

Market Concepts

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By:

Uma Thurnau - Treasurer

CONVERTIBLE BONDS

Convertible bonds are an exceptional asset that is often overlooked by both equity and bond investors. Liquidity is on everyone's mind during market dislocations and political uncertainty. With the global economic slowdown caused by the coronavirus pandemic and turbulence in the markets, it is vital to be able to identify trading and investment opportunities.

Convertible bonds are a debt security that provide flexibility for investors. Similar to any bond, they share common features with traditional fixed income instruments. Convertibles are issued with a maturity date, stated coupon, credit rating and redemption value. The main appeal of a convertible bonds in a portfolio is their ability to offer bond-like protection with equity-like performance. The "option" to convert a bond into common stock of an underlying company may offer an advantageous risk-reward profile with volatility-adjusted returns.

Risk/Reward Trade-Off - A Well-Diversified Portfolio

An analysis of returns over time shows that a strategic, long-term allocation can raise efficient frontiers. Compared to a portfolio with only stocks and bonds, a portfolio with convertible bonds has shown similar returns with lower standard deviation. The convertible bond market has been tapped for opportunistic reasons in high-growth sectors such as technology and healthcare.

Benefits

- Convertibles may provide current income and protection against server market declines and an opportunity to access defensive equity exposure.
- Reduce impact of interest rate fluctuations in a rising rate environment due to lower duration (measure of sensitivity) relative to conventional bonds.
- Increase alpha with asymmetric return portfolios (greater upside potential than downside risk) and add diversification benefits.

Drawbacks

- Issuers tend to offer convertible bonds at a lower coupon compared to regular bonds.
- In an event of a bankruptcy, convertible bonds are often considered an issuer's subordinated debt and therefore, other bondholders may be paid off first.
- If a stock price is unable to appreciate, investors will earn a yield below what they could have earned in a bond with no conversion or premium feature.



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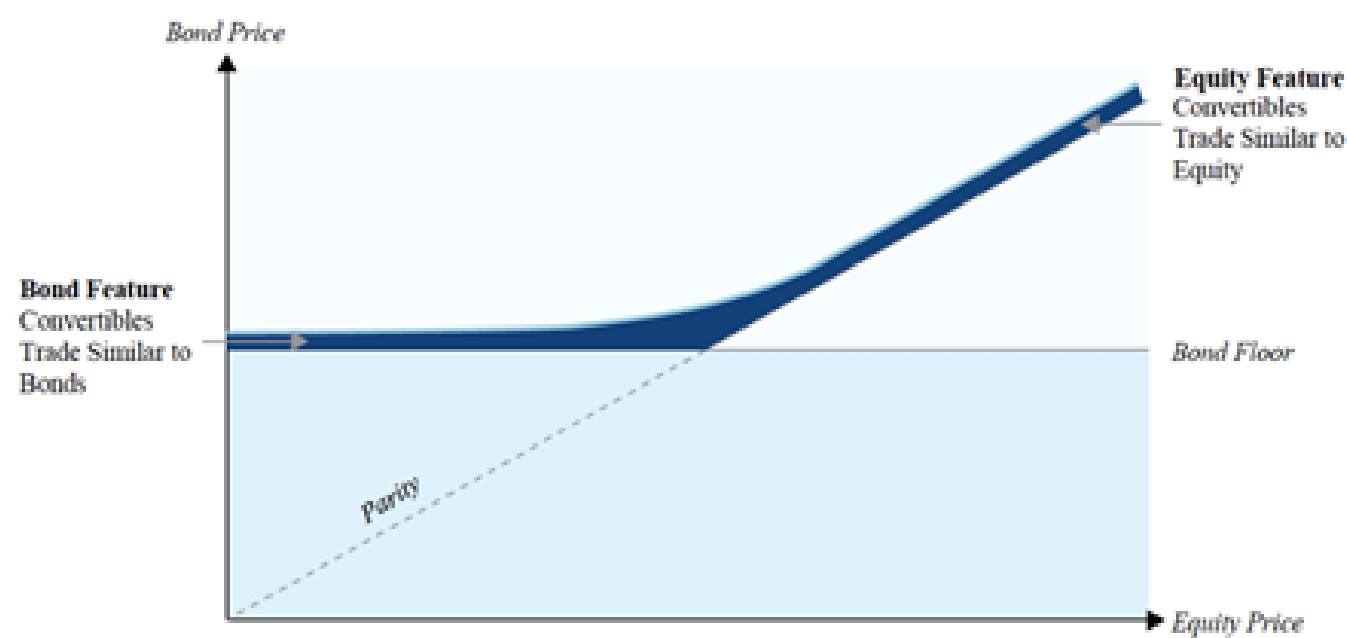
“Global convertible issuance has surged in the wake of the COVID-19 outbreak. The \$92 billions of convertible securities issued year-to-date (as of June 30, 2020) is the highest first-half total on record.” - Oaktree Capital Management

“Convertibles thrive in a pandemic but are no financial panacea” - Aidan Gregory, Global Capital Magazine

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At the moment, convertible issuers include high-growth technology and pharmaceutical corporations, as well as established industrial conglomerates. Holding convertible bonds provides a method to diversify the fixed income component of a fund or portfolio.

In the end, the global convertibles market offers a unique, secure and hybrid debt-and-equity solution for investors who wish to overcome today’s volatile and challenging environment.



Parity is the value received upon conversion from bond to stock. The dotted line indicates the intrinsic value.

The convertible price curve outlines the fair value.

