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The convertible option

But high volatility is a challenge for investors

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By Michael Nairne

As the search for yield intensifies, convertible bonds are receiving attention as an asset class that offers a unique blend of income, downside protection and opportunity.

To assess this asset class's long-term performance, the research team at Tacita Capital Inc. spliced the BofA Merrill Lynch U.S. convertible bonds all qualities index (ML index), available since January 1988, with the Ibbotson Associates (IA) monthly convertible bond index, available since January 1973. Canada lacks a similarly comprehensive index.

From January 1973 to June 2012, convertible bonds returned 10% annually to outpace all other major bond categories. Comparatively, Barclay's government, investment-grade corporate and high-yield bond indices returned 7.9%, 8.3% and 9.3% per annum, respectively.

However, convertible bonds were the most volatile. The annualized standard deviation of convertible bond returns was 12.6%. This was more than twice the 5.6% standard deviation of government bonds and almost 60% greater than the 7.9% of investment-grade corporate bonds. Even high-yield bonds, with a 10.2% standard deviation, were materially less volatile.

This volatility is the result of the convertible bond's unique attributes. A convertible bond is a corporate bond that grants the holder the option to convert the bond into a specified number of common shares at a particular price for a specified period. In essence, a convertible bond combines the features of a straight bond with a call option or warrant. Hence, it is a hybrid security combining debt and equity-like characteristics.

The lower credit quality of convertible bonds also contributes to their volatility. In the U.S., the majority of convertible bonds are either rated as speculative grade or not rated; in Canada, the majority simply are not rated. Convertible bonds often are issued by fast-growing, highly leveraged small and mid-sized companies.

Overall, the performance of convertible bonds is actually more correlated with that of stocks than bonds. Convertible bonds had 0.82 and 0.85 correlations with large and small company stocks, respectively (based on IA indices). This contrasts with convertible bonds' 0.67 and 0.42 correlations with high-yield and investment grade corporate bonds.

A 2009 study entitled Returns- Based Style Analysis of Convertible Bond Funds by Dale Domian and William Reichenstein, published in the Journal of Fixed Income, found that the performance of convertible bonds (as measured by the ML index from 1998 to 2007) most closely resembled a portfolio of 40% high-grade bonds and 60% stocks, with small company growth stocks primarily comprising the latter.

This blended asset-class composition means the riskiness of convertible bonds can easily be underestimated. The word "bond" connotes a level of protection not evident in historical drawdowns of this asset class. Convertible bonds have suffered 17 drawdowns in excess of 5% since 1973, averaging a decline of 13.1% and including a staggering drop of 35.4% in 2007-08. In Canada, convertible bonds' credit risk is illustrated by the recent meltdown in the convertible bonds of Yellow Media Inc.

Convertible bonds also are difficult to value, requiring expertise in both debt/credit and option valuation. Because of this complexity and the potential for mispricing, hedge funds are major players in the convertible bond market. Retail investors on the other side of trades with these professionals rarely will be winners. **IE**

Michael Nairne is president of Tacita Capital Inc. of Toronto, a private family office and investment counselling firm. The firm, its principals, employees and clients may own securities mentioned in this article.