The case for convertibles – an express version

15 April 2020

In our last update, we focused on the relative outperformance of convertible bonds versus other asset classes in the recent market correction. We now want to focus on the outlook. In short, we think that convertible bonds are the ideal asset class to navigate the current market.

- **General market environment is positive for the asset class**
  We are seeing unprecedented open-ended monetary and fiscal stimuli which we think offer a backstop to risk assets, especially equities. At the same time, we expect volatility to remain highly elevated for a long period of time. We believe convertible bonds provide a simple way for investors to build equity exposure with moderate risk. We expect this simple argument to attract flows to the asset class in the medium term.

- **Valuations are historically cheap**
  We estimate that the recent correction has opened a gap in convertibles' embedded option valuations of between 3% to 5%. As market conditions normalise – which we fully expect thanks to the announced US Federal Reserve stimulus – we think this gap should close and the asset class will likely benefit from this additional performance. This type of undervaluation is comparable to levels reached in the 2008 Global Financial Crisis.

- **We expect a buoyant primary market to drive performance**
  The recent dynamics in credit markets at large, across all instruments and credit qualities, were extreme and have not yet fully normalised. This poses a challenge for companies in need of refinancing. What we saw in previous instances of tight credit conditions was that companies were keen to use the convertible bond market. Issuing a convertible bond can provide a way to reduce interest payments and monetise volatility. In this process, companies are ready to give away equity upside at potentially cheap valuations. Historically, this has provided attractive opportunities for convertible investors, especially during 2009.

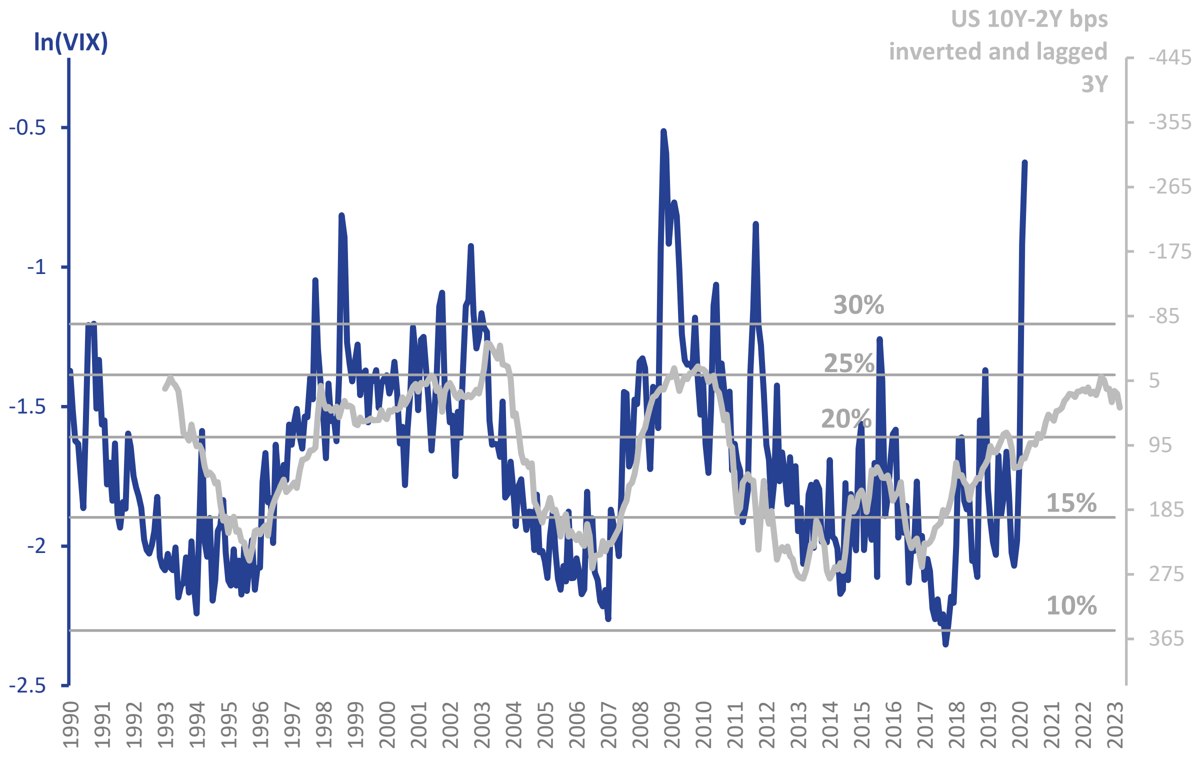
- **Sector bias is more favourable than ever**
  The convertible bond universe is generally light on financials and traditional industries. It is heavily biased towards technology, software, biotech and internet names. In our view, this sector bias is currently favourable to investors as the Covid-19 crisis seems to be accelerating the digital transition – if only from people working from home – and is proving very hard on more traditional sectors.

- **The income component becomes highly attractive for equity investors**
  One feature of the current market is that many companies have decided to suspend or cut dividends. For convertibles, the income – the coupon – is fixed. In our view, this makes the asset class attractive to equity investors in need of income. Anecdotally, it seems that equity income funds are looking at investing in convertible bonds to maintain their income levels. This is rather unusual and we believe it's a favourable development to see another type of investor coming to the asset class.

- **Experience from past episodes of market stress suggests a shorter drawdown for convertibles**
  Looking at past crises, mainly the dot.com bubble and the 2008 Global Financial Crisis, we have found that convertible bonds had a much shallower and shorter drawdown than equities. Roughly speaking, in these crises, it took convertible bonds half the time of equities to recoup losses and re-test their highs. We expect these dynamics to work in the same fashion for investors in the current market.

The team had long expected a rise in equity volatility. This view was supported by many traditional volatility indicators – in chart 1, the yield curve. Our view is that the Covid-19 crisis acted as a trigger and markets have now moved to a higher volatility regime.

Chart 1: Long-term history of the VIX and the market cycles

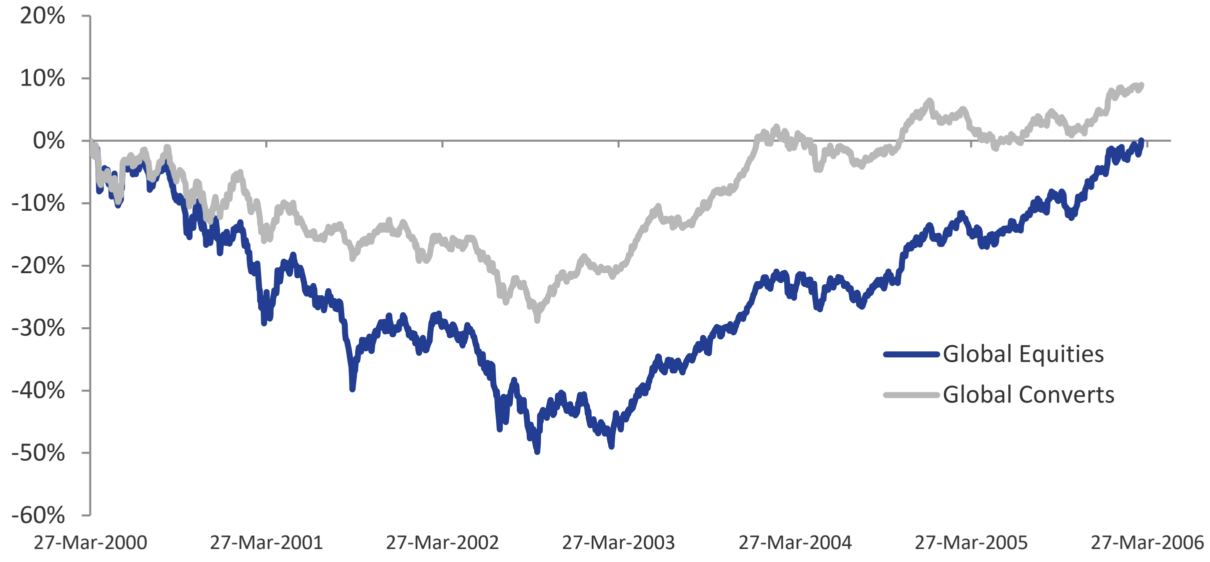


Source: Bloomberg and BlueBay, monthly data as at 31 March 2020

Charts 2, 3 & 4 show the behaviour of convertible bonds as compared to equities in previous crises and during the most recent Covid-19 crisis. Global convertible bonds displayed shallower and shorter drawdowns than equities in past crisis.

Chart 2: Total performance since the peak of the tech bubble

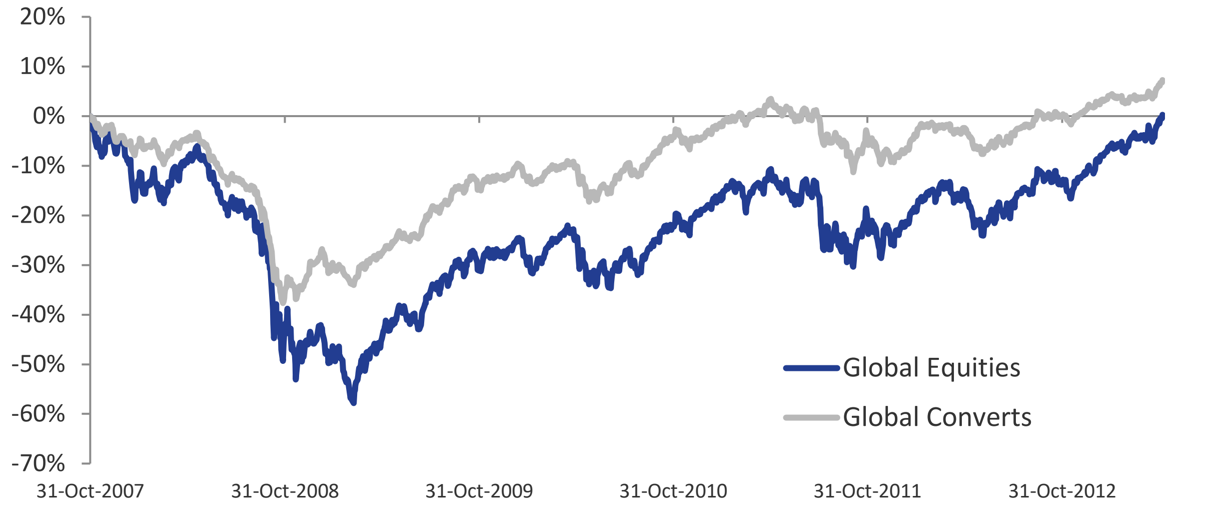
Global equities peak-to-trough = -49.8%; drawdown length = 1,536 trading days
Global convertibles peak-to-trough = -28.8%; drawdown length = 973 trading days



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

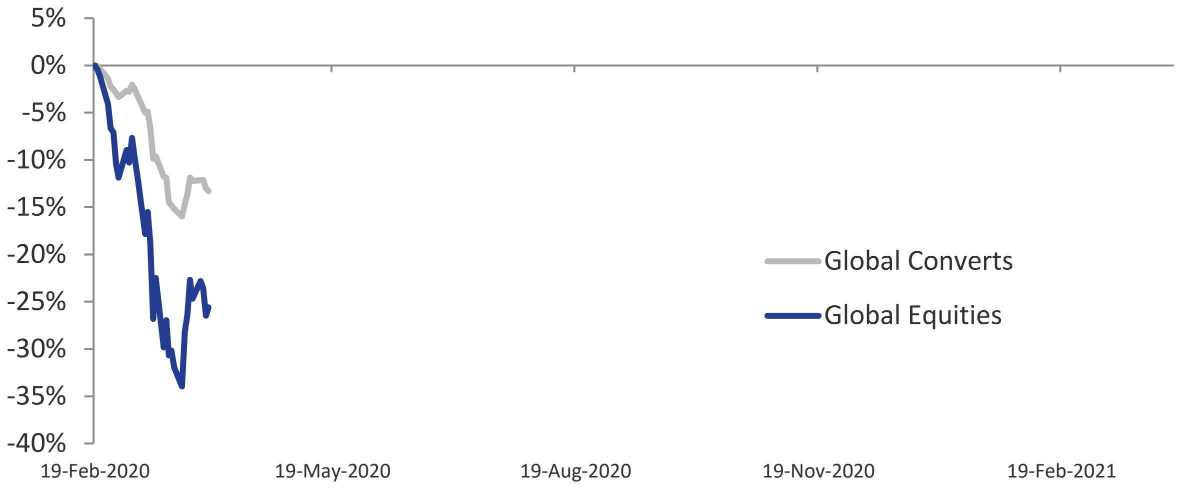
Chart 3: Total performance since the peak of the Global Financial Crisis

Global equities peak-to-trough = -57.8%; drawdown length = 1,417 trading days
Global convertibles peak-to-trough = -37.7%; drawdown length = 856 trading days



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

Chart 4: Total performance since the peak before Covid-19 crisis (data to 2 April 2020)



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