SHOULD CONVERTIBLE BONDS BE PART OF YOUR PORTFOLIO IN 2019?

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INTRODUCTION

Global convertibles outperformed equities by about 8% in 2018, the highest in almost a decade.[1] In fact, global convertibles were the second-best performing asset class last year, lagging only US Treasuries.[2]

WHY WAS THIS?

Concerns around global growth, a shift in central bank policy from easing into tightening, and ongoing macro risks (such as Brexit and the US/China trade dispute) all weighed on asset prices in 2018. Volatility also increased with the growing uncertainty.

These developments proved to be beneficial for convertibles for many reasons:

- Rising volatility can act as a tailwind for convertible valuations since it may increase the value of the embedded option. Indeed, with one exception in 2011, US convertibles have outperformed equities through every rising volatility environment since 2001, according to Bank of America Merrill Lynch ('BAML').[3]
- Convertible bond convexity means that during a market sell-off, valuations have an element of protection to the downside as the bond features a convertible kick-in. Equally, this convexity means convertibles retain upside exposure when markets rally.
- In a rising interest-rate environment, convertibles are widely seen as a potential replacement for high yield ('HY') and investment grade ('IG') credit given they typically exhibit the lowest duration of all major fixed income asset classes.

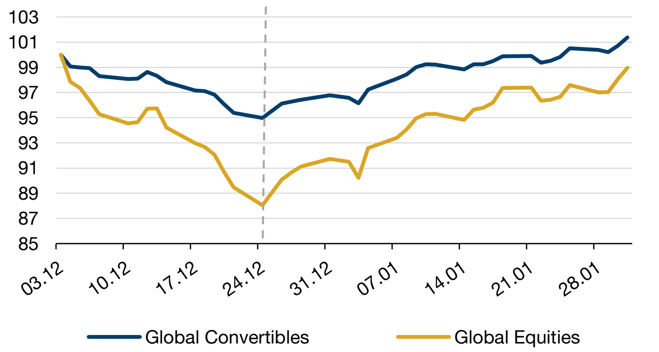
2019 OUTLOOK

While global equities have recovered some of their losses from the final quarter of 2018, opinion is divided as to whether markets have already peaked.

It's in this sort of uncertain environment that convertible bonds' convexity will prove to be advantageous, in our view. Figure 1 shows how convexity limited the downside for convertible bonds during the heavy selloff in December 2018, and ensured the asset class still performed well in January when equities subsequently recovered. This asymmetric return profile means that in the long run, convertibles can potentially offer equity-like returns with lower volatility.

Indeed, reduced fears of an economic slowdown and optimism of a trade deal between the US and China have both served to move equities higher from late-2018 lows. In addition, recent commentary from the Federal Reserve has placed more emphasis on "patience" and the need for more data to adjust the pace of rate hikes, which has served as another tailwind for markets. These factors aside, a global recovery is far from certain and various signals suggest we remain in the late stages of the cycle. One should caution, however, that despite this uncertainty, late market cycles have historically tended to be characterised by strong moves higher in global equities. Investors therefore may need to keep one eye on being able to participate in this but also ensure they are cognisant of the potential for a major downside correction (as seen in the fourth quarter of 2018).

Figure 1: Convertible Bonds' Convexity – Equity-Like Returns With Lower Volatility



Source: Bloomberg; Between 3 December 2018 and 31 January 2019 Normalised to 100 on 3 December 2018 Global Convertibles is the ICE BAML Global 300 CB Index; Global Equities is the MSCI ACWI Total Return (NDEUACWF Index).

We believe convertibles remain well-placed for such an environment. Following the outperformance of global convertible bonds in last year's down market, remarkably, global convertibles were then the second-best performing asset class in January 2019, when equity markets posted a large move to the upside (Figure 2).

Figure 2: Global Convertibles Were Second-Best Performing Asset Class in January 2019

Asset class	Jan '19 Returns (USD)	Jan '19 Returns (Local Currency)
Global Gov Bonds	1.29%	0.66%
Global IG Index	2.16%	1.75%
Global HY Index	4.12%	3.97%
MSCI World Index	7.93%	7.26%
Global Convertibles (G300)	4.76%	4.57%

Source: Bank of America Merrill Lynch, ICE Data Services; As of 31 January 2019.

1. Source: Bloomberg. ICE BofAML Global 300 CB Index fell 1.15% while MSCI ACWI Total Return Index declined 9.41%. **2.** Source: Bloomberg; As of 31 December 2018. Asset classes looked at include: Global Convertible Bonds, Global IG Index, Global HY Index, MSCI World Equities and Global Convertibles. **3.** BAML Global Convertibles Chartbook; 'The postmortem: 8 trends and themes as we say farewell to 2018'; published 2 January, 2019. BAML looked at the S&P 500 Index 1-year relative volatility from 2001 to 2018, and the corresponding outperformance of US convertibles against equity 1-year performance.

THE DRAWBACKS OF CONVERTIBLE BONDS

Convertible bonds generally offer investors a lower coupon than comparable straight debt, thus making straight debt more attractive to income-focused investors who only care about receiving a regular interest payment. Secondly, in a consistently rising equity market, convertibles will tend to lag equities due to their lower average delta, or equity sensitivity. However, this is compensated for by their downside protection features, which soften losses when equities decline.

CONCLUSION

Convertibles retain equity exposure should markets continue to move higher, while their convexity means investors have an element of protection to the downside if equities have another leg down. With markets likely to experience further bouts of volatility, we believe convertible valuations should hold up well – in fact, a record net 19% of CB investors believe convertibles already look cheap.[3] Lastly, the lower duration of convertibles mean they are less exposed to interest-rate increases than other fixed income asset classes, and so could outperform should rates move higher in 2019.

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Convertible securities may be affected by market interest rates, the risk of issuer default, the value of the underlying stock or the issuer's right to buy back the convertible securities. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating. Fixed income investments are subject to interest rate and credit risk. Subject to the terms and conditions, convertible bonds provide investors with the right to convert such bonds (at a specified conversion price) into either a specified number of shares or other fixed income securities of the issuer. Compared to other non-convertible bonds, convertible bonds generally have a lower coupon rate. As convertible bonds are hybrid debt-equity instruments, investors would face the risks associated with both equity investments and fixed income investments.

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