Convertible bonds can provide investors with the upside potential of equities with added benefits of lower price volatility and protection in a rising interest rate environment.

Year to date, convertible bonds have provided investors with robust returns despite rising interest rates, which have dampened returns on other fixed income instruments (Fig. 1). With the global economy normalising and the US Federal Reserve’s (Fed) quantitative easing (QE) programme widely expected to end next year, we believe there are a number of key investment themes to consider, which could prove beneficial for convertible bonds: rising equity markets, lower default rates and higher yields for core government markets. We also consider that a value opportunity exists in emerging market credit and equity markets and this should help these regions outperform those of the developed world over the medium term.

This paper explores these themes in more detail and how investors can benefit by increasing their exposure to the convertible bond market.

**Fig. 1 Convertible bonds have produced robust returns**

![Graph showing return on convertible bonds compared to world equities and corporate bonds with data source: BlueBay Asset Management, UBS and Bloomberg, as at 31 October 2013]
The improving global economy should benefit convertibles
Since the onset of the global financial crisis we have been in a period of abnormally low interest rates. However, the dynamics of the global economy are now shifting and the pace of global growth is set to accelerate. Although we believe the developed markets, led by the United States, should be the principle driver of higher global growth, the concerns about a slowdown in emerging market economies have been greatly exaggerated and they now offer some very attractive investment opportunities.

Fig. 2  Global growth expected to accelerate

The upturn in the US housing market, repair of household balance sheets and a profitable corporate sector should underpin the private-sector recovery. Thus as the Fed begins to taper QE, US interest rates should rise gradually. However with the unemployment rate above and inflation below government targets, we believe the Fed will keep policy interest rates close to zero and is determined to avoid any rise in long-term rates, which could derail the recovery. The European economy appears to have stabilised, but it is further away from a turning point in monetary policy than the United States. Progress on banking union has slowed to a crawl and regulatory pressure on bank balance sheets continues to shrink the supply of credit to the private sector. On a more positive note, the headwinds from fiscal austerity have eased substantially and as sovereign credit spreads continue to narrow, financial conditions should improve. With inflation below target and unemployment above 12%, interest rates are likely to remain low for several years. Thus the forward paths for interest rates in the worlds’ two major economic regions are set to diverge (Fig. 3).

Fig. 3  Interest rates are expected to rise gradually

The jury is still out on whether ‘Abenomics’ will succeed in revitalising the Japanese economy and the planned rise in the consumption tax will prove a drag. The Bank of Japan will continue its aggressive ‘quantitative and qualitative easing’ programme in an attempt to meet its 2% inflation target. In China we forecast growth should remain at a relatively robust rate of 7.3% in 2014.

A gradual acceleration in global economic activity, combined with continuing accommodative policy from major central banks, creates a benign backdrop for
both credit and equity markets. However, political and policy risks remain high and episodes of market volatility will probably recur as threats to the global economy re-emerge, be it from ‘shadow-banking’ in China, renewed stress in Europe or budget battles in Washington. Convertible bonds should benefit from rising equity markets and tighter credit spreads but also provide protection from the dangers of rising interest rates, which could negatively impact returns from fixed income portfolios and create volatility in equity markets.

Avoiding the dangers of duration
As global growth improves and the Fed begins to taper, we anticipate a ‘normalisation’ of US interest rates. Given current market expectations for inflation, this would imply a yield on 10-year US Treasuries of between 3.5% and 4%. An improving global economy would be beneficial for credit spreads, but the magnitude of tightening would be unlikely to compensate corporate bond investors for losses incurred due to rising risk-free interest rates. Although convertible bonds are fixed income instruments, the equity component in their hybrid structure has historically allowed them to generate positive returns in periods of rising interest rates (Fig.4).

Fig. 4  Convertibles offer positive returns despite falling bond prices

A number of factors contribute to this performance, but the main reason is that in periods where core government bond yields rise due to an improving growth outlook (as in our forecast for 2014), equities generally perform well. Therefore, although the fixed income element of a convertible will likely suffer some losses in this environment, the overall convertible price is likely to increase due to the rise in value of the equity element.

Equity markets have the potential to rise
One of the major drivers of convertible returns is the performance of equity markets. With analysts forecasting that earnings for the bellwether S&P 500 Index will rise 10.6% in 2014 to reach an all-time high, this puts the index on a forward price/earnings (P/E) ratio of approximately 14.2x, which is below the historical average of around 16x. Consequently the current price level of the index appears undemanding and equities could have room to rise further. Equities in Europe on a forward P/E of 12.5x and emerging markets on 10.3x trade at a discount relative to historic averages of 13.6x and 13.3x respectively.

The earnings prospects of global companies currently provides a strong argument for investment in equities versus bonds on a relative value basis. We can illustrate this by expressing corporate earnings in a yield format and then charting this against the yield on fixed income instruments - this highlights the divergence in relative value that has occurred over recent years (Fig.5 overleaf). This is driving companies to issue record amounts of corporate bonds and buy back their equities to improve their return on equity. We also believe it should give rise to a return of leveraged buyouts as both public and private firms take advantage of this dislocation. An active mergers and acquisitions market has historically driven strong returns from equity and convertible markets.

Although convertible bonds are fixed income instruments, their hybrid structure has allowed them to generate positive returns in periods of rising interest rates
Credit spreads offer value

The second major driver of convertible returns is credit spreads. Although credit spreads have tightened for both investment grade and high yield bonds, they still appear to offer investors value relative to anticipated default rates. 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. With the global economy growing, the likelihood of companies defaulting remains low (Fig. 6) and thus we believe investors are currently overcompensated for the risk of default-related losses given current market prices.

Convertible bonds generally rank pari passu with general corporate bond issuance in the capital structure and are therefore priced using the same corporate credit spread. Thus convertible investors can benefit as credit spreads tighten.

Opportunities in emerging markets

As highlighted in Fig. 2, emerging market economies are expected to continue to expand at around two and a half times the rate of those in the developed world. However, credit spreads in emerging markets remain wider and equities undervalued relative to their developed market counterparts. The dislocation in credit spreads is particularly striking as leverage ratios in emerging markets are lower for every credit rating bucket than for companies based in developed markets (Fig. 7). Leverage ratios have historically been a key measure used to highlight credit risk.

In the first quarter of 2013, concerns surrounding a hard landing for the Chinese economy led to an underperformance of emerging market equities versus those in developed markets. This was then compounded in the early summer on fears that the Fed’s planned tapering would lead to investors exiting emerging market economies. With the Chinese economy showing renewed signs of strength and investor outflows proving short-lived, emerging market equities have started to outperform global equities but still remain over 20% behind year-to-date (Fig. 8).
These anomalies can provide investors with the means to diversify their portfolios and generate alpha. Investors in emerging market convertible bonds can thus benefit from improving credit spreads and the equity potential of these high-growth companies. Emerging market convertible bonds have historically demonstrated considerably lower price volatility than direct equity investment and therefore much improved risk/reward ratios.

Fig. 7 Leverage lower in emerging markets

Fig. 8 Emerging market equities have underperformed

Data source: Merrill Lynch as at 30 June 2013

Data source: Bloomberg as at 31 October 2013

Conclusion

We believe the case for investing in convertible bonds in the current market environment appears compelling. In our view, the coming year promises improved growth prospects for the global economy that should prove beneficial for both equity and credit markets. However, core government bond yields are widely expected to rise, particularly in the US if the Fed commences tapering of quantitative easing, which could prove a drag on returns for pure fixed income portfolios.

Convertible bonds, with their ability to participate in both rising equity prices and improving credit markets, appear to offer an attractive investment opportunity. These factors combined with the historic ability of convertibles to generate positive returns in rising interest rate environments, make an investment at this time particularly interesting. The global convertible universe offers a diverse range of investment opportunities both on a regional and sector basis. In our opinion, only an active approach to fund management is likely to satisfy investor requirements to participate in the upside potential but also to provide convexity of returns in the event of market volatility.