RBC BlueBay Asset Management

De-risking your pension drawdown – no need to miss out on equity upside

For professional investors only | Marketing communication

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We believe that pension funds should utilise convertible bonds for those approaching and enjoying retirement.

Since the 'pension freedoms' were introduced in 2015, income drawdown has become popular as an alternative to annuities. In the UK in 2021/2022, drawdowns accounted for 205,641 of pension plans accessed for the first time compared to 68,514 annuities sold[1].

While there are many advantages to the drawdown option, there are some key features that must be targeted in your portfolio, to stop the risk of running out of money in retirement:

1. **Capital preservation**
2. **Income stream**
3. **Liquidity**

Here we discuss how convertible bonds can help with these factors.

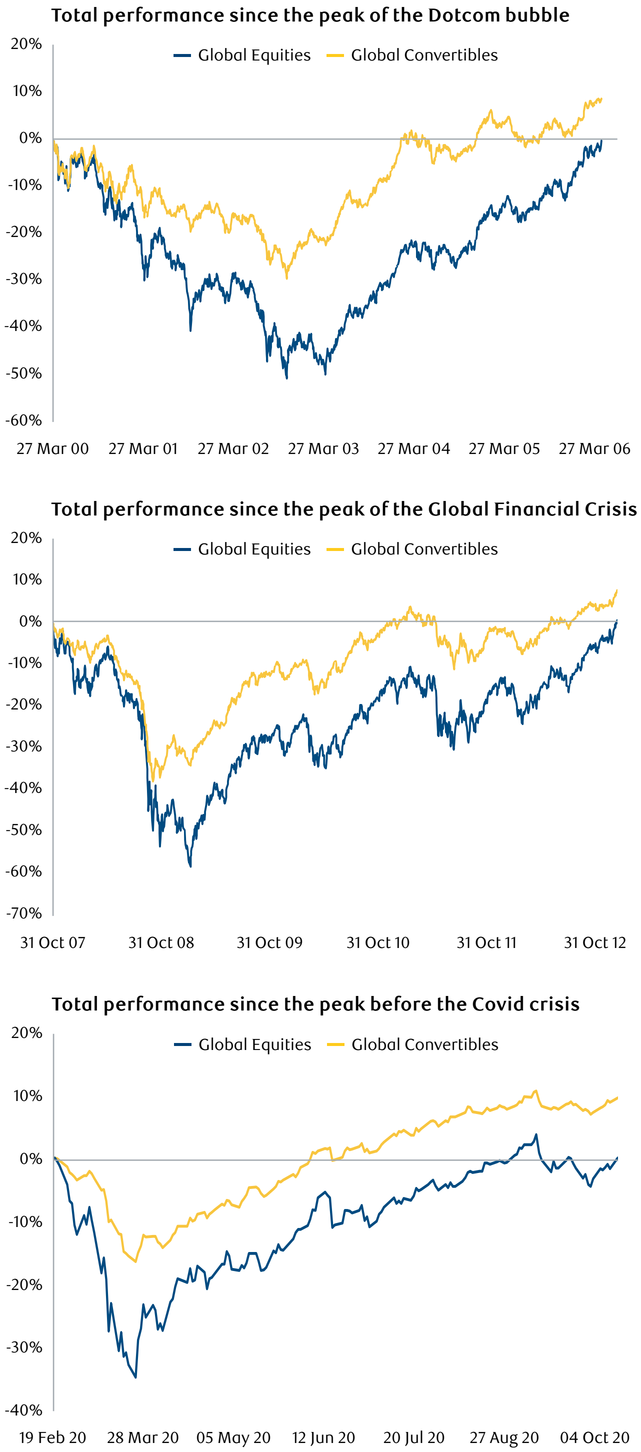
Capital preservation

Although we would all like to think our assets will grow uniformly year-on-year, in the absence of a guaranteed income afforded by an annuity, steps must be taken to mitigate negative outcomes to a falling stock market, while continuing to participate in one that is buoyant. In fact, it is very likely that you will experience a falling stock market on a few occasions during retirement. Whilst these falls can be ridden out when you are still contributing to your pension (you can buy 'cheap units') they can quickly become a source of worry when drawing from a pot. Draw too much and you crystallise the loss making it harder for your investment to recover, draw too little and you don't have enough money to pay the bills.

[1] FCA.

The obvious answer is to create a less risky portfolio; moving assets away from equity and into bonds. This is all well and good but one of the attractions of drawdown is that you can participate in equity upside. Convertible bonds allow you to do this whilst offering bond-like protection. Historically they have offered investors shorter and shallower sell-offs than equities (Chart 1).

Chart 1: Equities and convertibles performance comparison during past large sell-offs

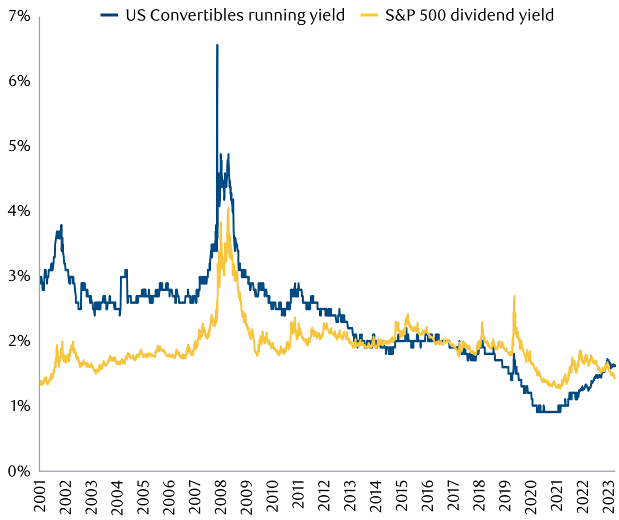


Source: Refinitiv Global Convertible Focus index, MSCI World, Bloomberg, RBC GAM calculations.

Income stream

At any time, and even more importantly during a falling stock market, if you can maintain your income stream without touching your capital, then you are in a far stronger position to see your investment grow or recover. The current high interest rate environment means we have seen a reversal of the trend of the last few years – an increasing number of companies are now turning to convertible bonds and paying coupons that outstrip the dividend yield of the stock, to the point that the convertible bond asset class is offering an income advantage versus equities (Chart 2). It is all the more interesting that convertible bonds income is made of fixed coupons and not dividends that can be cut by companies in difficult times; times when investors need income most.

Chart 2: US Convertibles: historical income components comparison



Source: Refinitiv US Vanilla convertible index, Bloomberg, RBC BlueBay Calculations. Daily data up to 9 February 2024.

Liquidity

There has been a trend among investors to shift their pension assets towards illiquid investments in the hope of capturing extra long-term performance and increasing diversification. One can see how risky this choice can be in the income drawdown phase.

Convertible bonds are a well-diversified, liquid asset class that can help meet the liquidity needs of income drawdown. A simple explanation for the healthy liquidity of the convertibles market is the fact that most issuers are from developed markets and have a quoted stock to convert into. This means a high level of disclosure and transparency. It also means that market makers can use the equity market to hedge their risk. In turn, this generally allows for favourable liquidity both in terms of market depth – i.e. the ability to transact – as well as transaction costs, even in times of market stress.

Why RBC BlueBay? Our expertise in convertible bonds

- **In-depth company research**
  Our team of analysts and portfolio managers research convertible bond issuers globally. We have developed a strong knowledge of these companies, as well as the sectors they operate in and the themes that affect them.
- **Platform for ESG analysis and stewardship**
  Our strategy intends to promote good ESG behaviours and identify ESG-driven active investment opportunities. We do so through applying exclusion lists, rating internally each investment and engaging with issuers. We have gained large experience in using our platform to build custom-made solutions to meet our client's sustainability requirements.
- **Unique expertise in managing risk for convertibles**
  Convertible bonds, because of their hybrid nature, require a specific risk management process. We have built tools that help us identify cheap and asymmetric instruments, monitor our risk and rebalance our portfolio.

What are convertible bonds?

Convertible bonds have all the usual features of traditional bonds; when buying a convertible bond, investors are lending money to a company to a fixed maturity and receive a regular coupon or interest payment. In the extreme and rare case that the company defaults, investors have a claim on the assets and enjoy a recovery value on their investment. In addition to this fixed-income component, convertible bond investors hold a conversion option; if they want to, they can ask the company to cancel their convertible bond and instead receive a pre-agreed number of shares. This option becomes attractive when the stock price of the company performs well. Thanks to this mechanism, the convertible asset class allows investors to participate in the upside of equity markets.

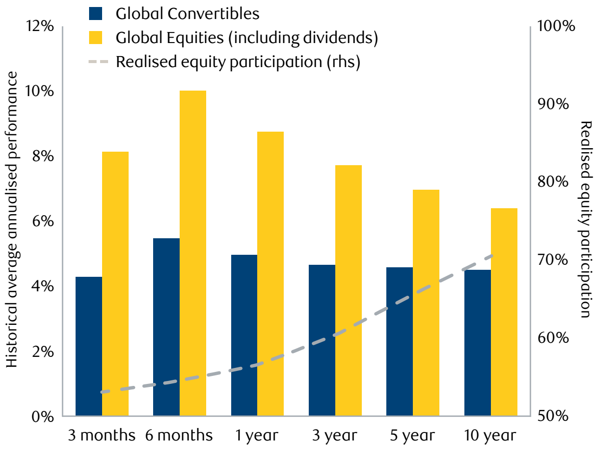
Convertible bonds can capture a large part of equity upside

We compared the average performance of Global Convertibles and Global Equities over fixed investment horizons (Chart 3). Over short time horizons, convertibles capture on average roughly 50% of equity upside. For longer time horizons, such as 5-year and 10-year, this figure goes up to 70% and above. This high level of upside participation comes from the income component of convertible bonds, as well as their capital preservation ability in times of market stress.

Convertible bonds have a similar risk profile to traditional bonds

Chart 4 compares the historic risk profile of Global Convertibles, Global Equities and US investment grade bonds – often seen as the most traditional bond investment. We observe that historically, the risk of convertible bonds has remained close to the one of bonds, even in periods of market stress when the risk of equities was spiking. This highlights the risk mitigation benefits of the asset class.

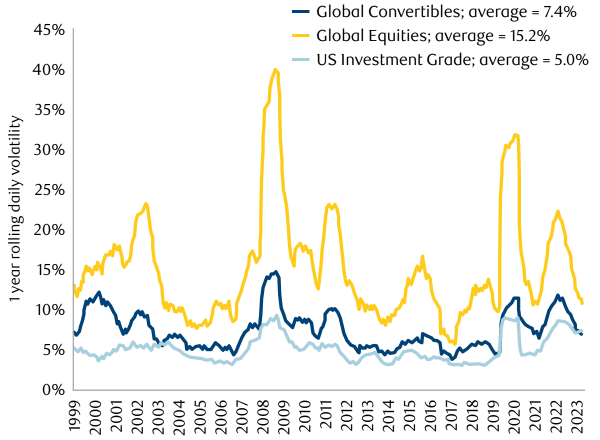
Chart 3: Global Convertibles and Global Equities over fixed investment horizons



Source: Refinitiv, Bloomberg and RBC GAM. Monthly data from December 1993 to 31 December 2023.

Indices: MSCI World Net Total Return USD Index and FTSE Global Focus Convertible Index (USD).

Chart 4: Historic risk profile of Global Convertibles, Global Equities and US investment grade bonds



Source: Bloomberg, RBC GAM.

Indices: MSCI World Net Total Return USD Index; Thomson Reuters Global Focus Convertible Index (USD); BoAML C0A0 Index; Daily data to 9 February 2024.

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