



Convertible Bonds – Should they be an addition to a diversified portfolio?

Rewind to the 4th Quarter of last year when numerous commentators and analysts were calling an end to arguably the longest bull market in history - certainly since World War II - with major indices, such as the S&P quadrupling since the lows of 2009. Since the end of Q4, and as we approach the end of 2019's 1st quarter, equity markets have shrugged off the various concerns felt by investors, of which, the reversal of tightening monetary policy by the Federal Reserve has appeared to be the main catalyst behind this V shaped recovery.

The speed of recovery in investor sentiment and subsequent snap back of markets coupled with the reduction in the VIX index (the markets expectation of future volatility) has caused us to question the validity of this resumption of the bull run. Namely, complacency of market participants and their confidence in central banks to support equity markets is, for us, a cause for apprehension. The concerns investors held at the end of 2018 remain (the Federal Reserve's hawkish stance excluded) and as one of the fixed income managers we invest in reminds us; the dynamics of the bond market is telling us the state of the economic landscape is different than that of the equity market's narrative – the US yield curve inverted on Friday 22nd March with the yield on the 10-year note falling below that of 3 month paper - as widely publicized, a recession indicator.

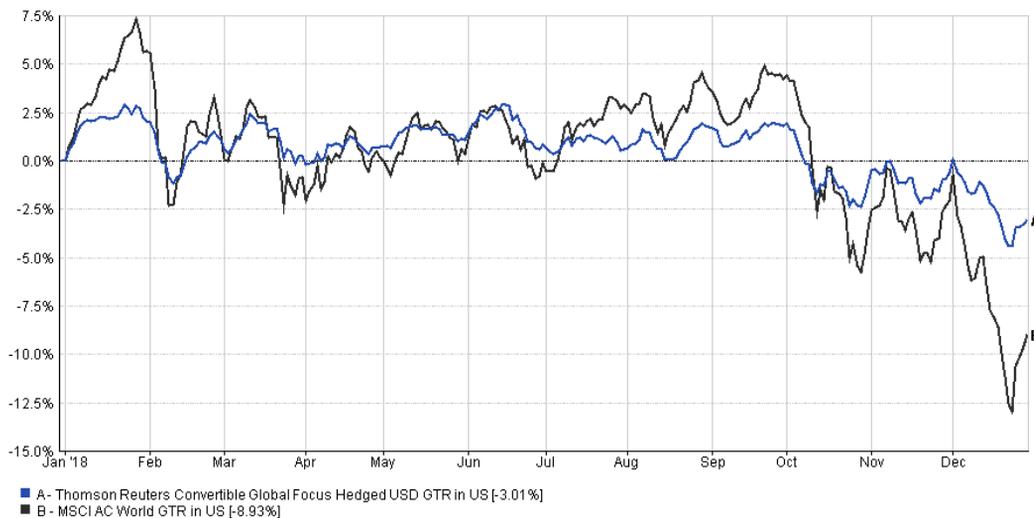
Notwithstanding the above, equities are still our favoured asset class, however, we have been exploring ways of gaining equity exposure whilst decreasing the risk within portfolios and maintaining a level of capital preservation. One way of achieving this is by introducing Convertible Bonds into our asset mix. In simplistic terms, a convertible bond behaves like any other bond in that it pays the investor a regular coupon and at maturity will pay out the par value of the bond, however, it differs from vanilla bonds due to an embedded option in the security which allows an investor to participate in the growth of a company by converting the bond into the equity of the company at a pre-determined stock price level. The price paid for this option is a lower coupon on the security than would be received in the typical bonds of the company.

As described above, the structure of the bond allows for partial participation in a rise in the stock price, while limiting the depreciation in the value of the convertible bond when stock prices fall, due to a bond floor offering a level of capital preservation. This performance profile is referred to as “convexity” and it is this convexity that convertible bond managers look to exploit when building a portfolio of convertible bonds.

The graph replicated overleaf of the environment encountered in 2018 highlights this asymmetric return profile where the total return of a convertible bond is skewed, where it's upside capture of equities is more than that of the downside capture in falling equity markets. Though, it should however be emphasised that convertible bonds will underperform in steadily climbing markets.

Continued overleaf

Performance of the Global Convertibles Index versus the World Equity Index



Source: Financial Express
 29.12.17-31.12.18

We are currently in the process of considering the inclusion of a convertible bond manager and whether a convertible bond strategy would fit within model portfolios. We've conducted a number of manager meetings, conference calls, watched webcasts and gone through various sources of research material in order to develop a list of prospective candidates that exhibit the attributes we look for in manager selection. Watch this space!



Blair Campbell Chartered MCSI
 Portfolio Manager (Guernsey)

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