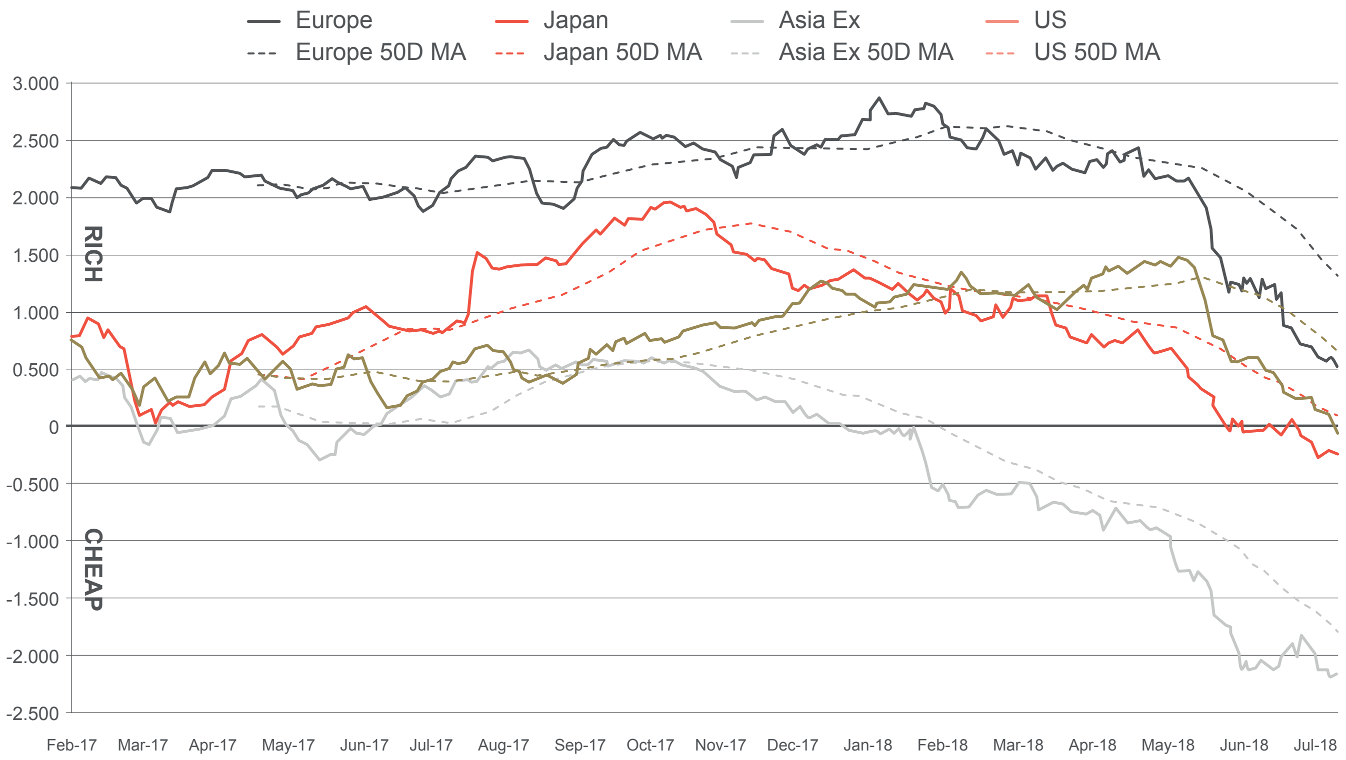
# The Price is Right – Convertible bonds offer cheapness globally

## July 2018

Over the last few months convertible bonds have cheapened across most regions, offering investors a very compelling entry point to the asset class, which since the beginning of the year has enjoyed a strong fundamental backdrop and good year-to-date returns.

**FIGURE 1**




Source: Jefferies, 13 July 2018

## Why has cheapening occurred

A multitude of factors could bring the valuation of convertibles lower, however, it is usually a combination of circumstances that explain cheapening. In this current environment we believe the following three factors are the prevalent ones.

### New issuance has been elevated

In periods of very active new issuance, as experienced year-to-date, existing convertibles may suffer as managers sell their positions to buy new convertibles. This is usually a short-term effect which is often reversed relatively quickly. We think this is the main cause for cheapening in developed market convertibles, particularly in Europe. Our process tends to be insulated somewhat from this cheapening effect as we are mindful of valuation mismatches. This has been a contributing factor to our underweight to the region.

### Volatility has increased but convertibles have not participated as much

Recently market volatility has begun to pick up as geopolitical events continue to garner attention. As cheapness is very simply a comparison of the volatility in the market compared to the volatility priced in the convertible option, if market volatility goes higher, but the price of the convertible stays the same, then convertibles could be seen to be cheapening. Given that we think that the pick-up in volatility this year will be a permanent factor, we think that pricing of convertibles is attractive, and convertibles have not yet adjusted to the higher volatility level.

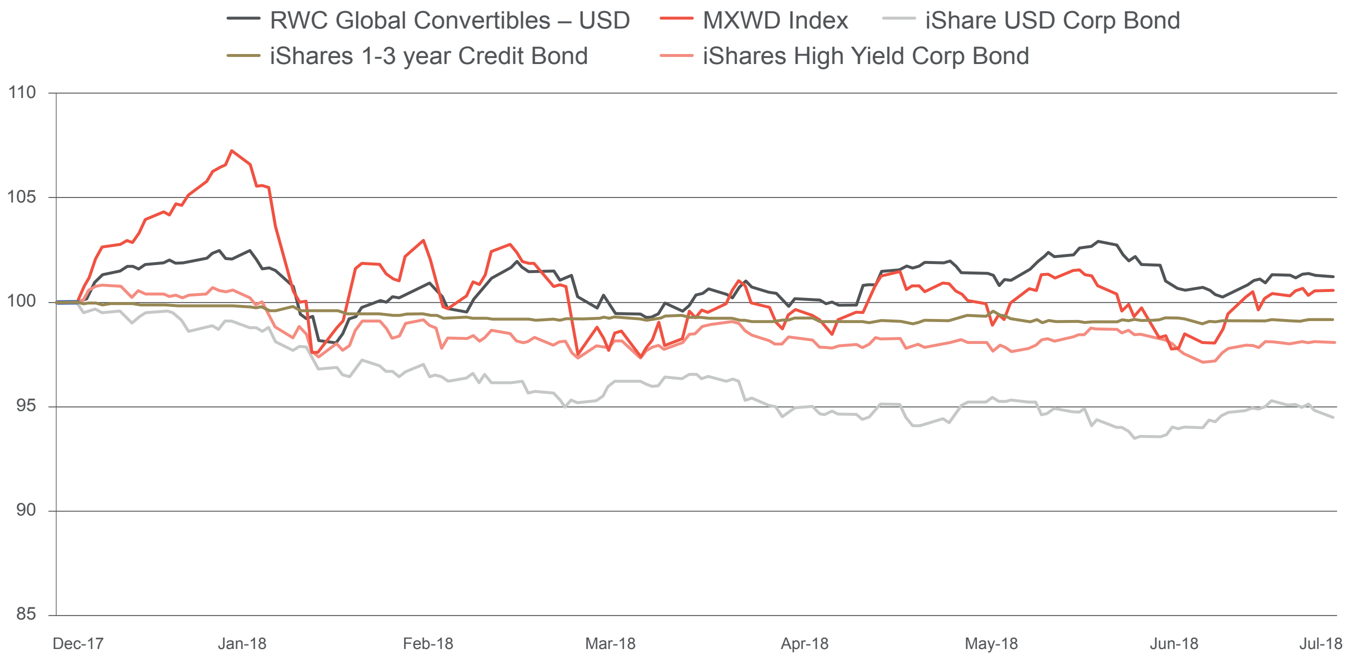
### Selling pressure can reduce valuations

Investor selling pressure and redemptions can lead to lower valuations as supply pressures can bring down the price of convertibles. We don't think this has been a prominent factor in the current cheapening. Our flows remain positive year-to-date, and peer group analysis does not suggest significant outflows. However, investors in Europe have been pulling money from all funds (active and passive) to the tune of nearly EUR 40bn in June 2018--this is the highest rate of outflows over the past 5 years. These risk-off fund flows have not been overly challenging for convertibles, but may explain some market cheapening as well.

## How have convertibles performed as valuations have moved lower

Although convertibles have cheapened, we note that performance has remained strong for the product and our funds. The snapshot below shows the year-to-date returns of the RWC Global Convertibles Fund versus a number of indices.

**FIGURE 2**




Source: Bloomberg, 23 July 2018

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested.

1. Source: Thomson Reuters Lipper, FT article 24 July 2018 "Trade war threat sparks €38bn European fund exodus"

We can attribute the strong performance of convertible bonds to the strong fundamental backdrop that the asset class currently exhibits, as discussed in previous reports. Namely low duration, which allows convertibles to be among the best fixed income asset classes in rising rate environments. Convertible bonds have an exposure to volatility and convexity which allows them to participate well with rising equity markets and compound returns as equities fluctuate. The active new issuance calendar allows for diversification and alpha generation through participation in actively priced new deals.

The RWC Global Convertibles Fund has also performed well versus its index and peer group over this period: we have actively avoided the expensive European convertibles which have suffered thus far year-to-date, and have a process which works very well in periods of increased volatility.

## Given the cheapening how is the asset class poised for the second half of the year

We are encouraged that convertible bonds have provided investors with a strong product to navigate the first part of the year, which has proved challenging for many asset classes. We think that the fundamental backdrop which has allowed for such strong returns is not transient and will continue for the foreseeable future. What is particularly exciting for the product is that this fundamental backdrop is now aligned with an attractive valuation entry point for new investors which has not overly penalised existing holders.

We believe that historically convertibles have experienced their best returns following periods of cheapening, as valuation gaps should not persist, especially if the reasons for cheapening are transitory, and that convertible bonds should eventually converge to a fair value. Combining a cheaply valued convertible asset class with a positive fundamental view is a compelling scenario.

## Davide Basile

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, CFA

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 and graduated from the University of Virginia where he gained a degree in English and History. He earned a Masters in Finance from London Business School.

## CONTACT US

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Unless otherwise stated, all opinions within this document are those of the RWC Convertible Bonds team, as at 31 July 2018.