A Rough Guide to:

Convertible Bonds

They have performed exceptionally well in recent years

For a convertible bond to be successful it is important that the correct manager is appointed

Unlike a regular bond, there is potential for capital gain

by: Charlotte Moore

Convertible bonds are not a mainstream asset class. But pension funds might be missing an opportunity as these hybrid bonds can provide equity like returns with much lower volatility.

This asset class has performed exceptionally well in recent years. The Bank of America Merrill Lynch All Convertibles All Qualities Index has risen by 81.8% since the end of August 2008, when the financial crisis broke. Year to date it has ratcheted up returns of 10.3%.

This article takes a closer look at convertible bonds and whether they are a suitable asset class for pension funds.

WHAT IS A CONVERTIBLE BOND?

A convertible is a hybrid instrument that contains both fixed income and equity elements. When a company issues a convertible, it is in the form of a bond – it usually promises to pay the investor an annual coupon and it can be redeemed at the value it was issued on maturity.

Ben Helm, investment manager at GAM, says: "Convertible bonds usually have the same seniority as senior unsubordinated debt. That means the investor can be confident they will be paid back their capital investment on the redemption of the debt."

A convertible is different from a standard corporate bond, however, as this debt can be converted into equity.

Helm says: "Within the structure of the convertible bond, there is a clear understanding of how, when and at what level the bond can be converted into equity."

WHY DO COMPANIES ISSUE CONVERTIBLES?

The main reason why a company might want to issue a convertible bond rather than another form of debt is that it comes with a lower financing cost – the coupons are lower than they would be on standard corporate bonds since there is the additional option of conversion to equity.

Helm says: "The convertible contains an embedded option which has an intrinsic value within the bond structure and compensates the investor for the lower coupon payments."

WHY WOULD AN INVESTOR BUY A CONVERTIBLE?

As convertibles pay lower coupons than other forms of bonds, it only makes sense for the investor to buy the convertible if they believe the equity option will provide additional compensation.

Eli Pars, senior vice president and co-portfolio manager on the growth/ fixed income team at Calamos, says: "Unlike a bond where the investor will simply receive back the value they invested, the investor receives an additional return from the embedded option as the share price rises."

Alex McKnight, investment manager at GAM, adds: "An investor hopes that the share price of the company will rise over the life of the convertible bond, this means they will switch into equity at a much higher price than if they had bought the equity at the outset."

WHY SHOULD PENSION FUNDS INVEST IN CONVERTIBLES?

For pension funds, the asymmetric characteristic of the return profile of a convertible make this asset class an appealing investment option.

Effectively the bond portion of a convertible gives the investor protection from the value of the share price falling.

Unlike a bond however, there is also the potential for capital gain. "If the share price goes higher than the strike price, they will get additional equity returns," says Pars.

With most schemes in deficit, yet with a constrained risk budget, convertibles can be a very useful addition to an investment strategy, adds Pars.

IS NOW A GOOD TIME TO INVEST IN CONVERTIBLES?

The current environment should be favourable for convertibles: while the outlook for the fixed income markets is not that favourable, equities are performing well.

John Belgrove, senior partner at Aon Hewitt, says: "If equity valuations continue to rise despite the expected increase in interest rates, then it is reasonable to assume that convertibles should perform well."

"On a risk-adjusted basis, returns have been strong relative to equities but they have not been as high as high yield," says Belgrove.

HOW DO YOU SELECT A CONVERTIBLE MANAGER?

Convertible managers need to be able to combine the skills of both bond and equity investors. Pars says: "It's important to assess the credit worthiness of the company issuing the convertible."

But it's also important to approach each issue with the mindset of an equity analyst. Marc Basselier, senior portfolio manager of the AXA WF Framlington global convertibles fund, says: "Understanding the equity portion of a convertible is much more labour-intensive."

WHAT ARE THE DISADVANTAGES OF INVESTING IN CONVERTIBLES?

The convertible market is that much smaller than the more conventional corporate bond market. Belgrove says: "The convertible bond market has a total value of $400bn, which is a tiny proportion of the $15trn standard corporate bond market."

The size of the market makes it difficult for large institutional investors to allocate a significant proportion of their assets to this market, he adds.

Liquidity constraints can also exacerbate pricing moves. Belgrove says: "It does not take significant changes in the balance of supply and demand to make the market either very cheap or very expensive."

Investors should also consider that convertibles have already performed very well over the last ten years.

But this does not mean that pension schemes should eschew convertibles altogether.

Belgrove says: "If a scheme has found a manager which can use convertibles effectively, then it should allow them the freedom to invest in this market to make additional returns."

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