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Synthetic convertible ETF aims at Magnificent Seven bond problem

Despite their outsized influence, megacap US companies cannot be accessed by traditional convertible bond investors

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The world's largest convertible bond manager has unveiled a "synthetic convertibles" exchange traded fund to spread the concept to companies that are so cash-rich they do not need to issue real bonds.

Last year saw a boom in convertibles — a type of bond that can be swapped for shares if a company's stock price hits a pre-agreed level — with issuance jumping 77 per cent to $48bn, according to LSEG.

The rebound, driven by rising interest rates as convertibles pay a lower coupon than mainstream bonds, has pulled in more established companies to augment the younger technology and biotech groups that have traditionally dominated issuance.

However, cash-rich companies such as the Magnificent Seven stocks that have an outsized influence in global equity markets do not issue such debt, leaving them out of bounds to convertible bond strategies.

Just 12 Nasdaq 100 companies currently issue convertible bonds, and none of the top 25 by market capitalisation, according to data from Illinois-based Calamos Investments, a $35.5bn house which manages $11bn in convertible assets.

It has now joined a smattering of rival managers in attempting to get around this by constructing synthetic convertible-like strategies that can be applied to every company.

Its Alternative Nasdaq & Bond ETF (CANQ) will buy call options on many of the largest Nasdaq 100 stocks, as well as on QQQE — the equal-weighted version of the index.

"We want to create $100 of equity exposure [for $100 of investment]," said Shaheen Iqbal, head of quantitative investments and co-head of risk at Calamos, which can be achieved as a result of the leverage inherent in options.

However, the overwhelming bulk of the assets will be invested in an actively managed portfolio of bonds, much of it in relatively high-yielding bank loans, high-yield bonds and emerging markets debt, to provide income.

Calamos said CANQ "was inspired by firm founder John Calamos's idea of creating a strategy similar to synthetic convertibles", with the asset mix "aim[ing] to damp volatility and drawdowns while accessing the growth potential of American innovation and attractive income distributions".

Matt Kaufman, head of ETFs at Calamos, said "the converts market is not a massive space, but the idea of delivering risk management that's similar to a convertible — I think a lot of people can get behind that".

Matt Freund, co-CIO, added "the advantage that CANQ offers is that it gives you exposure to the most dynamic companies in the Nasdaq. These companies have such strong balance sheets and have so much free cash flow that they don't need to issue [convertible bonds].

"John Calamos, years ago, had the idea that we could create converts on the companies that we liked without being tied to the issuance that they may or may not do," he added.

The vehicle has similarities to the $408mn Aptus Defined Risk ETF (DRSK), which launched in 2018. DRSK invests 90-95 per cent of its assets in investment-grade corporate bonds, with the balance used to buy call options on large-cap stocks and sectors in the S&P 500.

Likewise, the $174mn Amplify BlackSwan Growth & Treasury Core ETF (SWAN), which launched the same year, invests 90 per cent of its assets in Treasuries, with the remainder in S&P 500 call options, "seek[ing] uncapped exposure to the S&P 500, while buffering against the possibility of significant losses".

Todd Rosenbluth, head of research at VettaFi, a consultancy, said the "success of covered call ETFs from JPMorgan and others has opened up the door for asset managers to bring other relatively sophisticated options-based strategies into the ETF world," referring to the likes of the wildly popular $31.9bn JPMorgan Equity Premium Income ETF (JEPI), which sell, rather than buy, call options. "These products solve a problem. You want to get income and risk mitigation yet still need exposure to the mega cap growth stocks that have been leading the market higher," he added.

Rosenbluth said "the goal" of convertible bonds was to create "a lower risk, higher income way of accessing the equity market", and that CANQ offered a "creative . . . deconstructed way to get exposure to companies that are not offering bonds".

The success of such ETFs, he said, "will come down to can Calamos and the others educate the public to the merits of the strategies — compared to owning the Nasdaq outright and through a covered call strategy?"

Bryan Armour, director of passive strategies research, North America at Morningstar, believed it was accurate to label what CANQ has created as synthetic convertibles "to an extent".

However Armour said a purer synthetic convertibles strategy would involve more overlap between the bond and equity exposures, while "the use of calls on an equal-weighted [index] muddies the strategy further".

Looking at the bigger picture, Kaufman argued that CANQ was an example of an ETF that met the need for investors to position for a "new risk regime", now that global interest rates have normalised.

The likes of JEPI "were built for a time when rates were very low or zero. They used the equity markets to get income that you couldn't get from fixed income. Now that rates are off zero, it makes sense to use fixed income again for risk management and income," he added. "This [approach used by CANQ] does not cap your upside."

However, Armour said that, while bond yields were becoming more competitive with the level of income from covered calls, call option prices increase as interest rates increase.

"That means CANQ pays a higher price for its long call positions than it would have a year or two ago, all else equal, which can potentially eat away at the strategy's profitability," Armour said. "That doesn't make their statement untrue, but it's a consideration worth raising for investors."