

The Value of an Option: How pension schemes can use convertible bonds

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Even though most markets are up - strongly - for 2019 to date, it still isn't easy to make asset allocation decisions. Why is that? The proliferation of negatively yielding bonds, for starters. As of the end of October 2019, there were just over \$13 trillion in government and corporate bonds carrying a negative yield in US dollars.¹

With increasing volatility in markets and a whole host of unresolved geopolitical and economic issues, many of the usual hiding places for allocators to preserve capital now carry a cost. It may even be that at some point in the future central banks will finally raise rates, especially because of the pressure that negative yields are placing on pensions, and duration risk could expose schemes to capital losses.

This dynamic of negative yields requires fixed income investors to accept at least three major risks to achieve returns: duration, credit, and liquidity. Each of these could create problems. In addition, equity markets present further challenges for allocators taking a longer-term view: valuations seem fully priced, but the risks to the downside are piling up.

There are other options available for investors willing to look beyond traditional fixed income. One such avenue could be convertible bonds, which have an asymmetric return profile through an embedded option to convert into equity; the equity-like upside can be combined with bond-like robustness during periods of volatility.

Another advantage of convertibles is their long exposure to equity market volatility – which is particularly pertinent for pension schemes in an environment where more uncertainty seems likely.

Convertibles can benefit from higher volatility in two ways. Firstly, the embedded options become more valuable as they are worth more when the range of possible outcomes increases, i.e. in periods of volatility.

Secondly, convertibles can share in upside participation as markets rise, but bring capital preservation when markets decline. This effect compounds over time, increasing in periods of higher volatility.

To give an example of how the structure of convertible bonds can be used to capture gains but also limit downside in the current environment, let's look at Asia as a region.

With low certainty about how and when US and China trade talks will be resolved, the decision to hold or not hold could cost exposure to the upside if there is a reasonable outcome. An alternative to an equity allocation here might be Asian convertible bonds, which have low to moderate equity sensitivity and strong credit close to their bond floors, yet can still participate if stocks rally on the back of a resolution or other positive news.

Let's now look at the market for convertible bonds to see if an allocation to the asset class can bring some diversification benefits versus fixed income. As convertibles are a subset of global corporate credit, with about \$400 billion outstanding across 700+ individual issues,² the specialist nature of the asset class means that it has not yet been overwhelmed by passive flows or replication, leaving something on the table for active managers.

Issuers like convertibles because they bring flexibility - usually in the form of a lower coupon than a fixed-income investor might demand, with less stringent demands on published ratings and fast launch times. Whereas most credit investors will accept this flexibility with only a bond's coupon income to compensate them, investors in convertibles accept this in return for a share in the upside from an issuer's equity as well.

1. Bloomberg, 31 October 2019

2. As at 31 October 2019

Another key difference versus corporate credit is that convertibles are more commonly used to finance growth-focused projects. This means that the sector composition is different to other credit markets, particularly versus high yield. Yet as a whole, the asset class still has enough investment-grade (IG) or equivalent convertible bonds to create a portfolio that keeps a weighted-average IG stance.

Additionally, compared with other fixed-income choices, where sector compositions or supply/demand imbalance may force investors to accept more risk to earn income, convertibles can mitigate some of the concentration risks from high yield or leveraged loan allocations. Convertibles also tend to be short duration, which may prove a useful feature should central banks finally decide to raise rates.

Therefore, the diversification features and asymmetric profile of convertible bonds can help push out the efficient frontier of a pension plan or allocation. Furthermore, in today's challenging bond market, convertible bonds may provide schemes with diversification from more mainstream sources of fixed income and exposure to growth opportunities.

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