



## **Repeat of 2008 convertible bonds sell off unlikely says RWC Partners**

***Having seen only a 3% loss this year against reeling equity markets, David Basile, fund manager of the RWC Global Convertibles Fund, explains:***

“Even though we are in a period of heightened uncertainty, there are valid reasons not to fear a repeat of the sell-off in convertible bonds seen in 2008. That year the convertible bond asset class behaved in both a technically and theoretically inconsistent manner.

“The balance of convertible market participants in 2008 was skewed towards hedge funds using leverage to make a profit via volatility arbitrage versus long-only outright funds which invest based on fundamentals. The reduced availability of leverage and increased funding costs both negatively affected convertible arbitrage funds. These hedge funds became forced sellers of convertible bonds as positions became too expensive to hold, and they were required to deleverage. This was the key reason for the asset class becoming distressed in 2008.

“Leverage within the asset class is now vastly reduced. Our most recent data indicates that the balance between hedge funds and traditional long-only participation has swung by 20% such that long-only funds are now the dominant players in the convertibles market (see table 1&2).

“The short-selling ban adversely affected the valuations of convertible bonds as convertible arbitrageurs became unable to delta-hedge their positions and so the negative dynamic stemming from levered hedge funds was heightened. The ban applied to over 7,000 securities with a market capitalisation of \$3trillion.

“Currently, whilst some national market regulators have introduced new restrictions concerning short-selling, the impact on convertible bond markets and valuations should be limited. A number of European countries have introduced restrictions that are effective for limited periods and the UK, Germany and the Netherlands have announced that they are not introducing such restrictions for now. Additionally the more dominant role of long only accounts combined with the lower leverage levels of arbitrageurs will constrain any negative impact on convertible bonds in the event that short-selling restrictions are expanded.

“We have compared equity market performance over the key stress period of September 2008 to the recent moves in August when the decline in equity markets was of a similar magnitude (see chart 1&2). It is particularly confidence boosting that the market composition is now much more balanced between long only accounts and hedge funds, with long-only accounts being the dominant of the two. This means that the asset class is structurally stable and is in a far better position to withstand pressure than it was in 2008.”

Table 1: Europe

	HF (%)	Long Only
2007	63	37
2008	64	36
2009	45	55
2010	46	54
2011	41	59

Source: Greenwich Associates, Barclays Capital, August 2011

Table 2: USA

	HF (%)	Long Only
2007	76	24
2008	76	24
2009	62	38
2010	55	45
2011	52	48

Source: Greenwich Associates, Barclays Capital, August 2011



