Seeking Stability in Volatility

The Case for Global Convertibles

Today’s investor, faced with minimal fixed income returns, late-stage equity valuations, and the prospect of growing market volatility, may have somewhere to turn: convertible bonds. “Converts,” corporate bonds issued with a call option that gives the holder the right to convert the bond to equity shares, bring together equity and fixed income properties in a unique combination. The call option can give fixed income investors access to alternative sources of return in markets where returns of any sort are increasingly hard to come by. For stock investors, the bond component is designed to act as a floor underneath equity risk as markets become more volatile. For multi-asset investors, converts can extend a portfolio’s efficient frontier, adding bond-like stability to an equity tilt and stock-like potential to a fixed income tilt. And because of the idiosyncratic nature of the convertible universe, they can act as a diversifier across a range of portfolios.
Hoarding Capital

Convertible bonds originated in the US railroad boom of the 19th century. Entrepreneurs, eager to preserve capital to invest in laying down track, issued the hybrid instruments as a way to save on interest expense and avoid depleting their balance sheets when principal repayment came due. That fundamental objective, conserving liquidity, hasn’t changed. Small- and mid-cap companies seeking to finance their expansions dominate convert issuance (Exhibit 1).

If husbanding capital sums up convert issuers’ overriding objective, then converting the bond’s call option into equity shares describes their ulterior motive. Indeed, many issuers expect the exercise of the call option. Aside from achieving issuers’ capital and liquidity objectives by repaying bondholders in shares instead of cash, conversion into shares deepens the market for their equity. This mindset contrasts to the frequent circumstance in conventional bonds, where bondholder concern for protection of principal can collide with issuer plans for growth.

Unrated but Not Unworthy

The outsize proportion of small- and mid-cap issuance, untested in the credit markets, inevitably means much convert issuance doesn’t meet the exacting standards of an investment grade rating. In fact, well over half the issuers forgo an agency rating altogether to save on the expense of obtaining one (Exhibit 2).

On the other hand, convert issuers typically do not carry any other form of unsecured debt on their books. According to a November 2019 Bloomberg review, better than four out of five outstanding converts rank as senior unsecured debt, falling in right behind secured loans on the corporate capital stack. What’s more, since many convert issuers refrain from issuing other forms of debt, they tend to have cleaner balance sheets than high yield and even investment grade issuers, as measured by risk ratios like free cash flow to debt and debt to earnings before interest, taxes, depreciation, and amortization.

Regional Flavors

The geography of convertible issuance and the character of convertible issuers have shifted over the years. Today the lion’s share of activity—better than 60%—takes place in dollars in the United States (Exhibit 3). The proceeds go largely to fund companies in the most dynamic sectors of the economy: information technology, biotechnology, and telecommunications. Asia accounts for another 17% of the market. China has recently displaced Japan as the regional leader, and most of the region’s issuance, as in the United States, comes out of the more dynamic economic sectors from companies whose ADRs list on US markets.

Europe makes up the rest of the market, with an emphasis on consumer discretionary and industrial issuers. With prevailing euro zone credit yields treading perilously close to zero, and in some cases even below, European issuers have resorted to convertibles to entice fixed income investors with the opportunity for enhanced returns. European credit quality thus tilts more heavily toward investment grade than in the US and Asia.

Exhibit 1
Small Caps, Large Plans
Nearly two-thirds of convert issuers are “smid” caps ...

<table>
<thead>
<tr>
<th>Market Cap</th>
<th>Category</th>
<th>Percentage of Universe (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$100bn</td>
<td>Mega Cap</td>
<td>5</td>
</tr>
<tr>
<td>&gt;$15bn</td>
<td>Large Cap</td>
<td>29</td>
</tr>
<tr>
<td>&gt;$1bn</td>
<td>Mid Cap</td>
<td>46</td>
</tr>
<tr>
<td>&lt;$1bn</td>
<td>Small Cap</td>
<td>20</td>
</tr>
</tbody>
</table>

As of 30 November 2019
Source: Bloomberg, Jeffries

Exhibit 2
You Can’t Always Count on High Grades
... and most convert issuers are not rated at all

<table>
<thead>
<tr>
<th></th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Grade</td>
<td>23%</td>
</tr>
<tr>
<td>High Yield</td>
<td>20%</td>
</tr>
<tr>
<td>NR</td>
<td>57%</td>
</tr>
</tbody>
</table>

As of 31 October 2019
Source: Lazard, Bloomberg, Deutsche Bank

Exhibit 3
Around the Convertible World
Percentage of issuance by region

<table>
<thead>
<tr>
<th>Region</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>6.3%</td>
</tr>
<tr>
<td>Asia ex-Japan</td>
<td>9.7%</td>
</tr>
<tr>
<td>Europe</td>
<td>20.6%</td>
</tr>
<tr>
<td>US</td>
<td>63.5%</td>
</tr>
</tbody>
</table>

As of 30 November 2019
Source: BofA Merrill Lynch Global Research
An Asymmetric Advantage

In sum and as distinguished from every other investment, the structure of convertible bonds favors investors, in our view. Converts are in their primary incarnation bonds. Investors have contracted to get their principal back when the bonds mature. The bond-like contract places a floor underneath the convertible comparable to the principal value of a corresponding “plain vanilla” bond—the same bond, in other words, without the embedded call option. At this bond floor the convert runs the same risks as any corporate bond: liquidity in distressed circumstances and issuer insolvency at the extreme. Unlike a conventional bond, however, the convert has upside potential built in, in the form of the call option. If the issuer’s equity makes out well, convert holders can realize a greater return on their principal than they would have received in coupon payments alone.

The combination of the bond floor and the equity option can create an asymmetric return pattern. The potential for gain exceeds the potential risk of loss because of a differentiated payoff when the bond’s return profile falls in what we call the “mixed zone.” The graph of the convertible’s return illustrates this asymmetry. The line of the bond’s payoff balloons out and assumes its characteristic and uniquely convex shape as the price of the equity rises. The value of the convert flattens out at the lower bound of the equity price, the bond floor, and it should respond like a conventional bond. As the price of the underlying equity rises, taking the price of the option along with it, the value of the convertible itself rises. When the value of the shares embedded in the option catches up to the par value of the bond, the convertible has reached breakeven, or parity. Above and beyond parity generally lies profit; the convertible grows steadily more equity-like as it approaches the option’s strike price. The more convex the shape of a convertible’s curve—the faster it climbs off the bond floor toward parity and beyond—the more it resembles an equity investment (Exhibit 4).

The mixed zone, where a convertible manifests its dual qualities, defines its sweet spot. Below the mixed zone, along the bond floor, the call option has little value. Above the zone, the bond becomes less convex and more risky as the compensating protection afforded by the bond floor loses its value. A convert’s delta tracks the rate of change in its price relative to the price of the associated equity. As a general rule, the area between a delta of 20%, where the price appreciates at one-fifth the rate of the stock price, and a delta of 65% marks out what we define as the convertible mixed zone. Below 20% the convert behaves like a conventional bond; above 65%, more like the underlying stock. The most favorable position for the convertible investor lies in the 20% to 65% mixed zone, where the bond floor is near and convexity is highest.

Finding Value in Volatility

The properties of convertibles make them one of the few investments capable of thriving in volatile markets. The dual nature of the investment gives them an advantage over conventional investments. They typically have short durations compared to other fixed income asset classes, which makes them relatively less sensitive to changing interest rates—issuers, as a rule, seek to cap their call exposure by issuing converts with short maturities. Rising rates, which undermine bond markets, usually accompany rising equity markets, which tend to lift the value of call options. So the short duration supports the bond floor, while the call option affords an opportunity to participate in the upside. And just as greater convexity may generate more gain on the way up, it can deliver bond floor protection more swiftly on the way down.

Convertibles’ ability to withstand and even to profit from volatility has historically served long-term investors well. From the global financial crisis through the long subsequent recovery in US stocks, the convertible index held up better through the crash and kept...
pace in the rally. Convertibles’ resiliency enabled them to realize equity-like returns over the long run with fewer and shallower potholes along the way. (Exhibit 5).

Their diversifying qualities and the presence of upside equity potential with a fixed income cushion make converts a prudent allocation in a strategic portfolio. For those investors concerned that geopolitical uncertainties are mounting and the global economy may be slowing, now would seem to be an especially opportune moment for converts, in our view. We believe the prospect of volatility’s imminent return to the market creates a problem ripe for the convertible solution. At the same time, we believe convertibles are an asset class that demand active management in order to realize converts’ full investment potential.

A Second Convertible Asymmetry—the Information Gap

Plotting the long-term course of the convertible index against the standard global equity index demonstrates that a sound convertible allocation can fortify a strategic portfolio in good markets and bad. The challenge comes in identifying the right vehicles in a predominantly unrated and high yield corner of the investment universe. The challenge confers a large advantage on knowledgeable investors and active managers. It calls for weighing two sets of fundamentals simultaneously: a convertible’s growth prospects as an equity and its defensive qualities as a fixed income credit, plus how the idiosyncratic clauses in every convertible bond might affect both. And it requires judgment that can place all this analysis in the context of convexity—how sensitive is the delta and how reliable the bond floor? The ratings agencies can’t offer guidance for the majority of the market in that regard, and the issuer’s capital structure may call for a nuanced view of the risk.

The Lazard Global Convertible team’s investment philosophy, refined over two decades of market experience, recognizes the primary importance of active management in this asset class. A high active share, above 75%, and high conviction are its hallmarks. The approach filters the 900 or so names in the convertible universe down to the 60 to 75 that it believes exhibit the greatest convexity, compared to 200 in the standard convertible index, the Thomson Reuters Global Convertible Focus—USD unhedged.

While the team makes broad top-down tactical adjustments to accommodate macroeconomic shifts and maintain adequate diversification within the portfolio, it relies primarily on exhaustive fundamental analysis. That analysis covers a direct assessment of each issuer’s creditworthiness; the characteristics of the convertible’s bond component, such as duration; the relative valuation of its equity component; its ESG positioning; and, not least, the potential impact on returns of the clauses in its prospectus. We believe the Lazard strategy with its heavy fundamental emphasis can continue to deliver the intended benefits of the convertible bond asset class to a fully diversified strategic portfolio.
transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond’s maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and pre-payment risk, also apply. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one’s home market. The values of these securities may be affected by changes in currency rates, application of a country’s specific tax laws, changes in government administration, and economic and monetary policy. Derivatives contracts, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps significantly. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

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