25.02.2019

'AGEFI

THE APPEAL OF CONVERTIBLE BONDS IN VOLATILE MARKET CONDITIONS

The large amounts of convertible bonds issued in 2018 have created new investment opportunities.

Convertible bonds have had one of their best-ever starts to a year. However, investors' risk appetite was sorely tested in 2018 because of concern about global growth and political developments in several regions of the world. Those conditions caused equity volatility to increase substantially, and investors will probably have to get used to more volatile markets given the numerous uncertainties that remain.

However, few are willing to give up their equity exposure altogether. Although economic growth is softening around the world, it remains well above recession levels. Also, the sharp market correction in late 2018 brought global equity valuations down to more reasonable levels. Finally, in an environment of low interest rates, particularly in Europe, bond yields still offer a poor alternative to equity dividend yields.

In this transitional period, the convexity of convertible bonds is a key advantage. By adding an equity component to a bond investment, convertibles allow investors, via the conversion option, to maintain equity exposure while benefiting from the defensive attributes of traditional bonds, provided they carry out in-depth analysis of the issuer's credit quality beforehand.

Historically, the combination of a bond floor with a "call option" on the issuer's shares has been clearly advantageous for convertible investors over the long term, providing them with equity-like returns over a complete market cycle and significantly reduced volatility and downside risk. Another major advantage is that convertibles are much less sensitive to changes in interest rates than a bond investment with the same maturity.

After the financial crisis and until 2017, equities naturally outperformed in a context of sustained and synchronised growth, expansionary monetary policies and strong earnings growth. However, given the current uncertainties, convertibles have regained a clear competitive advantage, having shown their ability to alleviate the shocks that have affected the equity market. That was the case in 2018, when convertibles, with their lower volatility and the benefits of the bond floor, demonstrated solid resilience against sharp corrections in equity markets. Convertibles have also shown good momentum during the early-2019 market rally: in January, the Thomson Reuters Global Convertibles index captured more than 70% of the rise in the MSCI World Net TR index (both hedged into EUR).

In this advanced phase of the economic cycle, the global convertibles market also offers exposure to the shares of some highly sought-after companies, particularly those addressing the digital economy, emerging-market consumer and healthcare themes. Another notable fact is that most recently-issued convertible bonds have been from companies whose growth prospects rely more on positive secular trends than on the economic cycle. They are companies that have the potential to generate greater returns, with relatively low debt levels, but also solid cash generation prospects and relatively limited funding requirements: these are major advantages at a time of growing caution about credit risk.

Overall, large amounts of new convertible bonds were issued in 2018 globally. Almost half of these were from first-time issuers, offering convertible investors greater diversification opportunities at a time when valuations in the asset class remain lower than their historical average. The context is therefore supportive, and convertibles should continue to provide investors with exposure to the equity of high-quality companies, while limiting the risk of volatility and occasional corrections.

Marc Basselier, Head of Convertible Bonds, and Scarlett Claverie-Bulté, Investment Specialist, Union Bancaire Privée (UBP)