



# **CQS Strategy Perspectives**

## **Convertible Sweet Spot**

**MAY 2017**



## About CQS

CQS is a credit-focused, multi-strategy asset manager. Founded in 1999, CQS is headquartered in London and has a presence in key global markets. Our approach centres on fundamental analysis to identify absolute and relative value globally across corporate capital structures and asset classes. This fundamental research is combined with active investment management to create value for our investors. Since launching our first strategy in March 2000, we now manage alternative, long-only and bespoke mandates for institutional investors globally. Our robust operations and risk management platform provides all client mandates with liquidity management and risk monitoring, enabling our investment professionals to be nimble and effective in all market environments. CQS is regulated by the FCA in the UK, the SFC in Hong Kong, ASIC in Australia and registered with the SEC in the US, with a presence in the Channel Islands, Cayman Islands and Luxembourg.

**We believe that convertibles are particularly attractive and timely in the current market environment due to their asymmetric investment profile. In our view convertibles represent an attractive tactical investment opportunity due to the changing investment landscape. Over the long term a strategic allocation to convertibles has afforded investors equity-like returns with a lower risk profile and negative correlation with global government bonds. Our analysis suggests that convertibles are an attractive opportunity for insurance companies under Solvency II legislation.**

## Key Points

We see multiple potential tailwinds behind convertibles:

- Convexity in an environment of greater corporate change
- Upside exposure to a potential shift from deflationary to more inflationary environment
- Positive exposure to corporate activity and M&A
- Benefit from an increase in volatility
- Positive outlook for new convertible issuance
- Defensive interest rate exposure due to modest effective duration
- Minimal correlation to government bonds

## The Tactical Attraction of Convertibles Now

### Convexity in an Environment of Greater Corporate Change

We believe that we are experiencing a period of heightened corporate change driven by multiple factors including rapid advances in technology, the global economy and shifts in government policy. The environment of greater change and greater dispersion in equity returns is positive for convertibles - simply, the asymmetric payoff profile of convertibles 'plays out' more in this type of environment, where there are both more winners as well as more losers, given the downside protection offered by convertibles.

### Upside Exposure to a Potential Shift from Deflationary to more Inflationary Environment

Convertibles are generally well-placed to benefit from any asset class rotation from fixed income to equities. Convertibles have tended to do well in more inflationary environments due to their underlying equity exposure.

### Positive Exposure to Corporate Activity and M&A

Greater corporate change will likely increase M&A and other corporate activity, from which convertibles are often well-placed to benefit. M&A activity can be especially helpful to convertible investments as convertibles participate in the equity upside, often with enhanced terms.

### Benefit from Volatility

The theoretical valuation of convertibles is positively affected by volatility. Importantly, convertible securities are currently being priced off very low levels of overall equity volatility, and their relative valuation should increase with rises in volatility.

### Positive Outlook for New Convertible Issuance

We expect rising interest rates and potential changes to US corporate tax to increase convertible issuance. Global issuance in 2017 to date has been healthy at \$27 billion<sup>1</sup>. More issuance increases the investment opportunity set in convertibles and also the potential for idiosyncratic profits generated from new issues being priced to sell.

<sup>1</sup>Source: UBS Convertibles Marketing / MACE to 30 April 2017. 2017 is annualised based on YTD data.

### Protection from Rising Interest Rates

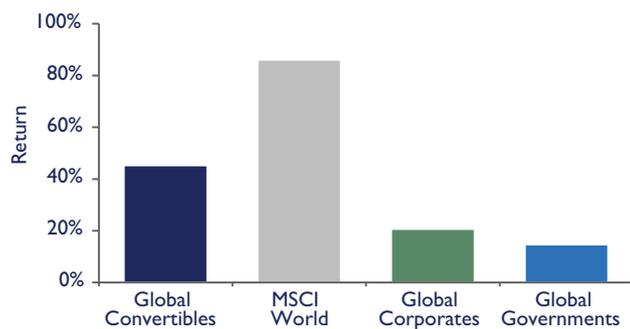
Convertibles are a short duration asset class and have demonstrated minimal correlation to government bond market returns.

Convertible bonds have an effective duration of approximately 2.8 years<sup>2</sup>, which compares to the effective duration of high yield of 3.8 years<sup>2</sup> and investment grade credit of 6.6 years.<sup>2</sup> The short effective duration of the convertible market means that convertibles can be expected to outperform other credit asset classes in periods of rising interest rates. This has been observed in previous periods of rising interest rates, as illustrated below.

**Figure 1: Convertibles in Rising Rate Environments<sup>3</sup>**

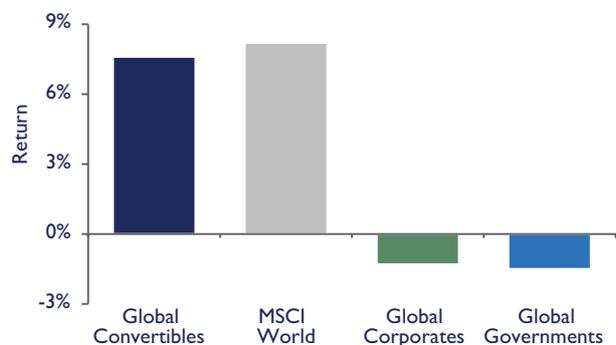
#### Rising Interest Rates:

1 January 2003 – 31 December 2006



#### Taper Tantrum:

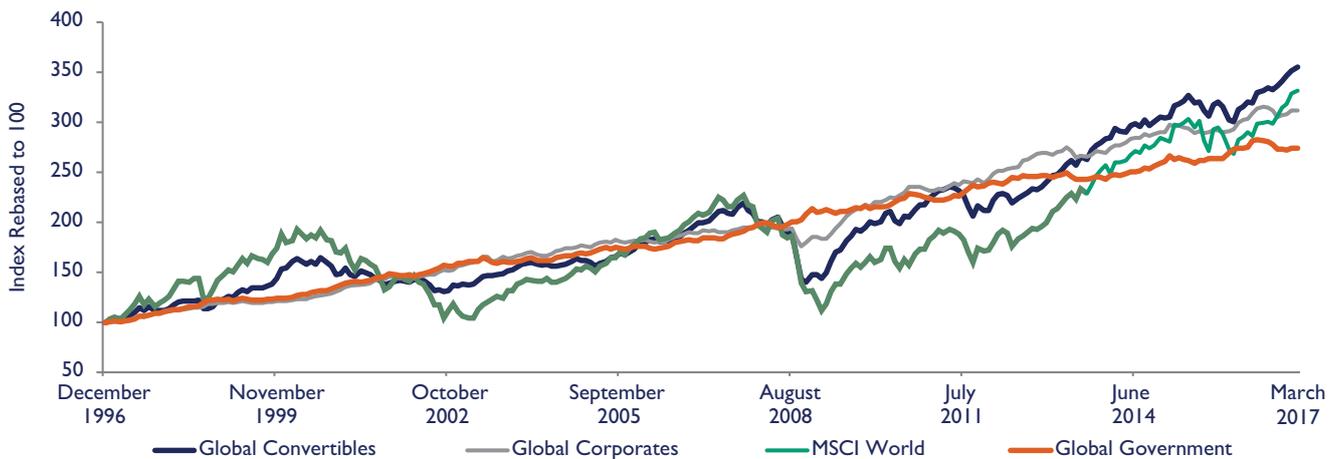
1 April 2013 – 31 September 2013



## The Strategic Attractions of Convertible Bonds in a Portfolio

As shown below, convertible bonds have outperformed equities, corporate bonds and government bonds over the long-term, while demonstrating lower volatility than equities.

**Figure 2: Global Convertible Market Returns Convertible Bonds<sup>4</sup>**



*Over the last 20 years global convertible securities have annualised total returns of 6.5%*

<sup>2</sup>Source: Bloomberg, CQS analysis, BofA Merrill Lynch Global High Yield Index (HW00) Index, BoAML Global Broad Market Corporate Index (G0BC), BoAML Global Convertible Master Index (VG00) as at 22 May 2017. <sup>3</sup>CQS, Bloomberg, Merrill Lynch and MSCI as at the date ranges indicated above. <sup>4</sup>CQS, Bloomberg, Merrill Lynch and MSCI as at 31 March 2017. Rebased to 100. This presentation includes historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up. BoAML Global Convertible Master Index (VG00), BoAML Global Broad Market Corporate Index (G0BC), BoAML: Global Government Bonds Index (W0G0) and MSCI World Index. All total return, USD Hedged indices. NB 31 December 1996 is the inception date of BoAML G0BC Global Broad Market Corporate Index. Please see the disclaimer at the end of this presentation for the full description of the above indices.

### Equity-like Returns with Lower Volatility

As illustrated in the risk and return data in Figure 3, convertible bond returns have matched or exceeded the returns of global equity market indices over the long-term, with lower volatility. Given these historic returns, convertible bonds tend to ‘displace’ equities in portfolio optimisation. In practice the relative size of the global convertible bond and equity markets (at approximately \$380 billion and \$70 trillion respectively<sup>5</sup>) limits implementation of the theoretically optimised asset allocation, however there remains a clear case for a long-term allocation to convertibles in addition to equities.

### Negative Correlation with Global Government Bonds

As shown in Figure 4, convertible bonds have a negative correlation with government bonds. This is reinforced by data which includes the 2008 credit crisis period. The asset class correlation analysis in Figure 4 illustrates the negative correlation to government bonds since 1996 and we believe the short effective duration of convertible bonds will continue to support this view in the short-term.

### Convertible Bond Outperformance of, and Moderate Correlation with, Corporate Bonds

Convertible bonds have similarly outperformed investment grade corporate bonds, while correlating moderately with them (we estimate correlation of approximately 0.4 in Figure 4<sup>5</sup>). We believe this strengthens the argument for employing convertible bonds as a diversifying asset, which is likely to be additive to a portfolio’s anticipated return per unit of risk (‘risk-adjusted return’).

### Solvency II

We believe that convertible bonds can offer attractive risk-reward opportunities for European insurance companies under Solvency II regulations. Convertible bonds typically have low duration and offer an attractive convexity: the bond-like floor offering downside protection with a significant proportion of the upside of equities. The Solvency Capital Requirement (SCR) that applies to convertible portfolios can be as little as half that of equities, while over the long term, convertible portfolios can offer equity-like returns.

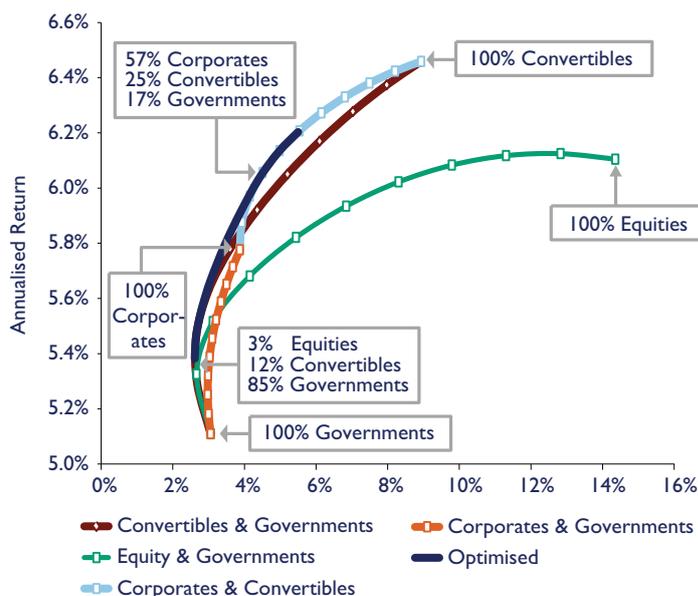
Figure 3: Asset Class Performance Analysis<sup>5</sup>

Asset Class	Return p.a.	Volatility p.a.	Sharpe
Global Convertibles	6.5%	8.9%	0.43
MSCI World	6.1%	14.4%	0.24
Global Corporates	5.8%	3.9%	0.82
Global Governments	5.1%	3.1%	0.82

Figure 4: Asset Class Correlation Analysis<sup>5</sup>

Asset Class	Global Convertibles	MSCI World	Global Corporates	Global Governments
Global Convertibles	1.00	0.88	0.40	(0.24)
MSCI World	0.88	1.00	0.21	(0.32)
Global Corporates	0.40	0.21	1.00	0.60
Global Governments	(0.24)	(0.32)	0.60	1.00

Figure 5: Convertible Bonds Have Improved Risk-Adjusted Returns<sup>5</sup>



<sup>5</sup>Source: CQS as at 31 March 2017. BoAML Global Convertible Master Index (VG00), BoAML Global Broad Market Corporate Index (G0BC), BoAML Global Government Bonds Index (W0G0) and MSCI World Index. All total return, USD Hedged from December 1996 to 31 March 2017. NB 31 December 1996 is the inception date of BoAML G0BC Global Broad Market Corporate Index. Please see the disclaimer at the end of this document for the full description of the above indices. Correlations, volatility and return are for illustrative purposes only. Past performance is no guarantee to future results.

## Summary

We believe that convertibles now have multiple potential tailwinds behind them:

- The environment of greater change and likely greater dispersion in equity returns is positive for convertibles - simply, the asymmetric payoff profile of convertibles 'plays out' more in this type of environment
- Convertibles tend to do well in more inflationary environments due to their underlying equity exposure
- Greater corporate change will likely increase M&A and other corporate activity, from which convertibles are often well-placed to benefit
- Convertibles have demonstrated minimal correlation to government bond market returns
- Low duration provides defensive rate exposure
- Rising interest rates and potential changes to US corporate tax are likely to increase convertible issuance

Analysis of the long-term returns and volatility of convertible bonds demonstrates that convertible bonds have delivered:

- Equity-like returns with less volatility
- Negative correlation with global government bonds
- Outperformance vs. corporate credit while being only moderately correlated with it

This combination of characteristics means that an allocation to convertible bonds should favourably shift the efficient frontier of a portfolio up and left.

Our analysis suggests that convertible bonds have particular attractions for insurance companies under Solvency II legislation.

We believe that the current combination of tactical and strategic arguments for convertible bond investment is compelling.

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