A PRIMER: CONVERTIBLE BONDS AND CONVERTIBLE BOND ARBITRAGE

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SUMMARY

Though many may not be as familiar with convertible bonds, they in many ways are similar to more traditional corporate bonds. Akin to traditional bonds, convertible bonds pay interest, have a maturity date, and are backed by the credit of the issuing company. The main difference is that convertible bonds have an added feature that allows the owner to convert the bond into common stock of the same company if the price of the stock rises beyond a certain level – the conversion price. If the stock never rises to the conversion price, the bondholders simply collect their coupon over the life of the bond and full principal upon maturity, just like a traditional bond. The conversion feature, however, provides the owner additional optionality which can improve the upside potential of the investment if the company backing it continues to perform well. In this way, convertible bonds combine the characteristics of both bonds and stocks.

Generally speaking, convertible bonds behave like stocks when the underlying stock approaches the conversion price, and more like bonds when it is further away. Therefore, convertible bonds provide investors the principal protection and static income traits of bonds, along with the opportunity for higher returns if the underlying stock price rises.

Convertible bond arbitrage is a long-short strategy of buying a convertible security while simultaneously selling (short) a commensurate amount of that company's stock to capitalize on the pricing inefficiencies present between the stock and the convertible bond. Ideally, if the stock rises, the loss from the short position in the stock should be less than the gain from the convertible bond's price appreciation. On the other hand, if the stock falls, the gains from shorting the stock should exceed the loss on the convertible bond as the convertible cannot fall below the bond floor. By managing the market exposure, investors can generate profits when price volatility increases by selling the stock as it goes up and buying more as it goes down, while their overall position is stabilized by the bond.

CONVERTIBLE BONDS

Despite the promising benefits they offer, convertible bonds are not risk-free. They are typically lower in the capital structure and are usually issued as senior unsecured notes, making them more vulnerable to losses when compared to more senior bonds if the issuer defaults. Another downside of convertible bonds is the forced conversion. Like most corporate bonds, convertible bonds are typically callable by the issuer. This call option insulates the issuers from any dramatic spike in the stock price while limiting the upside potential for the bondholders.

Convertible bonds are issued by a broad range of companies across various industries. A large segment of the issuer base today includes high-growth companies, rated just below investment grade, that utilize convertible bonds as a way to reduce their cost of capital. Convertibles generally have less restrictive covenants and lower coupons than the high yield bonds these companies may consider issuing as an alternative source of financing.

So what determines the value of a convertible bond? There are mainly four factors: credit, income, volatility, and underlying equity price. Credit can be modeled in much the same manner a straight bond can – current price, interest rate, yield spread over comparable treasury yield. Volatility is also important as it is closely related to the likelihood that a bond will convert into common stocks of the issuer. As volatility increases, the conversion option becomes more valuable.

Convertible bonds are recommended for investors who wish to participate in the growth of a particular company but want to reduce some uncertainty. By investing in convertibles, investors are limiting the downside risk, at the expense of limiting the upside potential. In the low interest rate environment in which we are currently living, the hybrid nature of these securities can provide investors the principal protection and static income traits of bonds, with the opportunity for higher returns if the underlying stock price rises.

CONVERTIBLE ARBITRAGE

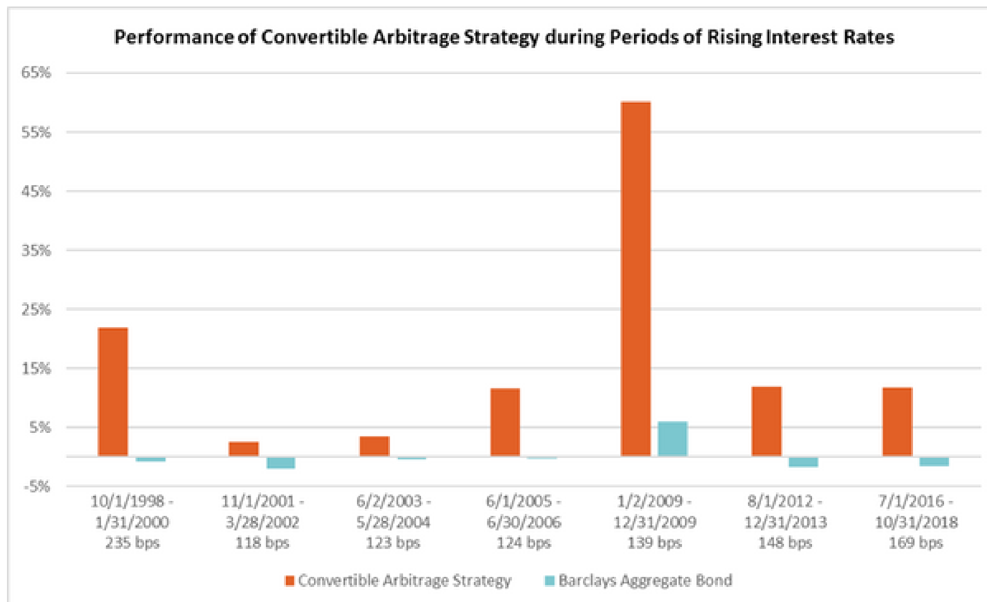
As previously discussed, convertible securities begin to exhibit price actions that are more correlated to the stock when the stock price of a company approaches the conversion price on the bond. One strategy to mitigate this equity sensitivity is to buy a convertible while selling (short) a commensurate amount of the underlying company's stock. This is referred to as convertible bond arbitrage and allows the manager to capitalize on the pricing inefficiencies present between the stock and the convertible.

In this scenario, the combined position will typically have a positive cash flow from the coupon of the bond, while having a reduced exposure to the movement of the stock price. It also creates the opportunity for additional gains as the manager will adjust the amount of stock exposure by trading the underlying shares as the stock price goes up or down. As such, it can be particularly effective during periods of heightened volatility.

For example, early in 2020 when there were significant declines in both the stock market and the corporate bond market, our approved manager employing a convertible arbitrage strategy performed much better – down a small fraction of the stock market and roughly one third of the losses experienced in investment grade corporate bonds.[1]

The strategy is a portfolio diversifier with low correlation to equities and bonds and may work as a hedge against an inflationary environment, as it has lower sensitivity to interest rate rises. Historical performance during periods of rising interest rates reinforces such a point. Selected dates in Figure 1 reflect periods during which the 10-year US Treasury yield increased by at least 100 basis points. Performance of the convertible bond arbitrage index and the broad bond market index during each rising rate period is shown in the chart. The strategy has consistently outperformed the broad bond market in all those periods.

CONVERTIBLE ARBITRAGE

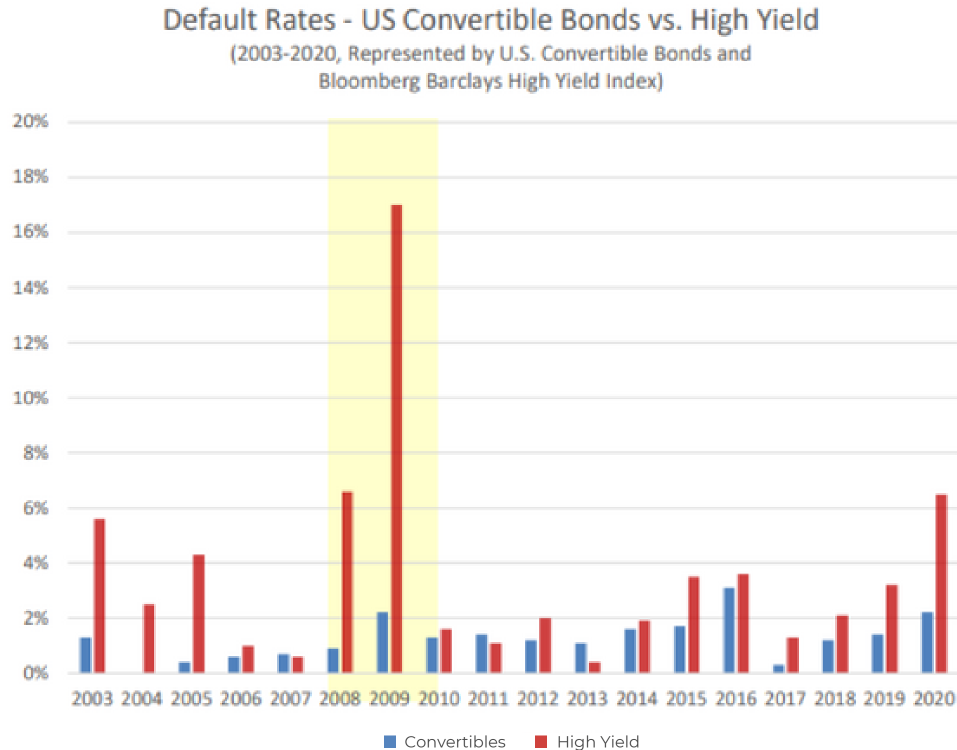


There are a few reasons behind the outperformance of the strategy over other fixed income investments when rates rise. As discussed in the previous section, the issuers of convertible bonds are often in sectors that tend to benefit from economic expansion when interest rates are most likely to rise. Convertibles also tend to have shorter durations than non-convertible debt, mitigating the impact of rising interest rates on their valuations. Finally, the value of the conversion option usually increases with higher interest rate volatility and volatility more generally.

Moreover, another advantage of this strategy is that it enables the manager to access the debt of some companies that may otherwise not be accessible, as many of these companies only issue convertible bonds and do not also issue more traditional bonds. Convertibles are a fairly small, niche market with a relatively small amount of new annual issuance compared to traditional corporate bonds. This creates a barrier to entry for the large multi-strategy funds whose assets are too big to deploy sufficient capital to make such trades meaningful.

CONVERTIBLE ARBITRAGE

As always, a convertible arbitrage strategy is not bullet-proof. Investors need to consider numerous risks associated with the strategy: credit risk, interest rate risk, manager risk, legal provision risk, and currency risk, just to name a few. While default rates for convertible bonds have historically been low compared to high yield bonds, as shown in Figure 2, investors should pay significant attention to the credit risk and a manager's skill in assessing that risk, as most of the issuers tend to have relatively low credit ratings or no credit ratings at all. Notably, more than half of the Bloomberg Barclays U.S. Convertible Composite Index is not rated and less than 20% of the index is composed of issuers with investment-grade ratings.[2] Therefore, selecting a manager with extensive fundamental credit research capabilities and a deep understanding of the asset class is crucial.



ABOUT LVW ADVISORS

LVW Advisors, based in Rochester, NY with a national presence, is an independent financial advisory firm serving wealthy families and nonprofit institutions nationwide. Lori Van Dusen founded LVW to realize her vision of doing financial and investment advisory differently: by putting the client first. The LVW Advisors team is committed to providing objective advice, transparency, access to vast resources and innovative solutions, delivered with outstanding, high-touch client service.

While LVW is founded upon a high-caliber institutional advisory practice anchored by a deep research process, Lori recognized early on that wealthy individuals and families were lacking the same kind of objective advice and discipline that the LVW team was delivering to institutions. Lori fortified an already seasoned team with Joe Zappia and his group, Zappia Family Wealth. Together, Lori and Joe, two complementary industry veterans, expanded LVW's financial planning and asset management capabilities. LVW Advisors has truly become an ideal fit for nonprofit organizations and for wealthy individuals and families seeking a truly consultative relationship, deeply rooted in integrated investment management, with a personalized, individualized touch.

LVW is built on two central ideas:

- An unwavering focus on attaining our clients' investment goals
- Leveraging a robust open-source platform of research and services

DISCLOSURE

SOURCES:
1 Bloomberg
2 Schwab
Figure 1 Bloomberg and U.S. Department of the Treasury. Convertible Arbitrage Strategy is represented by the HFRI RV: Fixed Income – Convertible Arbitrage Index. Returns greater than one year are not annualized. Index performance reflects reinvestment of dividends.
Figure 2 Barclays as of 12/31/2020

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