BlueBay Asset Management

Insight

Convertible bonds, the best of both worlds

September 2015

An upbeat medium-term growth picture, anticipation of positive corporate earnings and a move tighter in credit spreads offer an attractive outlook for investing in global convertibles.

Macro surprises rising in a positive growth environment

We anticipate global GDP growth will continue its expansionary path in 2015 and 2016 and that this will prove supportive for both equity and credit markets. We expect global growth to accelerate from the 2% recorded in the first half of 2015 to around 3% for the second half of the year. US growth is solid, underpinned by the recovery in the labour market which is fuelling consumption growth and adding to hopes that average salaries may start to rise. European growth could surprise on the upside, following the agreement of a further bailout package for Greece, a currency that has weakened 20% in the past twelve months and the monetary stimulus that is the direct result of quantitative easing. The European Central Bank's (ECB) programme of quantitative easing could be extended well beyond September 2016, and the combination of a lower oil price and weaker euro has added as much as 1.5% to GDP growth in the past 16 months. Although slowing demand from China poses some risk to Europe, euro area exports to China are less than 7% of total exports. The macro surprise index has been rising with readings consistent with PMI new orders rising globally. Euro area PMI manufacturing new orders picked up in August.

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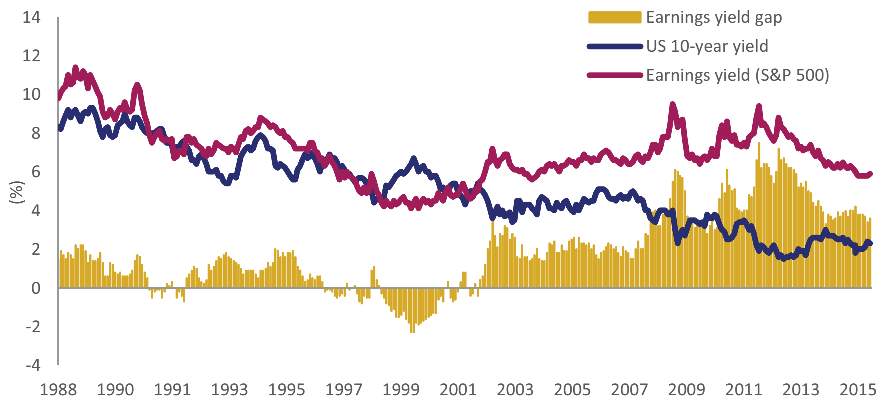
We have already witnessed the negative effect of lower commodity prices on producers and those emerging market countries which are dependent on commodity exports, and we are only just starting to see the positive effects of lower energy prices reflected in measures of consumer confidence. As consumers and energy importing countries become more accustomed to the lower price environment this should prove positive for growth in Europe, Japan and the US. Developed market central banks are likely to remain dovish in an environment of commodity price volatility and a structurally lower oil price which is ultimately beneficial for more sectors and countries than it penalises. A rise in deflationary expectations is likely to cause the Bank of Japan to increase monetary stimulus, may spur the ECB to extend quantitative easing and the Federal Reserve to postpone the first rise in US interest rates for almost a decade into early 2016.

RBC Global Asset Management

Positive earnings backdrop for equities

We believe that equities remain attractive on dividend and earnings-based measures and that convertible bonds provide higher-quality risk adjusted returns with lower volatility over the cycle than a direct equity investment. The earnings prospects of global companies currently provide a strong argument for an increase in equity-related exposure versus bonds on a relative value basis. We can illustrate this by expressing corporate earnings in a yield format and then comparing this to the yield on fixed income instruments – this highlights the divergence in relative value that has occurred over recent years (highlighted in Fig.1). This is driving companies to issue corporate bonds and buy back their stock to improve their return on equity. We also believe it should continue to support M&A activity as both public and private firms take advantage of this dislocation. An active M&A market has historically driven strong returns from equity and convertible markets.

Fig. 1 The earnings yield gap is driving corporate buybacks and pushing equity markets higher



Data source: Goldman Sachs, as at 31 July 2015

To estimate the beta of convertibles to equities we examined data going back to 2005; this includes 2008 and 2009 which were extreme performance years for the asset class. We observed the magnitude of moves in both equities and convertibles in months when the MSCI World Equity Index rose or fell by more than 2%. We concluded that the beta element would be most dominant in months where equity markets had large moves. During the period there were 48 months when the index rose more than 2% and 29 when the index fell more than 2%, giving us a significant number of data points. In positive months the convertible bond index captured 64.75% of the equity move and in negative months, it suffered 53.12% of the losses i.e. a ratio of 65/53. We believe this demonstrates the ability of the asset class to provide investors with a defensive alternative to a direct equity investment.

Convertible bonds provide higher-quality risk-adjusted returns with lower volatility over the cycle than a direct equity investment

Convertibles set to benefit from tightening credit spreads

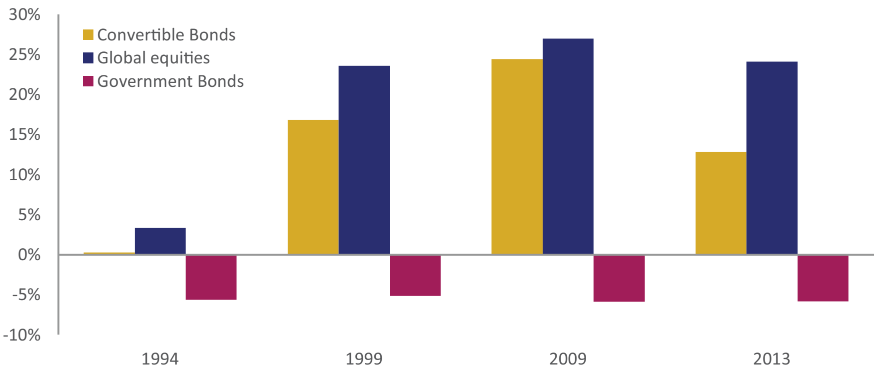
Credit spreads are the second major driver of convertible returns. The recent widening in credit spreads for both investment grade and high yield bonds appears to offer investors a value opportunity as anticipated default rates remain low. Since 2008 corporations have been working to deleverage balance sheets and improve their debt profiles. Interest rates, although forecast to rise gradually over the coming year, remain low by historic standards and thus the interest rate burden for companies is undemanding. The convertible universe also benefits from a low exposure to the oil and gas sector which is currently under considerable financial stress due to low oil prices.

With the global economy growing and interest rates set to remain low, corporate default rates should remain well below historic averages and thus we believe investors are currently overcompensated for the risk of default-related losses given current market prices. As convertible bonds are priced directly from the corporate curve and generally rank pari passu with normal unsecured corporate bonds, they look set to benefit from tightening credit spreads over the coming months.

Hybrid structure provides protection when rates rise

Due to their hybrid nature, convertibles have the potential to generate strong returns in the current environment where we believe interest rates will 'normalise'. The interaction between the equity and credit elements has historically allowed convertibles to post positive returns in years when government bonds have experienced losses (Fig. 2). Although they are fixed income instruments, convertibles have a shorter duration than equivalent straight bonds due to the equity optionality embedded in their structure. Improving economic growth should lead to revenue and profit expansion for many companies and this may drive equity prices higher. As the underlying equity price rises, the option embedded in a convertible moves further in-the-money. This in turn leads to a rising convertible bond price and a shortening in duration; a desirable attribute in a situation where risk-free rates are rising.

Fig. 2 Convertibles have produced positive returns when government bonds suffered losses



Source: Bloomberg, as at 15 June 2015

Note: Based on the last 20 years when government bonds have posted losses greater than 5%

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When analysing convertible securities, there are two elements which come into play when interest rates rise.

Firstly on a purely mathematical level, as interest rates go up the rise in the risk-free rate increases the 'risk-free forward value' of the equity; i.e. using risk-free rates the expected price of the equity in the future rises with increasing yields. This has the effect of increasing the value of the equity option and shortening duration.

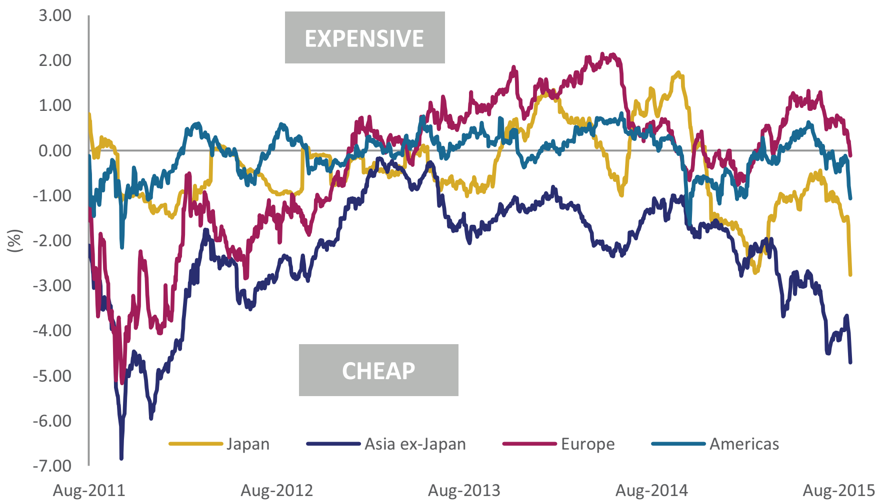
However, what is more important to consider is the second factor – what is happening in the 'real world'? If the economy 'normalises' we would anticipate that interest rates are likely to rise towards long-term averages as investors reduce their allocation to safe haven investments such as cash and government bonds and reallocate to areas that may benefit from global growth, such as equities and credit-spread products. This could lead to a rise in equity prices, which would naturally benefit the valuation of convertible securities. Therefore in periods such as 1994, 1999, 2009 and 2013 when US 10-year government bond yields rose, and both investment grade and high yield corporate bonds had meagre returns despite narrowing credit spreads, convertible bonds generated positive returns. Although high yield valuations look more attractive globally on a spread basis than they did at the beginning of 2015, many of the stronger credits have performed well. Weaker names in the commodity-related sectors have indeed cheapened, but in our view still remain vulnerable to a broader correction.

Convertible valuations remain attractive

We continue to believe that global convertibles are trading at attractive relative valuation levels. Fig.3 shows by region, over the past five years, how convertibles have traded relative to the theoretical fair value of their equity and credit components measured in bond points. The relative valuation of the individual regions reinforces our geographical allocations and outlines where we see medium term value in the asset class.

Our current preference is to be underweight European convertibles due to the fact that they are only at the mid-point of their 5-year valuation, overweight Japan and Asia ex-Japan and slightly overweight in the US.

Fig. 3 Many global convertibles still offer considerable relative value opportunities



Data source: Nomura, as at 24 August 2015

Japanese convertibles are trading at their cheapest valuations over the last five years and both Asia ex-Japan and the US are trading in the bottom decile of their ranges since the volatility caused by the worst of the 2011 European crisis. The cheapness of convertible bonds versus their underlying equity and credit is an additional strong argument for an allocation to the asset class.

Reasons to invest

The recent falls in commodity prices and increased volatility in the Chinese market have created some concerns that global equity market momentum may not be sustainable. However, the eurozone and Japanese economies are both showing signs of vitality. Even if US interest rates do rise later this year, it is clear that any subsequent increases will be gradual and we believe this should not prove detrimental to corporate profitability. With default rates remaining low and consumer spending set to benefit from lower prices at the pumps, we believe that convertible bonds remain well positioned to benefit from both rising equity markets and improving credit spreads.

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