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CONVERTIBLES: A GOOD ENTRY POINT IN TODAY'S MARKETS BUT THE FOCUS MUST BE ON ACTIVE QUALITY /

Today, we believe that investors have a very good entry point into the Convertible Bond asset class. Convertible Bonds have played a buffer role in the recent sell-off, bond flows are holding up and there is credit support from central banks and governments. There is also unlimited quantitative easing – even the US Federal Reserve is now buying in the High Yield segment – this means there is very strong credit support.

For the moment, greater visibility on the recovery remains core. We are entering the earnings season and we expect to see a lot of volatility. Convertible Bonds are perfect for navigating this environment because they can still capture some upside. From a valuation perspective, they are very cheap and well below the implied volatility of the listed options.

Historically, when we have seen such cheap valuations before - for example, in 2008 and 2011 – this has always been followed by a richening of the asset class as it returns to normal levels. Convertibles are ideal in navigating through uncertainty and the current environment presents a good entry point as valuations are now very cheap.

Questions, questions, questions

The credit market now offers some value after the widening of spreads and that the recent Monetary and Fiscal injection will have a meaningful impact on the market. What is crucial for each convertible bond we hold is to ask the following questions: What changes would result in a company facing a liquidity issue, how much leverage does it have and how strong is its balance sheet? We are also looking at dividends and share buy-backs. Due to the risk of defaults, our strategy is to avoid the weakest companies that might go bankrupt at this stage of the cycle.

Mirabaud – Convertible Bonds Europe

Resiliency is key

As we enter the earnings season, we believe there is likely to be a lot of volatility, which is good for this asset class because convertible bonds benefit from high volatility. We are currently positioned in very resilient business models with access to credit and strong balance sheets. We don't yet know when and how the lockdowns will be lifted in Europe, so it's important to focus on those companies that have low levels of leverage.

In the past, companies have had access to cheap money as a result of low rates, and therefore, they had the ability to increase their leverage cheaply, resulting in higher debt. We call them Zombie Companies – companies that were already fragile before the crisis, where over-leverage creates a significant burden. Furthermore, we are also cautious about small- and mid-cap companies and we have reduced our exposure in these areas.

We think it is time to be very opportunistic because there are currently many pricing anomalies, such as heavily discounted high quality credits. Consequently, we remain very active, taking opportunity from volatility and looking for mispricing.

Sector and structural thematic plays

In terms of sectors, we are overweight in IT, Healthcare and Utilities and underweight Industrials, Materials and Energy. We are positioned in companies we believe will emerge as winners once the crisis is over and that will benefit from various structural changes. For example, in Automation we are investing in Ocado, the food delivery company, and also Takeaway & Delivery Hero. We are also investing in companies benefitting from home working such as GN store. Furthermore, we also believe that governments will accelerate the shift in green energy, which remains and area of focus for us.

Mirabaud – Convertible Bonds Global

At the end of the first quarter, 2020, we had 50 positions versus 191 for the benchmark (Refinitiv Global Focused Hedged Index $), with the twenty top positions accounting for around 58% of the overall portfolio and an active share ratio of around 83%.

We think some great investment opportunities have already emerged since the market lows on 23rd March. The sell-off represents the best buying opportunity we have seen since 2009. We therefore increased the delta to close to its maximum limit of 60%, by deploying 20% of cash or its proxy in early March because we had reached levels that were pricing systemic damage and not only a business cycle recession. This created exceptional valuation opportunities.

Since then, risk assets have rebounded strongly, more than 20% on most equity indices, and we took advantage again to reduce the equity participation to its lowest level since inception. We did this for two reasons. First, because we feel more comfortable being long in credit and secondly because we think the strong rebound in equities will not continue. We believe effective vaccines for the virus will not arrive soon enough and the road to economic success will not be easy. As a result, we expect the economic data will be very challenging in the coming weeks and as a result, our attention will shift on company data as we enter the first quarter of the earnings season in the US.

Following the latest bounce, key multiples have moved closer to their historical average and are not cheap anymore. The forward PE ratio for the S&P is 16x with earnings expected of $175, which is below the five year average of 16.7 but above the 10-year average of 15X. We believe the index is now priced for perfection and the fair value range for the S&P is somewhere between 1,800 and 2,500 based on $140 EPS – 20% below where the consensus currently stands. This would translate into a forward ratio of between 13 and 18 times.*

V, U or W?

The coming weeks will be challenging because meeting or missing an estimate will need to be viewed cautiously. The majority of businesses have been impacted by lock downs, some mildly others severely, so there will be lots of new questions such as the scope of the damage, guidance going forward and how this will impact future earnings. Investors will therefore need to be patient. We do not think we are going to have a V-shaped recovery, although that's always the hope after a sharp market decline. It's more likely to be a U-shaped or W-shaped recovery.

*Source: Mirabaud Asset Management Convertible Bond's Team

Our sector plays

In terms of sectors, we are overweight cyclical value sectors like technology, consumer discretionary and industrials at the expense of defensives such as consumer staples and utilities because we believe that bond yields are more likely to move up than down from here. We prefer to concentrate our equity exposure on high convictions. The top two positions among the top five sectors make up 50% of the total equity sensitivity of the Fund.

Elsewhere, we are also diversifying in other sectors such as Financials. In Energy the only position we hold is Total. In Consumer staples, we hold a Japanese company that is a leader in cosmetics.