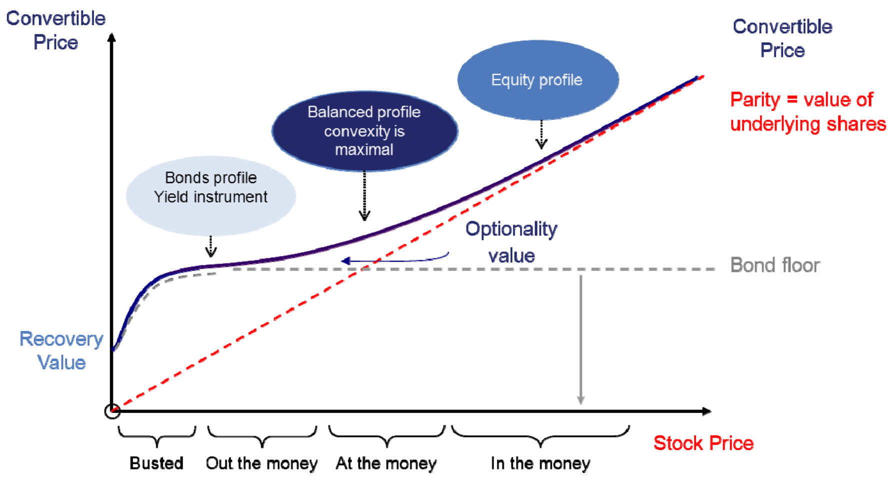
MIRABAUD 1819 Asset Management

Global Convertible Bonds
November 2013

Performance of convertible bonds

A convertible bond is a fixed income security with a redemption value and, typically, a coupon payment similar to a straight bond.

However, in addition, the holder has the right to convert the bond into a fixed number of the underlying equity shares. This flexibility results in the theoretical valuation profile illustrated above.



The figure illustrates the convertible's price changes with equity: its profile can be divided into three broad categories: bond-like, balanced and equity alternative.

In their area of convexity, balanced convertible (defined as an equity sensitivity in the range of 30 - 70% with a credit risk less than 350bp) are sensitive to both following factors in decreasing order:

- Evolution of the underlying stock: as a stock price rises, the equity sensitivity of the convertible increases. Should equity fall, the sensitivity decreases, thereby providing lower participation in an equity market decline.
- Changes in interest rates and issuer risk (credit spread): widening spreads and interest rates lower a bond value and therefore a convertible price. As a result strong credit names have more stable bond values in the event of a decline in the underlying shares.

The lower risk profile derives from the downside protection given the support of the bond floor while retaining upside exposure to the equity, yet with lower volatility and mitigating the most significant drawdowns.

Renaud Martin - Nicolas Crémieux

Compelling long-term convertibles performance and interest for investors

Convertible bonds offer equity investors the opportunity to diversify into an alternative asset class with superior risk adjusted returns.

	10 years period (31 october 2003 - 31 october 2013)							
	Government bonds		Corporate Bonds		Convertible Bonds		Equities	
	JPM Global Government Bonds hedged $		Bofa Merril Lynch BBB Corporate hedged $		UBS Global Focus Hedged $		MSCI World Hedged $	
	Annual Return	Standard Deviation	Annual Return	Standard Deviation	Annual Return	Standard Deviation	Annual Return	Standard Deviation
	4.5	2.9	6.6	4.3	5.3	7.5	4.7	12.8
Correlation of convertibles with other assset classes	-0.15		0.37		1		0.88	

Source: Bloomberg

Over the last 10 years, convertible bonds have offered greater returns than equities (5.3% vs 4.7%) with a lower level of risk (7.5% vs 12.8%). The addition of convertible bonds to a debt-only portfolio is seen as enhancing risk adjusted returns as well. Over this same period, convertible bonds have outperformed government bonds Index (5.3% vs 4.5%), but with a higher standard deviation (7.5% vs 2.9%). Most importantly, one of the key insights of mean-variance optimization is that the addition of a risky asset to a portfolio can reduce portfolio risk if the asset has low correlations with the other portfolio assets. The figure above shows the correlations of total returns for convertibles with major asset classes over the period 2003-2013.

The results indicate that convertibles have been highly correlated with equities (0.88), but much less correlated with the various fixed income asset classes: 0.37 with corporate bonds and -0.15 with government bonds. This implies convertible bonds will provide particularly effective diversification in fixed income-oriented portfolios.

Why invest in convertible bonds today?

Looking ahead to 2014, convertible bonds should continue to show attractive returns. Even if we are concerned about monetary disequilibria, markets should be supported by fundamentals and continued earnings growth. Whilst government bonds could suffer from issues surrounding central bank exit strategies, we believe that convertible bonds are poised to more than compensate investors for the higher interest rates, especially given the markets very low duration (currently only about 2.8) and the higher equity sensitivity, with a delta of around 40%.

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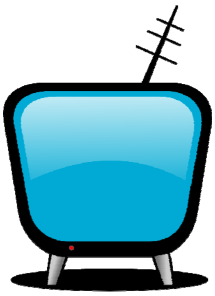
With over 850 issues and a total 300bn Euros market capitalization, the average expected life for Global CB is 5 years. Issues year to date have been very strong with EUR 50 billions from 220 issues. The global market offers a balanced choice of sectors with information technology (18%), consumer discretionary (14%), industrials (12%) and energy (9%).

The current credit sensitivity of the convertible bonds market is rather important as only 20% of the global market is currently rated investment grade, while 21% is rated sub investment grade and the remaining 59% having no official rating from an agency (most of these issuers are midcaps with stock market capitalization under five billion euros).

We stay constructive in the credit market, given current high cash levels, high rates of profitability, low cost of debt and increase corporate risk appetite.

Moreover, convertible bonds are attractive thanks to their speculative appeal linked to the put at par and the ratchet clause (which offers compensation to CB-holders in the event of a change in control), which is now standard in the asset class. We believe 2014 could mark the beginning of a new cycle of mergers and acquisitions.

In conclusion, we believe that convertibles provide a defensive alternative to equities, with fixed coupons and support from their investment values, whilst maintaining a degree of equity exposure.



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