Global Asset Management

Convertible bonds: positioning for a recovery without timing it

Pierre-Henri de Monts de Savasse
Senior Portfolio Manager

Zain Jaffer
Portfolio Manager

Marketing Communication

Published August 2022

- Global convertible bonds have been in the eye of the storm during the recent correction. The asset class has failed to provide investors with the downside protection they were expecting.
- We believe that this phase of underperformance has presented a valuation opportunity. Convertible bonds have cheapened to levels that historically corresponded to buy signals.
- In previous bear markets, convertibles showed similar behaviour: they corrected in line with equities in a first phase before generating solid outperformance afterwards. We expect the current bear market to be no exception.
- The challenge for investors is to time the end of the current correction in risk assets. We see investing in convertibles as a way to position for a bounce without timing it. Convertible bonds tend to perform well in the early stages of a recovery. However, if volatility were to persist for a longer period, convertible bonds are a lower-volatility asset class with good credit quality, which should help to preserve capital.

What happened? A sharper correction than competing asset classes brings a valuation opportunity

Since the beginning of 2020: better than bonds, behind equities

2020 saw the Covid crisis and the ensuing, unprecedently large monetary and fiscal stimulus. Stimulus is now being withdrawn at a fast pace. We think it is relevant to judge the performance of financial assets over this full liquidity cycle to balance how much upside was captured in the up market of 2020, and how much was lost in the 2022 correction. Global convertibles have outperformed competing fixed income asset classes over the period as they captured a large part of the equity upside of 2020 and subsequently suffered less from rising rates and widening spreads. However, equity markets have largely outperformed convertible bonds (see chart 1).

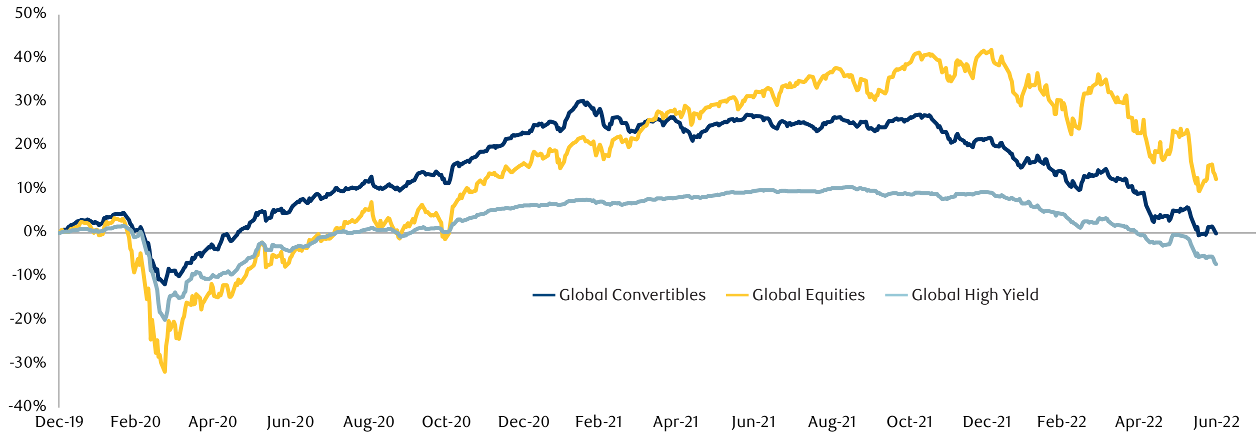
Recent performance was poor, typical of the initial phase of a bear market

The first few months of 2022 saw a large underperformance of the asset class. This was mainly due to the sector bias of the universe towards high-growth, high-equity-multiple sectors. Although this correction was brutal, we found on analysing previous bear markets that this is not unusual (see page 7). It is in the later phases of a bear market that convertibles tend to outperform. We expect to see a similar pattern this time.

Current valuation levels were buy-signals in the past

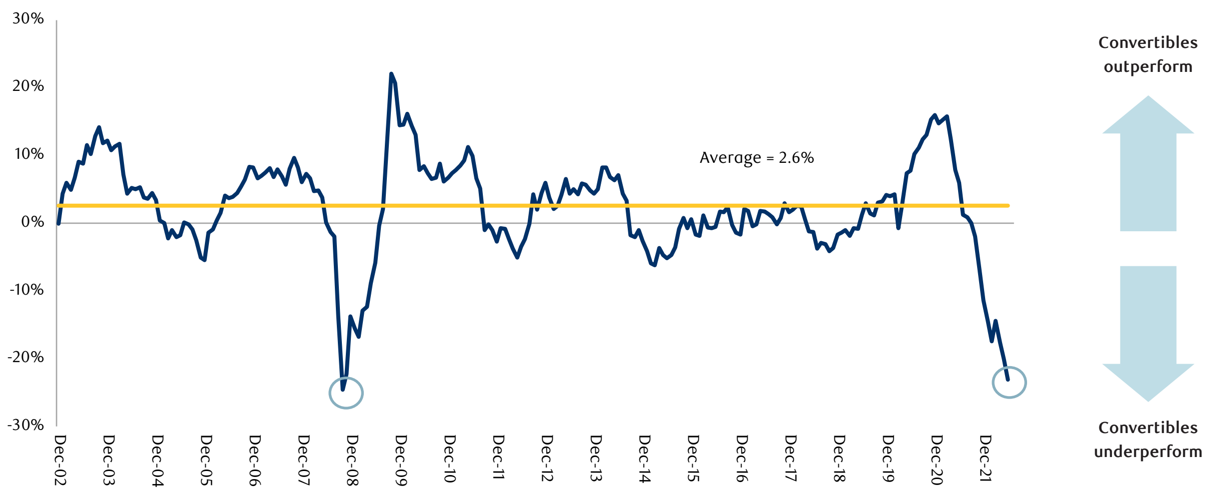
Valuation measures for convertible bonds suggest that the correction is much more advanced than for other asset classes. One measure we favour and that we developed internally is called the “basis” performance. It breaks down the performance of convertible bonds into the equity component and a “basis” effect. Recently, the basis effect was so weak that it reached levels only seen in the Global Financial Crisis in late 2008 (see chart 2). At the time, this indicator offered a reliable buy signal for convertible bond investors that subsequently benefited from solid returns. The valuation of convertible bonds appears much cheaper than many other asset classes that have not reached their historical lows. This gives us comfort that the worst is behind us for convertible bonds and that the coming months should see the relative performance vs. other asset classes improve.

Chart 1: Asset class comparison (total returns in USD)



Source: Bloomberg as at 30 June 2022

Chart 2: Global convertibles – basis performance vs. global equities YoY %



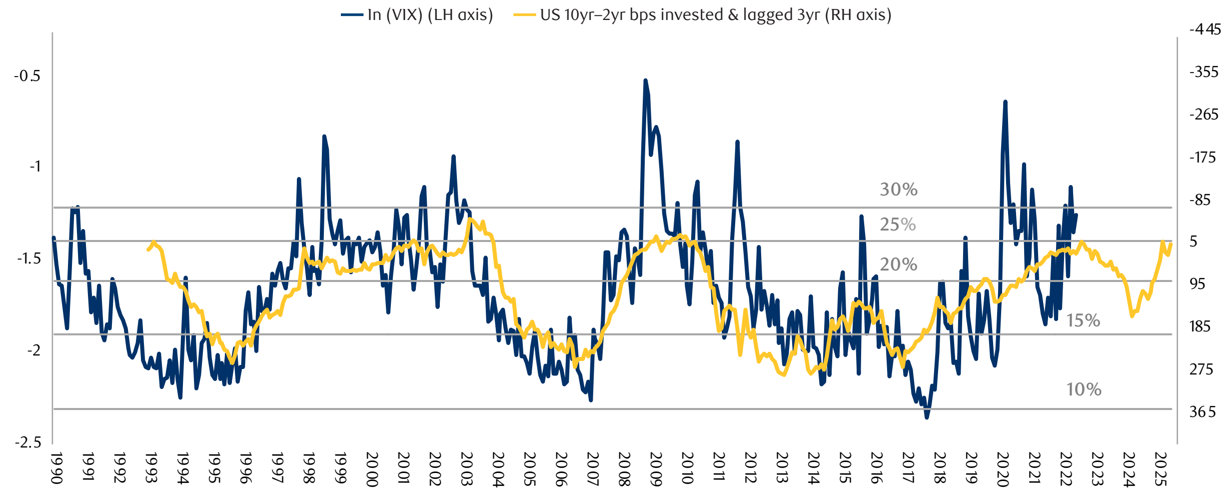
Source: MSCI, Refinitiv, Bloomberg, BlueBay Asset Management. Monthly data as of end of June 2022
Indexes: MSCI World Net Total Return USD Index and Refinitiv Global Focus Convertible Index (USD)
Methodology: we use the monthly share sensitivity estimated for the benchmark index. We calculate the equity component of the convertible performance by multiplying the share sensitivity by the performance of the MSCI world. The “basis” component is the residual.

Key asset class themes for the coming months

Volatility is here to stay: a favourable environment for convertibles

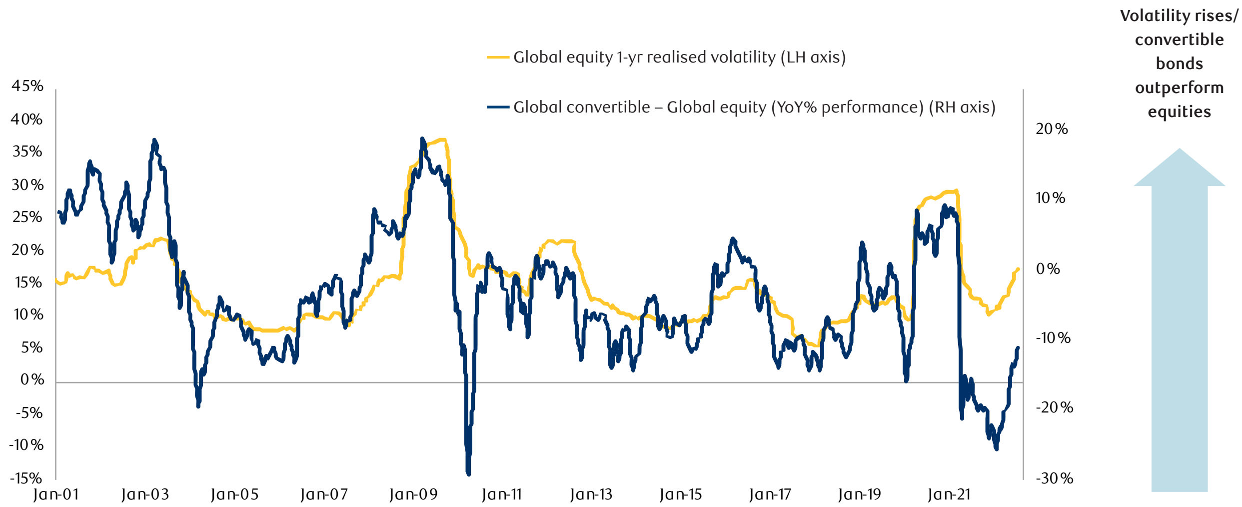
Growth is slowing down and at the same time, major central banks are tightening policies as inflation pressures are proving stickier than expected. This unusual combination is causing the yield curve to flatten. Historically, higher short-term rates and a flat curve have coincided with higher volatility. As a result, over the next few years we expect a volatility regime at higher levels (see chart 3). We expect many market participants to have to review their asset allocations in the face of higher volatility as their risk-tolerance remains unchanged. In that context, convertible bonds appear, in our view, an effective asset allocation tool allowing investors to maintain some equity exposure with a lower volatility. These mechanics explain why, historically, higher volatility has coincided with an outperformance of convertibles (see chart 4).

Chart 3: Long-term history of the VIX and the market cycles



Source: Bloomberg. Monthly data from 31 January 1990 to 30 June 2022
Indices: USYC2Y10 Index and VIX Index
For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue

Chart 4: Relationship between realised equity volatility and the outperformance of convertibles vs. equities



Source: Bloomberg. Monthly data from 1 January 2001 to 18 July 2022
Indices: USYC2Y10 Index and VIX Index
For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

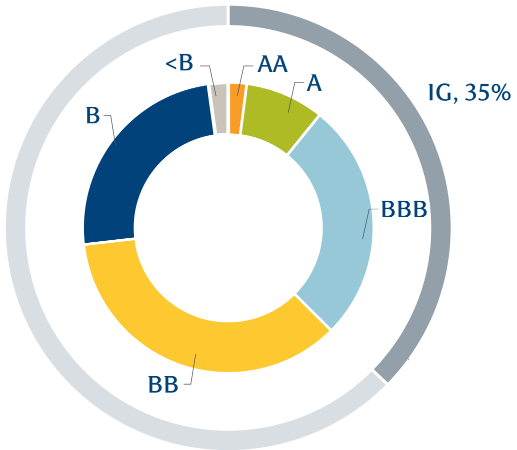
Credit quality will be key in this market phase

Credit quality was not a concern for investors in the time of QE. All instruments with a high carry component performed well and the rate of defaults was kept near record lows as refinancing was so cheap and easy even for the most leveraged of corporates. We expect this to change. Higher rates and wider spreads make refinancing much more expensive for corporates.

Credit metrics are likely to deteriorate in the coming months as the rise in inflation feeds into labour and input costs and weighs on final demand. For this reason, we expect market participants to look for ways to improve the credit quality of their portfolios. Global convertible bonds with 35% of investment-grade issues and 36% of BB issues offer solid credit quality (see chart 5).

We think this is a notable advantage for convertible bond investors: an asset class with a strong credit profile but that retains a high return potential.

Chart 5: Rating breakdown of the global convertible universe



Source: Refinitiv, Bloomberg, BlueBay Asset Management. When instruments are not explicitly rated, we are showing BlueBay's internal ratings. Breakdown is for the Global Focus Convertible Bond index from Refinitiv as at 30 June 2022.

A new investment regime? Duration may not save you this time

There is a firm sense among market participants that the end of QE for major central banks marked a regime change for financial markets. This seems to be supported by the current bear market seen in "60-40" portfolios. It seems that the mix of duration and equity that delivered such positive risk-adjusted returns over the QE period is now struggling to offer attractive performance, or even good diversification benefits. We think that, if confirmed, this new investment regime will be favourable to hybrid asset classes like convertibles (see chart 6). We expect these long-term dynamics to support the asset class in the coming years as asset allocation shifts to a more diversified, hybrid mix.

Chart 6: Synthetic overview of the new investment regime

Macro	▪ Inflation	→ Sticky
	▪ Growth	→ Challenged
Policy	▪ Monetary policy	→ Inflation-orientated, hawkish
Financial Assets	▪ Real returns	→ Low or negative
	▪ Volatility	→ Higher
	▪ Sharpe ratios	→ Lower
	▪ Fixed income	→ Challenging performance OK
	▪ Equities	→ returns/very high volatility

Convertibles = equity exposure with lower volatility

What we are doing and where do we see opportunities?

Asian convertibles: the recent market dislocation has created a rare valuation opportunity

We maintain our positive view on Asian convertible bonds following the recent market dislocation. Asian convertibles have little direct exposure to the Chinese property sector and are mostly exposed to tech companies. This later sector came under a lot of pressure on the back of the regulatory squeeze initiated last year. We think that the worst of this regulatory tightening is now behind us. We also note that those regulatory developments are likely to cap equity returns but were not aimed at bankrupting the tech sector. Therefore, the level of yield on offer in some convertibles can be highly attractive – especially as the conversion options are mostly priced out (see chart 7). Some of our best ideas come from that segment of the market.

Chart 7: Asia (ex-Japan) convertible bonds – yield comparison (USD) vs. traditional credit

Source: Refinitiv Asia ex-Japan Convertibles index, ICE indexes ACOR Index , BlueBay Asset Management. Daily data to 30 June 2022. The differential in yield can be seen as the cost of the embedded conversion option. When convertibles yield as much or more than straight bonds, one can say that the conversion option is "for free".

ESG analysis will be a key driver of outperformance in the next refinancing cycle

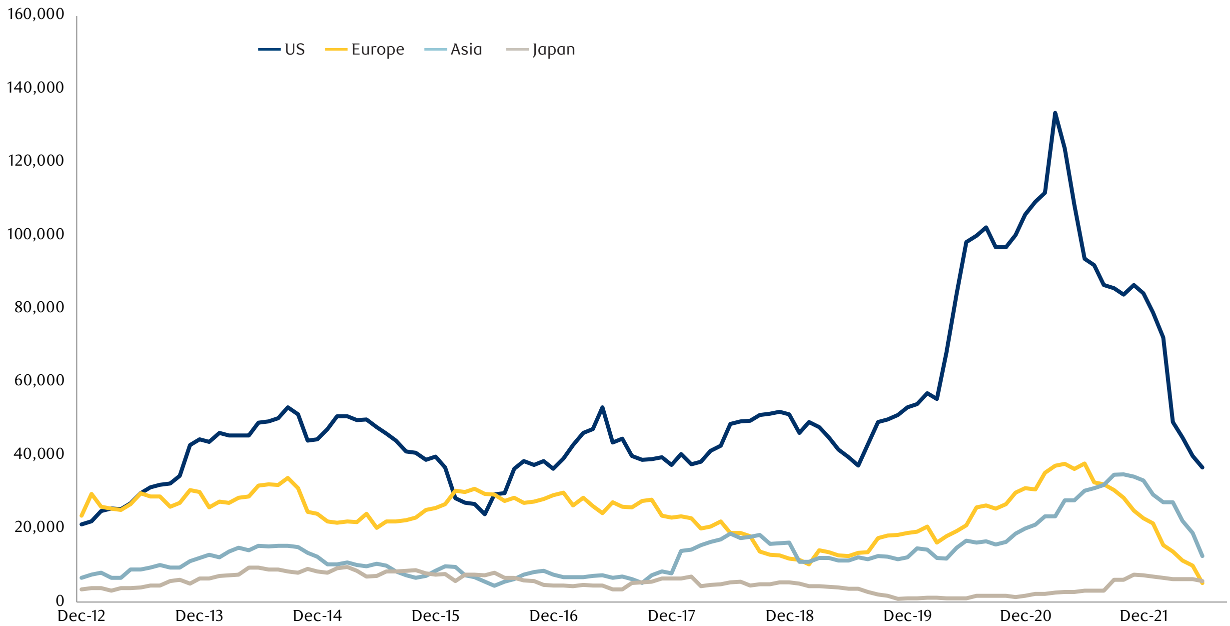
A lot has been written and said about the performance of ESG analysis and factors in the recent market correction. We continue to focus on our in-house ESG analysis as a key tool to add value. We think this discipline will pay off when the primary market re-opens and re-financing activity picks up. In a context where the cost of capital has increased materially, we expect the sustainability of business models and strategies to be a key performance differentiator. This should create potential opportunities for our investment process.

We expect the primary market to lead the recovery

At present, the primary market in convertible bonds is essentially closed. Too much equity volatility, too much uncertainty on fundamentals and fragile market sentiment means that corporates and underwriters have stopped issuing. Many asset classes are experiencing such a slowdown in primary market volumes, but this effect is particularly notable for convertibles (see chart 8).

Our experience suggests that after a large market shock, such as the one that we experienced in H1 2022, the convertible bond primary market is the first market to re-open as corporates want to monetise the higher volatility of their stock price. Historically, this is a time when corporates tend to offer favourable terms to convertible bond investors: they are happy to give away cheap optionality and favourable covenants in return for a debt instrument with a lower coupon. We think this mechanism will work again this time round and will provide promising potential investment opportunities.

Chart 8: Convertible bonds – primary market issuance over the past 12 months (USD mn)



Source: BofA Convertible Research, as at 30 June 2022

Global convertibles in a bear market

So far in 2022, convertible bonds have performed in line with equity markets. This is disappointing as the asset class is expected to provide downside protection when equity markets correct.

We looked at two previous bear markets that we think have similarities to the current market environment – the Dotcom bubble and the Global Financial Crisis (GFC). On analysis, we found that the current behaviour of convertible bonds is not unusual and that it is in the later phases of a bear market that convertibles tend to perform best.

Historic behaviour patterns

Phase 1: convertibles fall in line with equities

Both in the Dotcom bubble and the GFC, convertible bonds sold off aggressively at the beginning of the bear market. Our view is that this original correction is due to the sector bias of the convertible bond universe, which tends to be tilted towards high-growth, high-beta sectors. We think the beginning of 2022 corresponded to this initial phase and that the bear market is now moving to phase 2.

Phase 2: convertibles offer downside protection

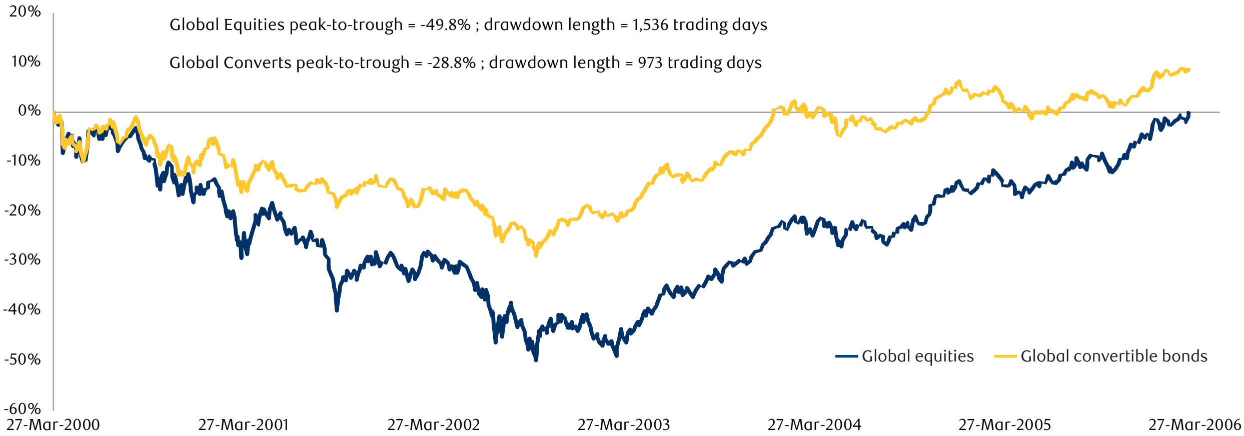
At this stage, the convertible bond universe has migrated to a bond-like profile with short maturity, a large investment-grade portion and a higher income component. This is when convertible bonds offer a good place for investors to hide, with cheap optionality to time the end of the bear market. This could be particularly relevant this time round as many market participants are worried about a sharp deterioration in credit fundamentals and a spike in defaults.

Phase 3: convertibles outperform equities as the primary market picks up

Convertible bonds tend to perform when the bear market nears the end. At that point, the volume of issuance picks up as corporates refinance. They tend to offer favourable terms to convertible bond investors.

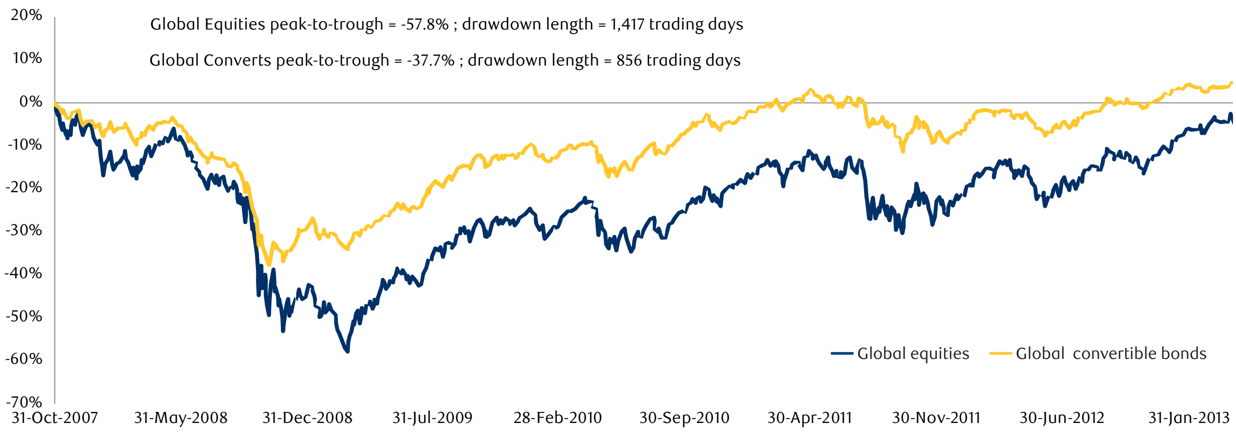
We think that phase 2 and phase 3 are the key mechanisms that explain why convertibles tend to have shorter and shallower drawdowns than equity markets. We think these mechanisms will work again in this bear market and that patient investors will be rewarded.

Total performance since the peak of the Dotcom bubble (USD)



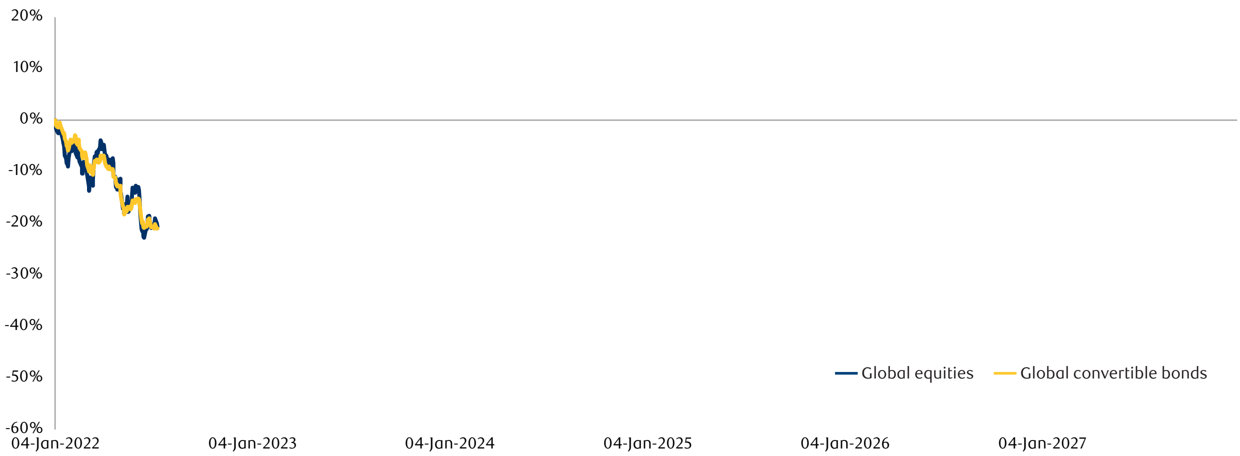
Source: BlueBay, Bloomberg. Indexes: MSCI World Net Total Return USD Index and Refinitiv Global Focus Convertible Index (USD)

Total performance since the peak of the Global Financial Crisis (GFC) (USD)



Source: BlueBay, Bloomberg. Indexes: MSCI World Net Total Return USD Index and Refinitiv Global Focus Convertible Index (USD)

Total performance since the peak of 2022 (USD) – Current bear market



Source: BlueBay, Bloomberg. Indexes: MSCI World Net Total Return USD Index and Refinitiv Global Focus Convertible Index (USD).
Data as of 11 July 2022

Portfolio Manager Perspectives
Our experts offer their perspectives on the latest developments in global credit and the state of the markets.

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