a dramatic cheapening of the asset class, typically only witnessed during periods of market dislocation.
- However, our analysis shows that an investment in convertible bonds can offer a significant return pick-up without adding risk to the balance sheet.

THE BENEFITS OF CONVERTIBLE BONDS

In simple terms, convertible bonds may be considered as a hybrid of corporate bonds and equities – benefiting from the features of both asset classes. As such, convertibles offer a return pick-up compared to corporate bonds through their sensitivity to equities, while they have a low capital requirement compared to traditional equity investments.

Although insurers are increasingly looking to gain exposure to convertible bonds, the asset class does not yet represent a large share of the typical insurance balance sheet. However, from an asset liability management (ALM) point of view, convertibles can help provide insurers with exposure to equities in a capital efficient manner.

ADDING CONVERTIBLE BONDS TO A STRATEGIC ASSET ALLOCATION

I. Risk/return trade-off

To highlight the benefit of investing in the asset class, Exhibit 1 plots the incremental changes in expected return, surplus volatility and the market risk capital requirement arising from reallocating 0.5% to 2.5% of an existing investment into one of the broad asset classes in the investment universe. The intersection of the y axis and x axis represents a typical life insurance portfolio.

From a surplus volatility point of view, assets in the top left quadrant would help diversify the portfolio (reducing surplus volatility) and increase expected return. We can see that convertible bonds would offer a significant pick-up in return without adding risk to the insurance balance sheet.

From a market risk solvency capital requirement (SCR) perspective, most asset classes sit on the right hand side of the chart and therefore cause an increase in SCR. However, the allocation to convertible bonds is more efficient than allocating to developed and emerging market equities.

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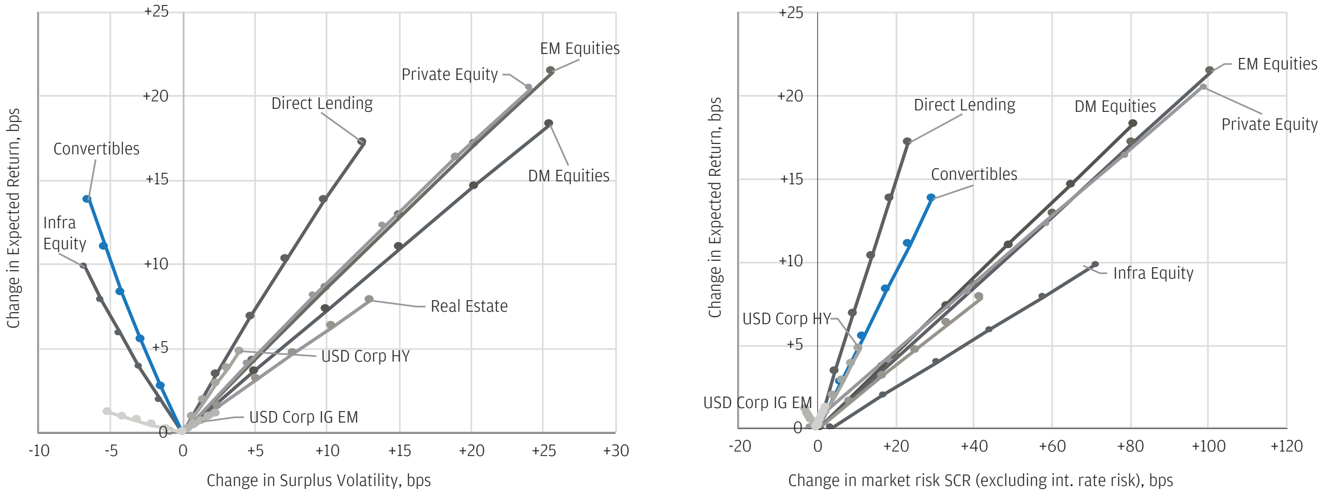
EXHIBIT 1: ADDING CONVERTIBLES TO AN INSURANCE PORTFOLIO



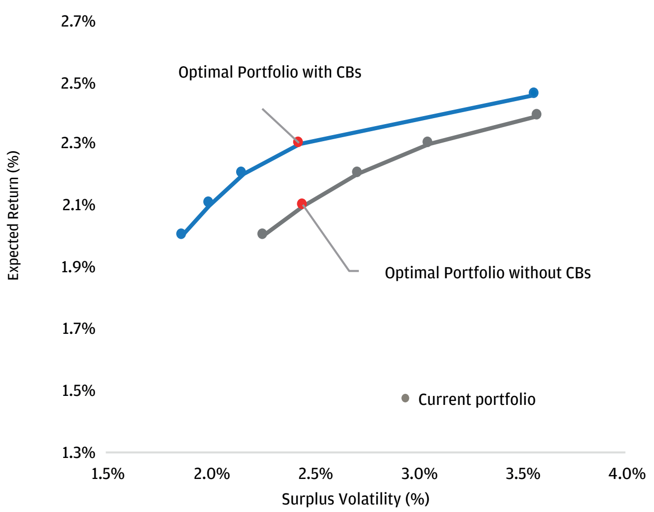
Source: Bloomberg as at 31/05/2020; J.P. Morgan Asset Management (JPMAM) analysis. Expected returns for fixed income indices are based on current market yields, adjusted for historical average default losses and for FX hedging costs. Expected returns for non-fixed assets are based on JPMAM 2020 Long-Term Capital Markets assumptions. Covariances are based on historical returns analysis. These are estimates and are not guaranteed. DM – Developed Market; EM – Emerging Market; IG – Investment Grade; HY – High Yield; HC – Hard Currency (e.g. USD, EUR); SCR – solvency capital requirement

II. Strategic asset allocation results

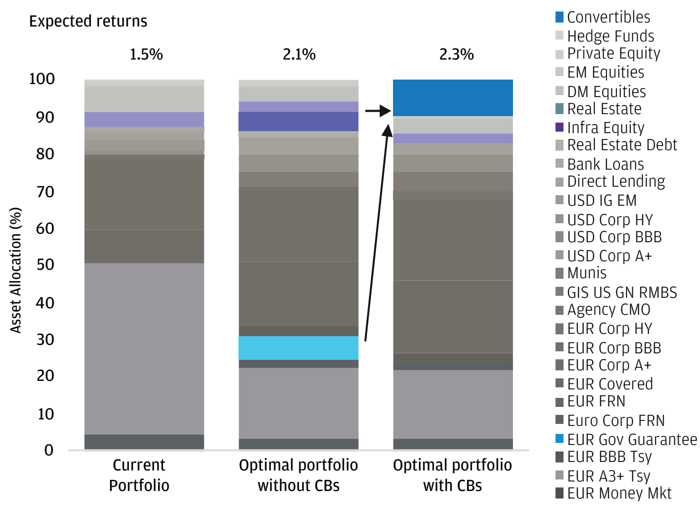
To support our analysis, we conducted an asset allocation optimisation exercise that seeks to minimise surplus volatility for varying levels of expected return. We considered two scenarios – one with and one without convertible bonds – and plotted the two efficient frontiers in Exhibit 2. For an equivalent level of surplus volatility, adding convertible bonds to the asset allocation generates an additional 20 basis points of expected return. The allocation to convertible bonds is funded mainly from European government guaranteed bonds, developed market equities and infrastructure equity.

EXHIBIT 2: ASSET ALLOCATION SCENARIOS

Efficient frontier – CBs increases the expected return by 20bps



Strategic asset allocation and expected returns



Source: J.P. Morgan Asset Management analysis as at 31 May 2020. Forecasts are not a reliable indicator of future performance.

CONVERTIBLE BONDS AND THE SCR SPECTRUM

Convertible bonds offer a spectrum of market risk SCR characteristics for investors. We have created our in-house market risk SCR calculation methodology, which in our view adequately reflects the capital requirements for a range of convertible bond strategies. We offer three open-ended convertible bond strategies and manage additional segregated portfolios for insurance clients across the spectrum.

EXHIBIT 3: SCR CALCULATION METHODOLOGY

Model Portfolio's	JPM Global Opportunistic Convertible Income Fund	JPM Global Convertibles Conservative Fund	JPM Global Convertibles Fund	Refinitiv Global Focus Index
Market Risk SCR	17.4	20.1	26.7	23.5
Price	97.6	121.1	168.2	119.4
Equity Sensitivity	26.0	43.7	69.4	47.1
Portfolio yield	3.6[1]	0.8[2]	-0.4[3]	0.6[4]
Gamma	0.29	0.54	0.44	0.59
Rho (Years)	-2.2	-3.1	-1.0	-1.8
Average Rating	BB+	BBB-	BBB-	BB+
Number of positions	30 to 40	60 to 80	70 to 90	210 to 220

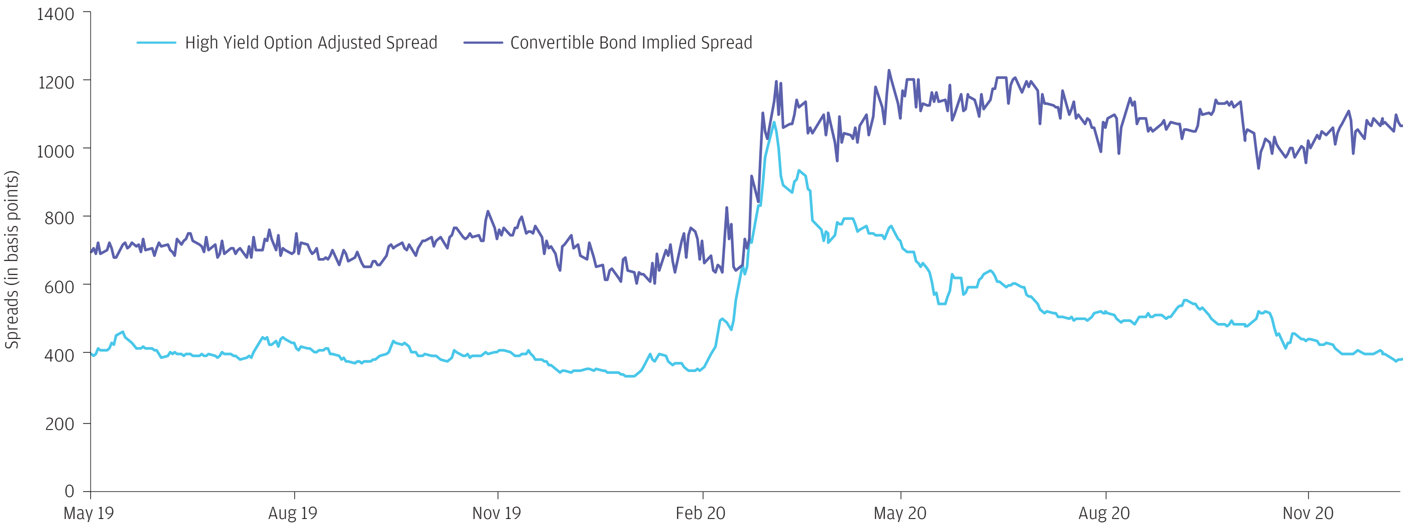
Source: J.P. Morgan Asset Management as at 31 December 2020. The portfolios are actively managed. Holdings, sector weights, allocations and leverage, as applicable, are subject to change at the discretion of the Investment Manager without notice. [1] Portfolio yield is the yield to best (YTB) in local currency (CB equivalent of YTM) and excludes cash. The YTB for the EUR hedged version is 3.7%. [2] A (dist) annualised. [3] A (dist) EUR annualised. [4] YTB (positive) shown in local currency. Yield is not guaranteed and may change over time.

WHY INVEST IN CONVERTIBLE BONDS NOW?

The volatility in markets since the COVID-19 outbreak led to a cheapening of the asset class, marking an attractive entry level. We believe this valuation opportunity and a resurgence in primary market issuance has created opportunities for both balanced and income-focused opportunistic strategies.

While markets rebounded strongly since the initial correction in the first quarter of 2020, volatility and implied credit spreads remain high.

EXHIBIT 4: CONVERTIBLE BOND IMPLIED SPREAD VERSUS HIGH YIELD OPTION-ADJUSTED SPREADS



Source: J.P. Morgan Asset Management, BofA Global Research, Ice Data Indices, LLC. Data as at 31 December 2020. Convertible bond implied spread shown for ICE BofA US Convertible Index (Bloomberg ticker - VXA0) and high yield option adjusted spread using ICE BofA US High Yield Index (Bloomberg ticker - H0A0).

We believe the market currently provides attractive valuations and still offers a good entry point into the asset class, especially in comparison to straight bonds where credit spreads have already largely retracted to pre-crisis levels. There are three factors that explain why convertible bond spreads have stayed at elevated levels:

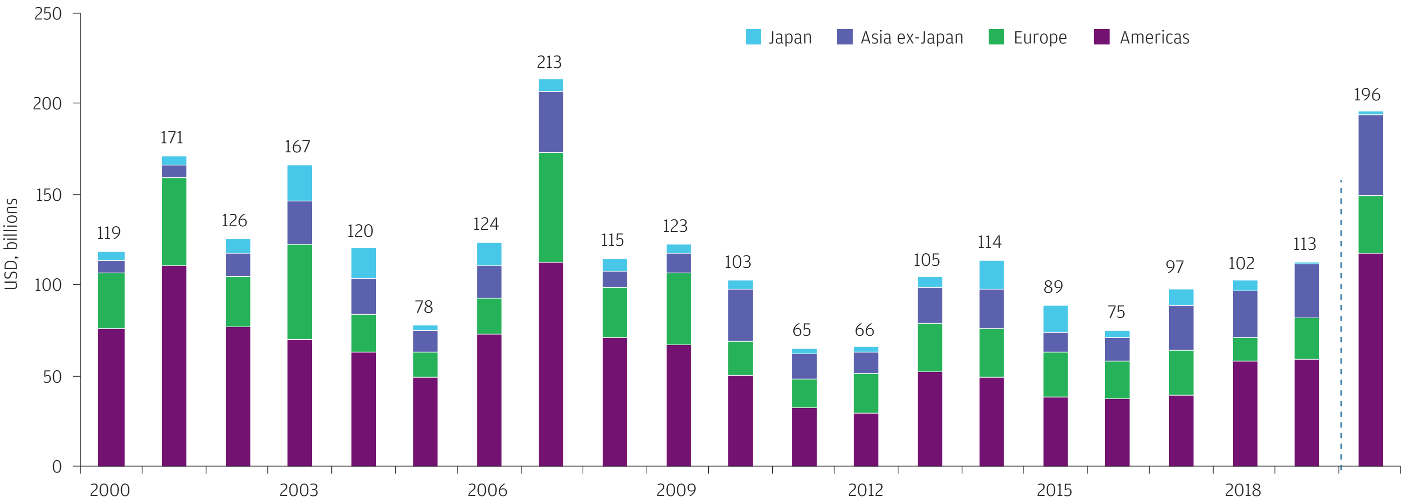
- Central banks are targeting government bonds and credit with their quantitative easing programmes, not convertible bonds;
- Investors have fewer opportunities to exploit market dislocations via tactical asset allocation in the convertible market given the limited offering of passive investment vehicles (exchange-traded funds);
- Record new issuance has suppressed prices in the convertible bond secondary market.

OPPORTUNITIES PROVIDED BY NEW ISSUANCE

2020 convertible bond new issuance is the strongest since the global financial crisis. This strong supply provides the opportunity to build exposure to quality companies trading at a significant discount to their intrinsic value that need to strengthen their balance sheet through new issuance.

New convertible bond issues can represent an attractive opportunity for investors, since convertible issuance simultaneously strengthens the issuer's balance sheet while creating a catalyst for its share price to re-rate. Issuers will also find convertibles an attractive financing tool since convertibles can provide lower coupon costs than straight debt by selling the right to convert the bond into shares, effectively offering investors access to potential equity upside.

EXHIBIT 5: TOTAL CONVERTIBLE ISSUANCE (USD)



Source: J.P. Morgan Asset Management. Data as at 31 December 2020. Note: Data is not annualized.

NEXT STEPS

For more information, contact your J.P. Morgan Asset Management representative.

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