INSIGHTS

CONVERTIBLE BONDS

UPSIDE PARTICIPATION TO RISING EQUITIES SET TO JUMP

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A primary justification for investing in convertible bonds (CB) is their asymmetric performance compared to the return of the underlying common stock. Positive asymmetry accounts for the convertible indices' historical equity-like returns, which have been characterised by lower volatility and less downside than equity indices. But let's not forget that CB are a mutant asset class and their sensitivity to their underlying equities varies in combination with stock market variations and the flow of new issues, as well as the redemption or conversion at maturity of older papers.

The usual metric used to measure the rate of change of the market price of a convertible relative to the share price move is delta. This could also be viewed as the probability of a convertible expiring in the money.

CHART 1: NEW ISSUES WITH MATURITIES OF 2028 AND ABOVE CONTRIBUTE TO THE RISE OF DELTA

Source: Refinitiv, Mirabaud Asset Management as of 31 January 2024. Data is from the Refinitiv Global CB hedged USD index. **Past performance is not indicative or a guarantee of future returns.**

It is interesting to observe in chart 1 that the average delta of the Refinitiv Global Convertible Bond Index reached near all-time lows in 2022 and CB upside participation was limited in 2023 to 41%. This is explained by the combination of the rates-driven sell-off and aggressive pricing from the pandemic era, which left many embedded options on CBs far out of the money.

Consequently, despite the 16.7% increase of the parity (underlying equities) in 2023, the delta of this index has been roughly flat at around 45% as a sizable portion of so-called "busted" convertibles (whose underlying warrants trade like pure bonds) are still present in the market.

The dashboard shows that 54% of convertible bonds have a maturity before the end 2026, and that a large majority of them have a bond profile with a delta below 40% (63% in 2024, 57% in 2025 and 73% in 2026). Or put another way, the share price of those convertibles trades significantly lower than their conversion price.

As time goes by, their delta should remain under pressure because the loss of value time lowers the chance that their underlying stocks will appreciate to the point where the convertible is in the money at expiration.

CHART 2: BREAKDOWN OF CB PROFILE BY CALENDAR YEAR

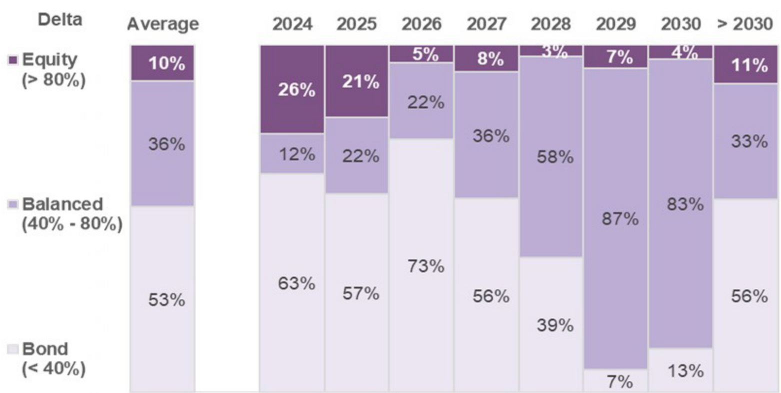
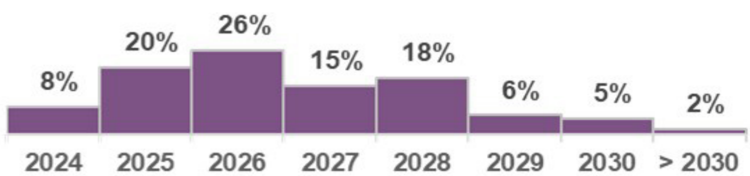


CHART 3: BREAKDOWN BY MATURITY



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From those numbers, we can conclude that the redemption of bond profiles will contribute to increase the average delta. But the strong comeback of the primary market should also support the uptrend of the average delta, all things being equal, as new deals typically come with a balanced profile, which is the only category that provides convexity. Balanced profiles currently dominate post-2026 maturities (36% in 2027, 58% in 2028 and 87% in 2029).

The renewal of the universe makes us confident in the ability of convertibles to capture a much higher upside participation to rising equities. We recently discussed how the upside/downside participation ratio was on the rise in 2023 and we are optimistic that it will continue to expand in 2024. Remember, the asset class is a "mutant" and is currently renewed with characteristics that should enhance its overall risk-return profile.