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INITIATING COVERAGE OF CONVERTIBLE BONDS

BEARISH BEGINNINGS

Authors

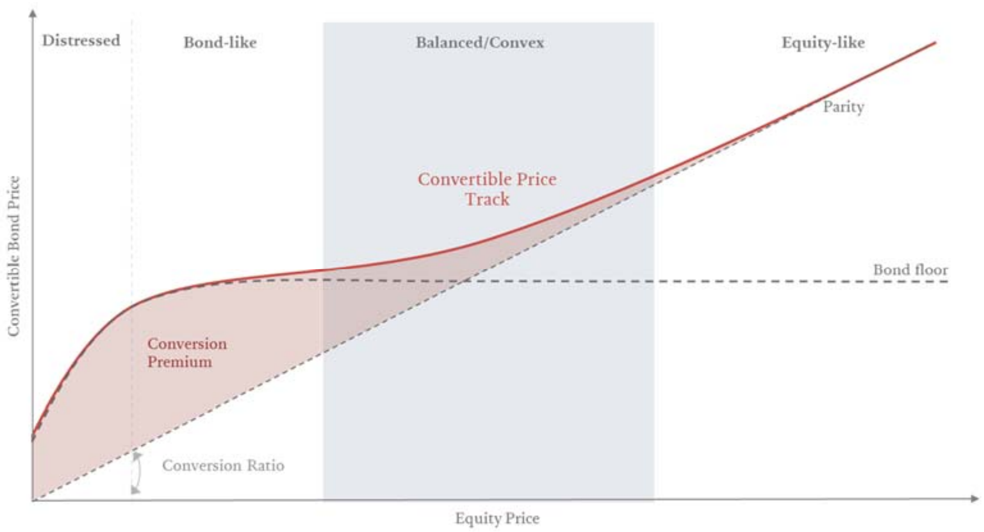
MICHELLE MERTIN
mmertin@pictet.com

JACQUES HENRY, CFA
jhenry@pictet.com

SUMMARY

- Convertible bonds are a tiny asset class that combine bond and equity features, giving them some natural convexity.
- Convertibles are mostly issued by small and mid-sized growth-style companies. Most issuers are not rated, but if they were, they would be closer in credit quality to high-yield corporate bonds than investment-grade ones.
- Waning demand in an increasingly unfavourable market and economic environment has resulted in weak issuance year to date.
- After outstanding returns in 2020, and even more so in 2021, the convertible bond market has suffered significant losses so far this year, on a par with equities.
- The bond floor has not held firm for two main reasons: aggressive issuance over the past two years and rising yields this year.
- Structurally, US convertibles show more delta (equity sensitivity) than their European equivalents. US convertibles are also pricier and have more tech exposure, which has contributed to their recent poor performance.
- Appetite will come back for convertibles turned toward recovery or long-term growth stories, but it may still be too early to step back into this market.

CHART 1: CONVERTIBLE BOND BEHAVIOUR



Source: PWM – CIO&MR, 07 June 2022

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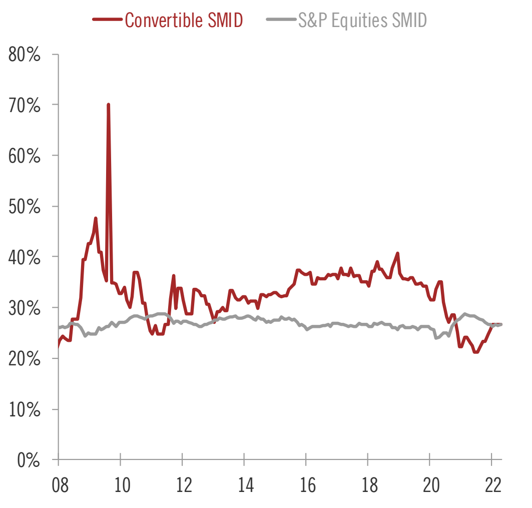
Convertible bonds are hybrid financial instruments that combine debt and equity-like features. They resemble conventional bonds in that they pay a defined coupon and principal upon maturity, but they also possess an embedded option giving holders the right to convert the bond into a set number of shares. The conversion option thereby allows convertible bonds to be naturally convex *(see Chart 1).*

Historically, this natural convexity has ensured returns for convertible bonds comparable to those for equities. Convertible bonds participate in equity bull markets while they offer protection during equity sell-offs. Convertible bonds have generally demonstrated structurally lower volatility than their underlying equities, meaning the value of the conversion option increases during volatile markets.

Although convertible bonds have been an investable asset class since the 19th century, global issuance has only gained traction in the past 20 years. But the asset class remains small, with a market capitalisation of just over USD 0.5 tr, accounting for 0.3% of total global financial assets under management.

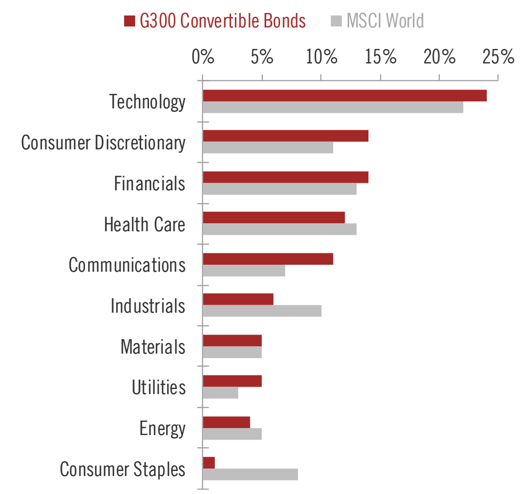
Convertible bonds hold a certain attraction as a financing tool for unrated or high-yield bond issuers and for small and mid-sized issuers of equity with a growth tilt. On average, small and mid-sized companies have contributed 33% to the index's value contrasting to 27% for S&P Equities *(see Chart 2)*. Furthermore, global convertible bonds have a higher exposure than global equities to sectors harbouring high-growth companies such as technology and communications.

CHART 2: CONVERTIBLES VS EQUITIES SMID VALUE



Source: PWM – CIO&MR, BofA, FactSet, 31 May 2022

CHART 3: CONVERTIBLE BONDS BY SECTOR VS MSCI WORLD



Source: PWM - CIO&MR, BofA, FactSet, 13 May 2022

Convertible bond issuance soared following the March 2020 market correction as companies sought to regain access to the capital markets. Issuance was dominated by companies in growth and recovery mode. Pandemic restrictions and ultra-accommodative central banks enabled high-growth companies to thrive in 2020 and early

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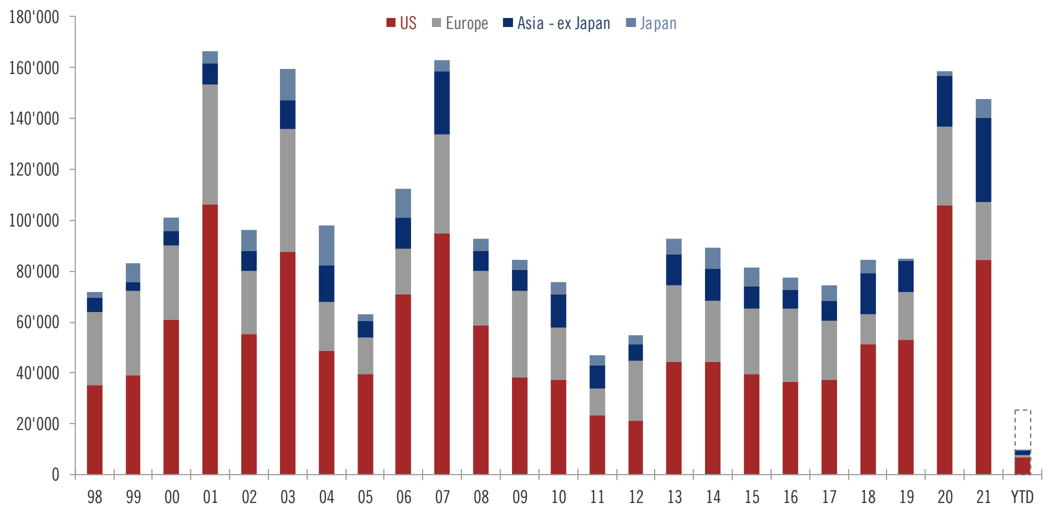
2021. Recovery names in leisure and tourism-related sectors were also important convertible bond issuers in 2020 and 2021. By contrast, issuance in 2022 year to date has fallen to historical lows due to waning demand, high volatility and low prices.

CHART 4: GLOBAL CONVERTIBLE BOND ISSUANCE



Source: PWM - CIO&MR, BofA, 31 May 2022

Speculative issues and those with a "growth tilt" are driving convertible bonds' underperformance

Strong performance and a favourable market environment attracted a wave of opportunistic convertible issuance in 2020 and 2021. The underperformance of convertible bonds this year can largely be attributed to these new deals.

Deal pricing had climbed to very aggressive levels, with coupons far below average and substantial average conversion premiums, which weakened the "bond floor". This is the theoretical investment value of an issuer's bond without the conversion feature, below which the value of the convertible bond should not fall. However, a stable bond floor assumes interest rates and credit quality remain unchanged. In the event, this year's rise in market rates and in corporate bond yields has undermined the bond floor of the most aggressive convertible bond issues *(see Chart 5)*, which have thus offered lower downside protection to investors.

Since 1996, there have been 13 periods when the 10-year US Treasury yield increased by more than 100 bps. During these periods, convertible bonds consistently have outperformed corporate bonds and outperformed equities on five occasions. However, convertibles appeared to be less resilient to rate increases and posted negative returns during the two most recent downturns in bond markets. Behind this underperformance lies the rotation away from growth stocks and the longer average duration of new convertible bond issues, with rate increases coming at a time of rising inflation and signs of slowing economic momentum.

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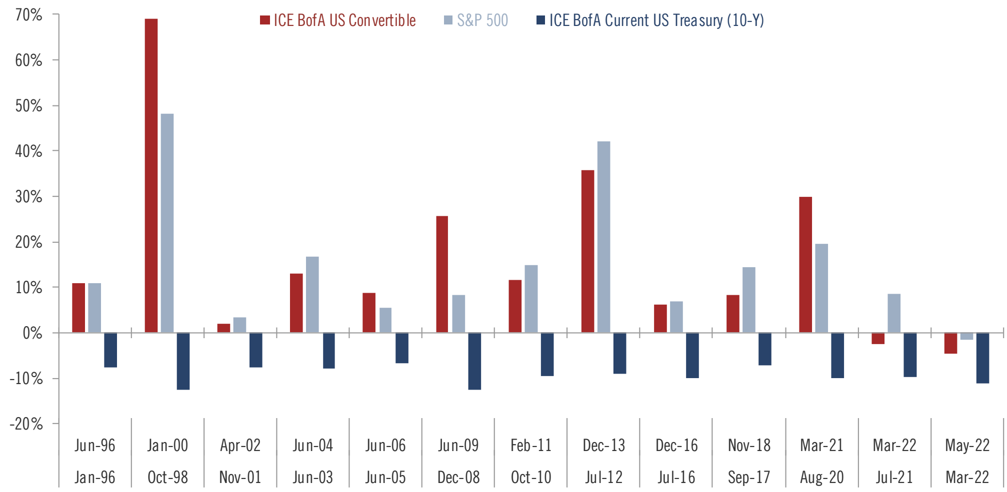
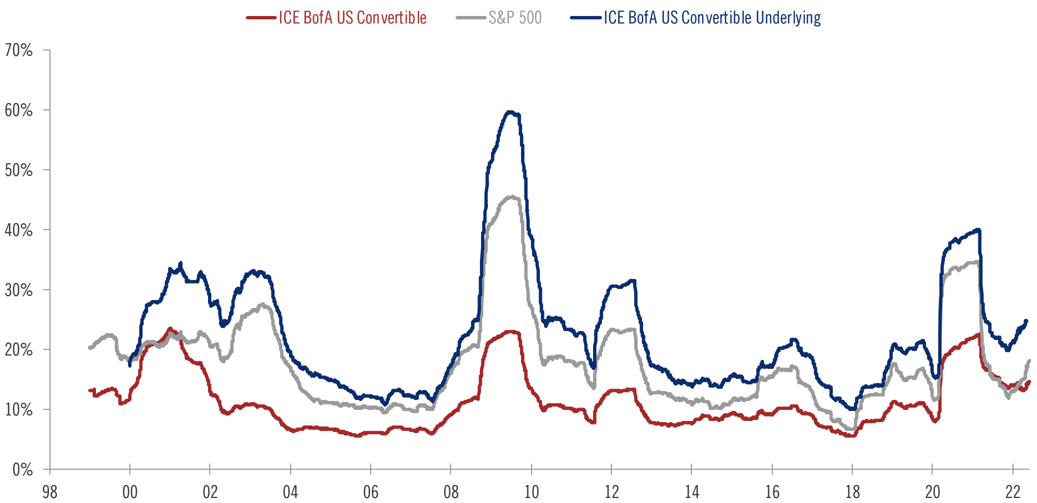
CHART 5: CROSS-ASSET RETURNS IN PERIODS WHEN 10-YIELD TREASURY YIELDS HAVE INCREASED BY OVER 100 BPS



Source: PWM – CIO&MR, FactSet, 19 May 2022

While the rise in US Treasury yields has hurt their bond floor, convertible bonds have also been exposed to increasing equity volatility. On average, convertible bonds showed around 60% of the volatility of blue-chip US equities between 1999 and 2019 *(see Chart 6)*. This limited the downside risk for convertible bonds and meant they participated in equities' upside potential once volatility peaked. However, more recently, the persistence of high volatility has rubbed off on the convertible bond market, whose volatility has risen to about 90% of the level of the S&P 500 since 2021. Nevertheless, convertible bonds' volatility has remained much lower than that of their underlying stocks.

CHART 6: US CONVERTIBLES' VOLATILITY VS. VOLATILITY OF UNDERLYING EQUITES AND OF BLUE CHIPS



Source: PWM - CIO&MR, FactSet, 07 June 2022

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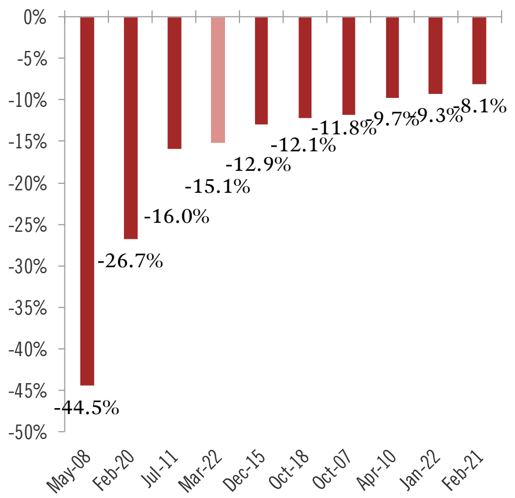
Rising market volatility meant the US convertible bond market experienced its fourth largest drawdown since 1998 in the three months to end May. Losses in Europe were much smaller *(see Charts 7 & 8)*, reflecting differing characteristics of these assets on each side of the Atlantic. For one, over the last 10 years the ICE BofA US Convertible Index has generally have had a much higher average delta (a measure of equity sensitivity)—55% compared to 34.94% in Europe. This meant US convertibles have matched 90% of the drawdown on the S&P 500 whereas European convertibles have matched "only" 68% of the MSCI Europe's decline.

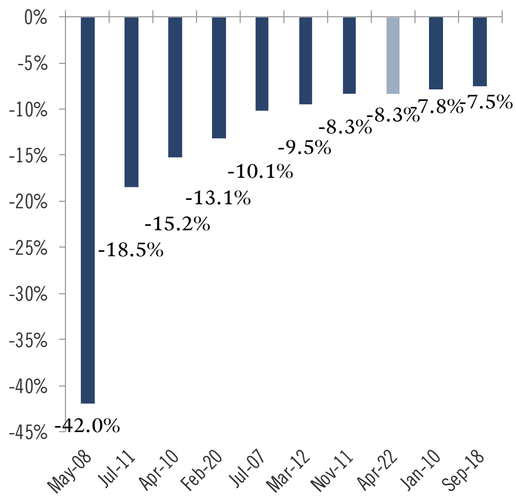
Another factor explaining the difference between performance in the US and Europe is US convertibles higher tech exposure (24% of the US convertible bond index). With the sell-off in tech accelerating in May, this sector accounted for one third of US convertibles negative performance in the past three months.

CHART 7: US CONVERTIBLES, MAX DRAWDOWNS



Source: PWM – CIO&MR, FactSet, 31 May 2022

CHART 8: EUROPE CONVERTIBLES, MAX DRAWDOWNS



Source: PWM - CIO&MR, FactSet, 31 May 2022

Overall, around 15% of the global convertible chart market now trades in the "distressed" category (the bottom left part of chart 1), with prices near or below their theoretical bond floor. Distressed-level convertibles tend to have speculative credit profiles, with vulnerable bond floors and high continued sensitivity to equity prices (even though the asset's market price has already fallen below the strike price). The lack of downside support has weakened these convertible bonds' natural convexity, meaning they now capture a larger portion of the downside of their underlying stocks.

Historically, distressed convertibles, offering a comparatively high yield, have outperformed during market rebounds. But despite the rise in yields for convertible bonds this year, they look far less appealing than the yields offered by investment grade and high-yield bonds in light of comparatively high default and credit risk.

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The silver lining

The silver lining of this downturn in the convertible space is that the selloff should undo the aggressive pricing seen during 2020 and 2021. The arrival at maturity of existing convertibles together with new issues should further change the universe going forward. While our macro outlook sees growth softening as the year progresses, we could see less aggressive pricing by growth companies once economic conditions look like improving again. Therefore, while it would be premature to buy convertible bonds now, opportunities will re-emerge once economic prospects recover.

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