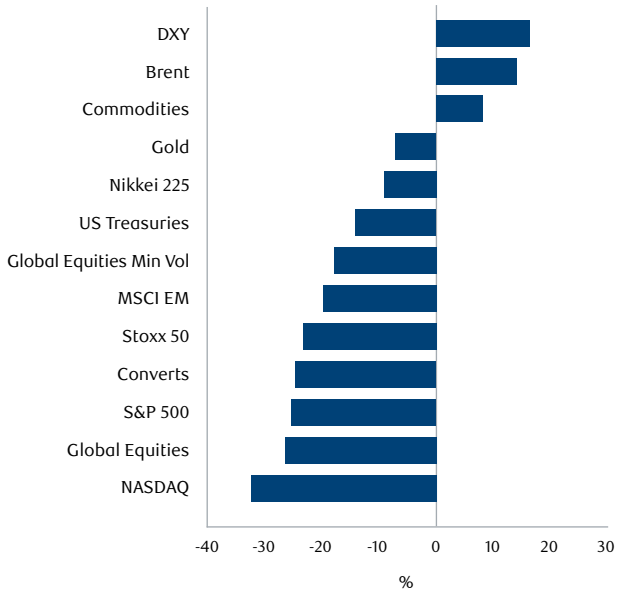
Marketing communication

RBC BlueBay
Asset Management

Convertible bonds: when rates are rising, being defensive in equities requires a different approach

The sell-off YTD (see chart 1) has claimed several victims and typical diversification has not helped weather the storm. Outside a narrow sleave of commodities, most assets are down in absolute terms, and look even worse in real terms. While investors lick their wounds and consider how to adapt portfolio strategy, the need to minimise volatility and downside risk while participating in any recovery is at the forefront of investors' minds.

Chart 1: Asset returns, YTD to September



Source: Bloomberg, September 2022.

For those with foresight, defensive equity approaches may have helped YTD. However, they offer little in the way of upside participation going forward. This is why we think that convertibles bonds, with their unique hybrid structure, are well placed to offer an effective alternative.

This time it's different

Growth across the developed world is falling in response to higher inflation and tighter financial conditions. The IMF predicts that the growth of the global economy will fall from 6% last year to 3.2% this year, and 2.7% next year (IMF October outlook). Suggestions of a quick recovery are somewhat misplaced, as while markets appear to be a tightly coiled spring looking for a reason to bounce on monetary easing, these same signals represent a cooling of economic indicators. This does not lend itself to a long term, sustained period of outperformance.

Furthermore, as inflation hits consumers, the excess capital that has defined a lot of the investment and growth over the covid period is likely to retrace as people deal with spiralling energy or housing costs.

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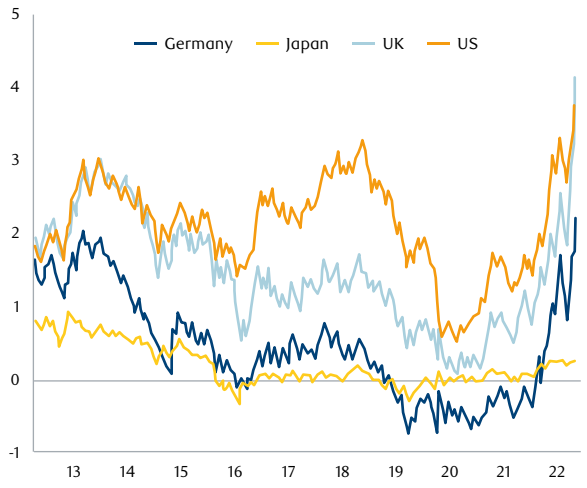
There are real alternatives

To list a few, typical defensive approaches historically included, low vol equities, and high dividend stocks in defensive sectors (Health Care, Utilities, Infrastructure and Consumer Staples). While tracking a low vol index would have been an ideal place to position at the start of the year, it's still relatively symmetric in its approach, and will have a low beta against traditional equities. It's a useful alternative to cash although, given that the market has already sold off quite far, its role in the next leg of the story is uncertain. Similarly, defensive sectors are also no longer an obvious bet.

The mixture of outperformance YTD due to crowding, relative underperformance of other sectors, and the emerging availability of higher income low risk assets, such as investment grade bonds, means these assets risk being value traps and might not participate as actively in a recovery as they might have in other cycles.

Chart 2: Ten-year government bond yields

Yield to maturity in percent

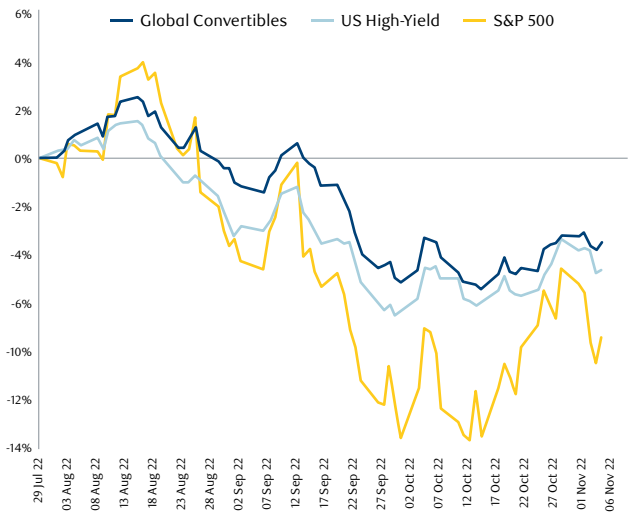


Source: Refinitiv Datastream, September 2022.

Becoming a convert

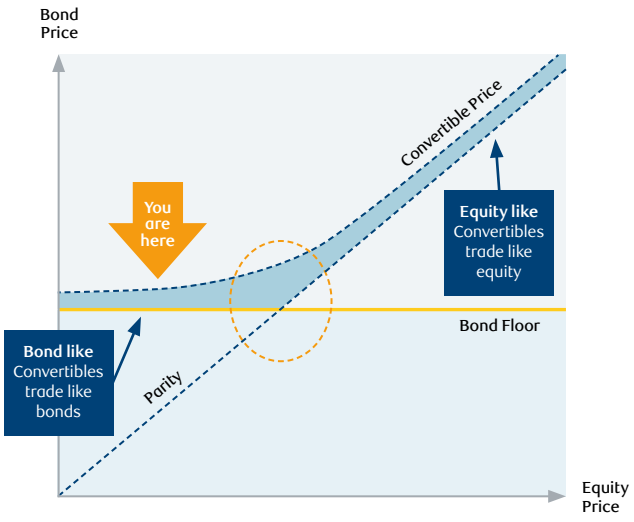
Convertibles YTD performance has been challenging. Due to a bias amongst convertible issuers to be from growth sectors such as technology, converts had a very tough start to 2022 which led to a worse performance than global equity indices. Converts at their core are a relatively short duration bond with an embedded equity option. Over the last few years of rapid growth in equity markets the option component within converts helped drive returns but the sharp reversals this year have dragged down returns. However, it is this sharp sell-off that is now providing an interesting entry point as a many of the outstanding issues are close to the bond floor limiting their downside and creating an asymmetry in their performance going forward. Downside pressure is now muted, while the embedded equity option provides active participation in a recovery in equities. If you compare their performance over the last year, you can see the that, while initially underperforming equities, convertibles are now outperforming them in periods of market weakness.

Chart 3: Short-term performance comparison since August 2022 (in USD)



Source: Bloomberg, BlueBay Asset Management. Daily date from 29 July to 6 November 2022. Indexes used: S&P 500, Bloomberg US High-Yield Index (LHVLTRUU Index) and Refinitiv Global Convertibles Focus Index (hedged to USD).

Chart 4: Pricing a convertible bond



Source: RBC BlueBay, October 2022.

The issues with issuance

The question is, why are convertible bonds likely to outperform into a recovery? The potential key is to consider how companies are likely to raise finance going forward given that coupons on any newly issued debt will be in the high single-digits, even for investment grade companies, and equity valuations have taken a pummelling. In prior periods similar to this, such as 2009 and 2013, companies have preferred to issue convertible debt to reduce both coupon payments and equity dilution. In our view, this can prove very advantageous to convertible bond funds as they are able to purchase this new issuance in the primary market and effectively restrike their portfolio equity optionality at current market levels.

While no one has a crystal ball about how the next months or years play out, what is clear is that looking at your portfolio today requires a different mentality to what has come before. In terms of defensive equities, while converts have not been a traditional haven, the current asymmetry offers an interesting entry point into the asset class, and a compelling case for equity diversification during a period of marked uncertainty.

"What is clear is that looking at your portfolio today requires a different mentality to what has come before."

Author

David Horsburgh

Head of Client Solutions

David joined BlueBay in May 2013 to develop our footprint with global financial institutions, taking on the role of Head of Client Solutions at the start of 2022. He has spent his career working across business development and strategy for asset management firms, most recently working to support the CEO office build product and solutions for North America. In his role, David looks to help clients translate their requirements into practical implementation, navigating the complex landscape including ESG, allocation, implementation, and asset class expectations. David also works to build new capabilities, working to develop our investment platform. He holds an MBA from the London Business School and a BSc in Artificial Intelligence from the University of East Anglia. David also holds the Series 3 designation under FINRA and the NFA.

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