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RWC

Convertible Bonds – Certainty in uncertainty

May 2018

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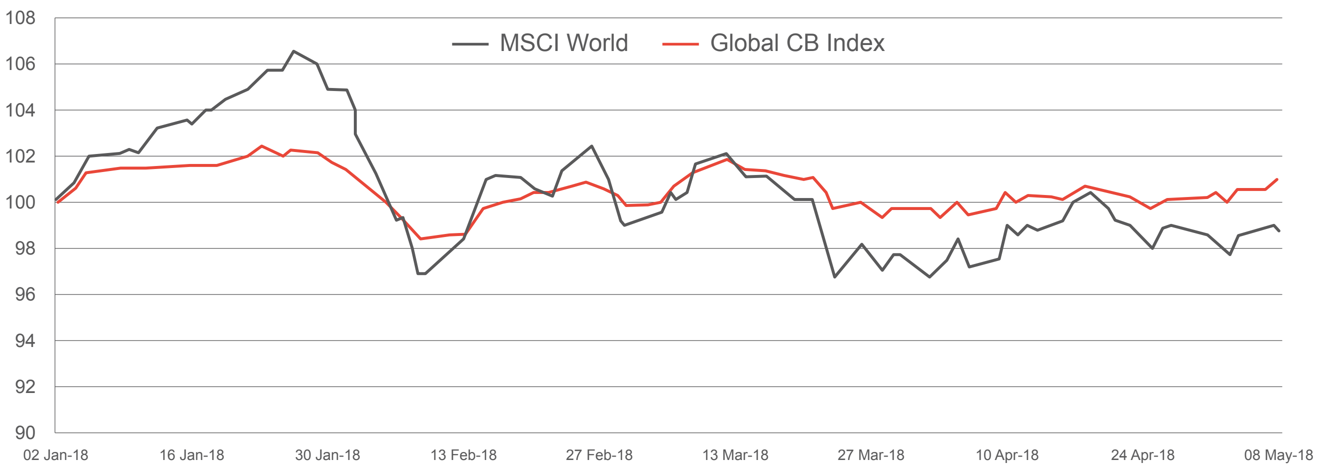
The increased uncertainty since the beginning of the year has caught the attention of many market participants as volatility has returned quite dramatically to financial assets. Asset allocation decisions and market timing, while always important, are of greater significance in these periods where divergences between asset classes are elevated. Convertibles can offer a valuable tool to investors, especially in a period where the dynamics are pointing to a golden period of outperformance for the asset class versus static balanced portfolios of equities and bonds only. We analyse the benefits of convertibles from a few different angles to assess the reasons why we believe an investment in the asset class is compelling and will potentially remain so for a protracted period.

Increasing volatility drastically benefits convertible bonds

As witnessed since the beginning of the year, volatility has increased quite markedly. We feel this increase is not an isolated event, but rather a return to normalcy of historical standards. The recent history of low levels of volatility can potentially be explained by central banks adding liquidity to markets and pursuing accommodative monetary policies. The willingness of central banks to choose policies that supported financial markets suppressed volatility when it appeared that negative outcomes for countries and companies were unlikely to occur. As this accommodation is removed, we feel that volatility will normalise back to historic levels. Convertibles benefit immensely with higher periods of volatility. First, their embedded options become more valuable because options are worth more when the range of possible outcomes (another way to describe volatility) increases. Second, convertibles share in upside participation as markets rise, but bring capital preservation when markets decline. This effect compounds over time, increasing the more volatile the period when this compounding occurs. In figure 1 we show graphically how the compounding effect of the convex nature of the asset class, with participation when equity markets are rising, and capital preservation when equities are falling.

FIGURE 1:

Thomson Reuters Global Focus Index vs. MSCI World Index



Source: RWC, Bloomberg, as at 8th May 2018.

In figure 2 we show the same data in a tabular form, where we take peak to trough periods to show that participation while markets are declining remains lower, but conversely is higher as equities rise, providing the compounding benefit as described above.

FIGURE 2:
MSCI World Index vs. Thomson Reuters Global Focus Index

	MSCI	TR Index	Partici-pation
24-Jan to 9-Feb	-8.30%	-3.87%	47%
9-Feb to 12-Mar	5.27%	3.57%	68%
13-Mar to 3-Apr	-5.24%	-2.48%	47%
3-Apr to 8-May	2.15%	1.64%	76%
26-Jan to 8-May	-6.52%	-1.32%	20%
YTD	0.36%	1.49%	>100%

Source: RWC, Bloomberg, as at 8th May 2018. Past performance is not a guide to the future.

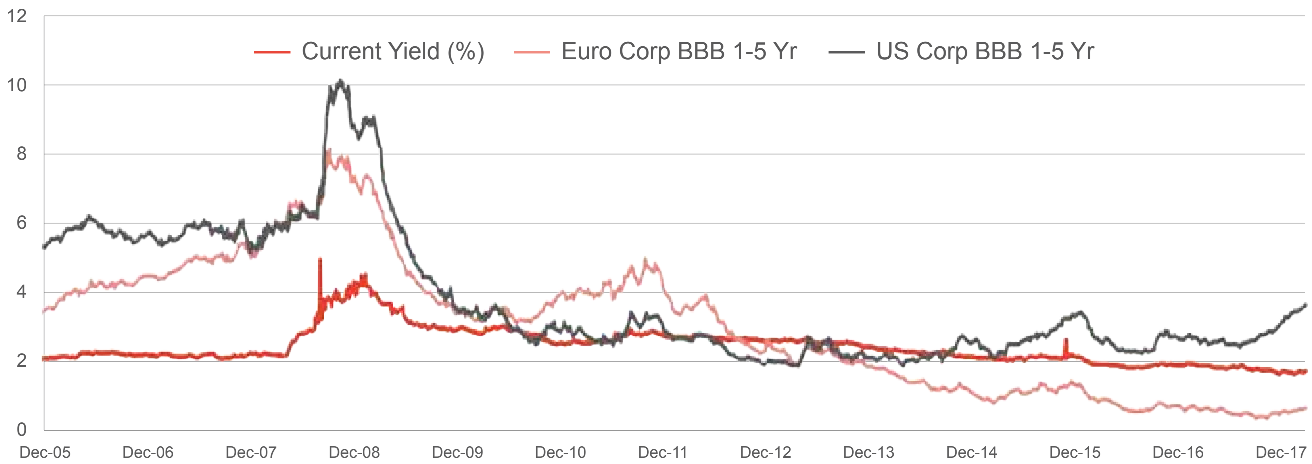
Observing the graph and analysing the table showcases why the asset class benefits in periods of rising volatility. This also partly explains why the previous 2 years showed a lower return than expected versus equities, as the volatility environment was very subdued. Looking back at that period, investors would not have required an option to preserve capital if they knew in advance that all markets would be rising. We feel that as we enter this new period of higher volatility that option for capital preservation will be far more valuable. In addition, we feel that the participation rate to equities on the upside will remain elevated, but could be more subdued on the downside, making the asset class a compelling and prudent alternative to equities.

Income difference between convertible and fixed income very low

Historically convertibles would have an income discount versus straight debt, as the lower coupon would finance the call option on the stock. Many investors would look at this income differential and equate that to the cost of their option. We have tried to extract the current yield of convertibles versus comparable duration/quality bonds and have displayed this in figure 3:

While current yield is not traditionally a good metric to use to look at convertibles, for comparison purposes to straight debt, it gives a clear indication of the meaningful change witnessed over the last 10 years. We can clearly observe a fact well known to investors that the income from corporate credit has declined quite markedly. The yield on convertibles in some cases is now comparable to the yield on corporates, hence the opportunity cost of holding convertibles versus fixed income has eroded. That said, convertibles hold a call option which can become more valuable in periods of rising volatility. Hence, if investors are comfortable with the potentially different risks of holding convertible debt versus fixed income, we feel that the cost is low and the case strong to transition some holdings from fixed income to convertibles.

FIGURE 3:
Convertible Bonds vs. Euro Corporate Bonds vs. US Corporate Bonds



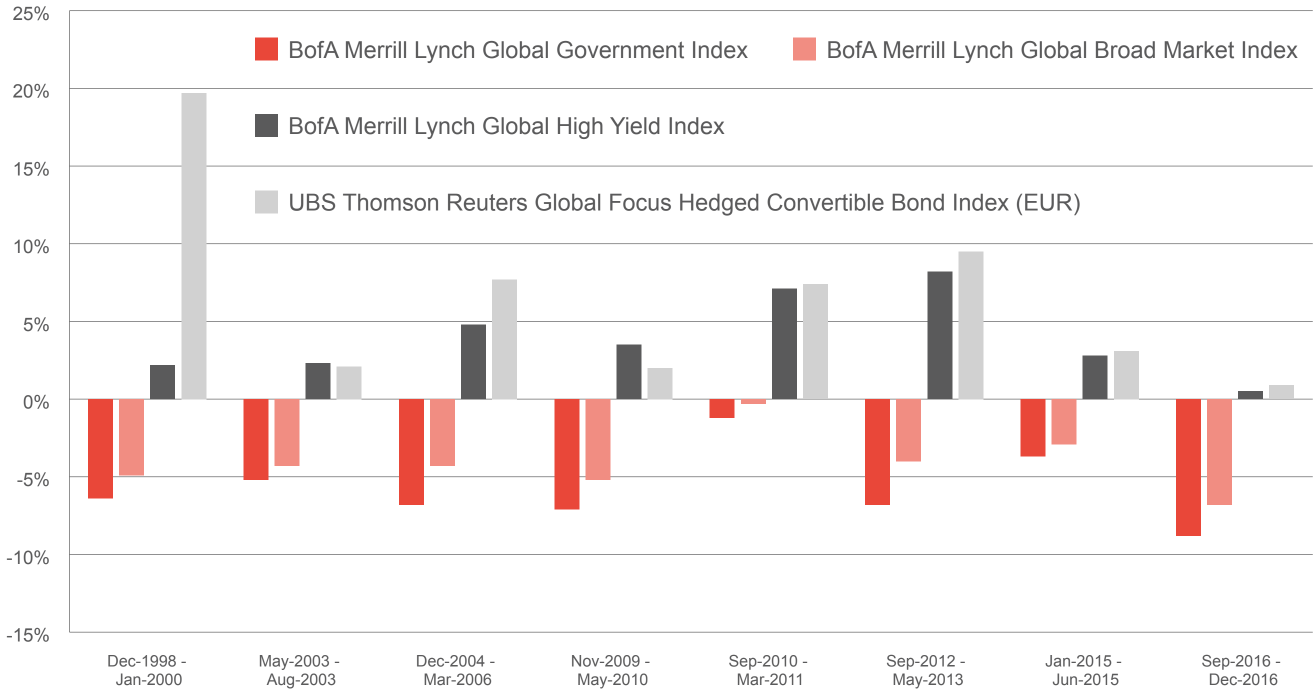
Source: Bloomberg, RWC, BofA Merrill Lynch, as at 30th April 2018.

Convertibles are among the better fixed income asset classes in rising rate environments

Duration is a topic of paramount importance to fixed-income investors, and even more so when central banks such as the Fed are clear that they are on a path to raising rates in a return to a normalised policy. This is because longer duration bonds can suffer capital losses when rates rise. If investors are fearful of an increasing rate environment, convertibles would offer an additional benefit to fixed income investors looking to switch some of their fixed income holdings. Convertibles have among the lowest durations within long only fixed income securities, which we feel is very beneficial in this current environment, as we see a gradual but protracted rising rate environment. In figure 4 we have looked at periods where we have been able to identify rising rates and compared convertible returns to other fixed income asset classes. We can see that in such periods convertibles have tended to be the best performing fixed income asset class, and while it's important to be mindful that there may be other factors which drive the performance of convertibles over those periods, given the significant amount of data points and lower duration of the product, we feel the data is representative and compelling.

FIGURE 4:

Convertible Bonds in times of rising rates



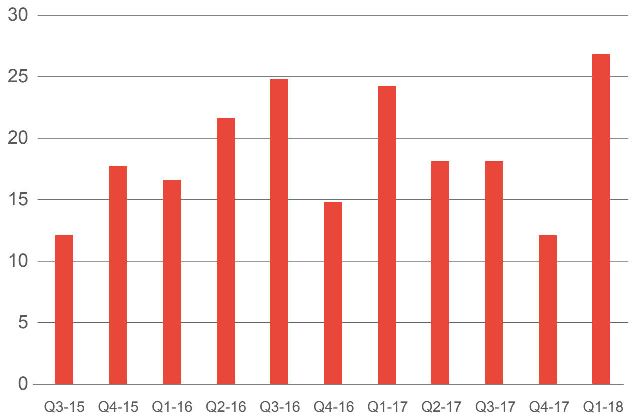
Source: Bloomberg, RWC, as at 30 December 2016 (data range from 1 January 1999 to 30 December 2016).

High new issuance levels benefitting the asset class

New issuance has dramatically picked up in the first quarter of 2018 as companies return to issuing convertibles as demonstrated in figure 5 where we show the quarterly issuance of convertibles over the last few years:

FIGURE 5:

Quarterly Convertible Issuance Q3 2015- Q1 2018



Source: UBS/Thomson Reuters, (data as at 29th March 2018).

We think that increase in issuance of new convertibles will remain elevated for the foreseeable future. When interest rates move higher, companies get a greater saving versus straight debt when issuing a lower coupon convertible. That effect makes convertibles look increasingly attractive as a means to raise capital. Additionally, as volatility in markets increases, companies are getting greater value for selling a more valuable call option to investors. Finally, given that equity prices are higher, companies are more willing to issue a potentially dilutive security.

As investors, we benefit from increased issuance of convertible bonds. These new issues provide an opportunity to sell names with very high or low equity sensitivity, and to reinvest into names with rebalance a more balanced exposure to equities. Also, new issuers into the convertible market help to provide diversification. Finally, convertibles tend to be issued cheaply, which provides a good source of alpha generation. In figure 6, we have shown the 5 and 10 day average performance of every convertible issued this year:

FIGURE 6:

Average 5 & 10 day return of every convertible issued YTD

	5-day	10-day
North America	0.9%	0.5%
Europe	0.2%	0.7%
Japan	0.9%	0.7%
Asia	0.9%	-0.2%

Source: UBS/Thomson Reuters, data as at 8 May 2018.

Conclusion

From a product perspective, and looking ahead to 2018, we think that convertibles are in a rare and unique position where the various aspects of returns discussed above are aligning to make the investment in the asset class compelling. We think that this backdrop is fundamental in nature and will be protracted in time and evidenced by recent moves. Convertibles can be seen not only as a valuable alternative to Fixed income and equities, but also as a compelling alternative to a static mix of equities and bonds. Additionally we feel the asset class will benefit from drivers which are unique to the product such as an incremental benefit from M&A activity given valuable takeover ratchets and a strong liquidity and valuation level for the convertible bond market.

Convertible Bonds

Davide Basille

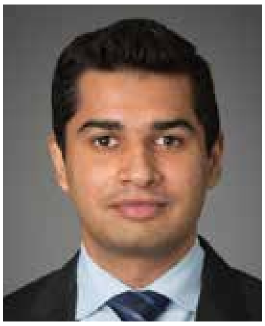
Davide is the Head of the Team and lead portfolio manager for the RWC Convertible Bond strategies. Davide joined RWC in January 2010 to lead the team and he brought with him a long history in convertible bonds having worked at Morgan Stanley since 2001.

At Morgan Stanley Davide worked with in both the Private Wealth and Investment Management divisions, and most recently held the Head of Convertible Bonds position. Davide graduated from Imperial College London with a degree in Material Science Engineering.

Justin Craib-Cox

Justin joined RWC Partners as a senior member of the Convertible Bond team and co-manager of the Core Plus Funds in March 2018. He brings extensive industry experience via Investment Management, Trading & Execution, Equity & Credit Research, and Corporate Development. Prior to joining RWC, Justin worked as Senior Fund Manager to the Global Convertible Bond Portfolio, with peak AUM of USD +2.5bn, at Aviva Investments. Justin was responsible for global allocation, security analysis and selection, trading and execution and generation of risk-adjusted returns. Prior to Aviva Investments, he was deputy fund manager/analyst for global convertible bonds at M&G Investments, working alongside the lead manager for a EUR +1bn portfolio.

Justin is a CFA Charterholder, graduated from the University of Virginia where he gained a degree in English and History and earned a Masters in Finance from London Business School.



Uday Sikand, CFA

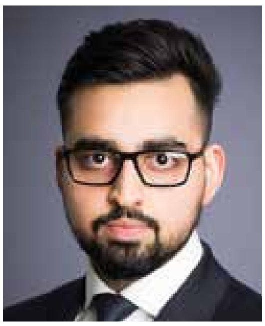
Uday joined RWC Partners as an intern in December 2011; he was subsequently offered a full-time position as an Developer working on risk and performance related projects. He joined the RWC Global Convertibles team in July 2014 as an analyst primarily focusing on security analysis and developing proprietary portfolio models.

His current role is focused around idea generation and security analysis with emphasis on the IT sector in North America and Asia. Uday is a CFA charterholder, graduated from Henley Business School in 2011 where he gained a MSc in Investment Management.

Georgi Dodov

Georgi joined the RWC convertible bonds team in April 2017 from Kepler Cheuvreux. At Kepler Cheuvreux Georgi worked within the convertible bonds team as an analyst where his responsibilities included the production of trade ideas and pricing of issuance structures. Prior to this he was a junior analyst at Aviva Investors.

Georgi has an MSc in Investment and Wealth Management from Imperial College, London and a BSc in International Business, Finance and Economics from the University of Manchester.



Akash Kanda

Akash joined RWC Partners in June 2014 as an intern in the Long/Short European Equity team and was later offered a full-time position as an Equity Analyst in July 2016. He covered a range of sectors within the European universe and contributed towards idea generation for the portfolio. In November 2017, Akash joined the RWC convertible bonds team where he now primarily focuses on the fundamental analysis of companies. Akash graduated from Cass Business School in June 2016 with a First-class degree in BSc Hons Investment and Financial Risk Management.

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Unless expressed otherwise, all opinions within this document are those of the RWC Convertible Bonds investment team as at 21 May 2018.