



Portfolio Strategies for the Conventional Investor:

Ten Reasons to Look at Convertible Opportunities

Portfolio managers are using their time to figure out which way they will bet on a recovery and when it will happen. Somewhat cynically, we learned from the recent cover story of a major business periodical that PIMCO—one of the largest US fixed-income asset managers—now “likes stocks.” Given the firm’s role in the government financial-system bailout, perhaps they had to find something new to do with all that money? More constructively, it may be time to re-think convertible bonds and associated strategies, which often perform well in this type of sideways environment.

Our Most Important Argument

1. Stable long-term return potential. Convertible bonds typically pay a comparatively substantial yield, which is in short supply at this time. The last great stock-dividend story may have been BP, yielding some 7%, at least prior to the Gulf of Mexico disaster.

Convertible bonds offer a healthy baseline return, potentially reinforced in fund structures by arbitrage and related credit-trading strategies. For context, the average annual return in convertible arbitrage over the past 20 years has been about 10%-to-12% in US dollar terms.

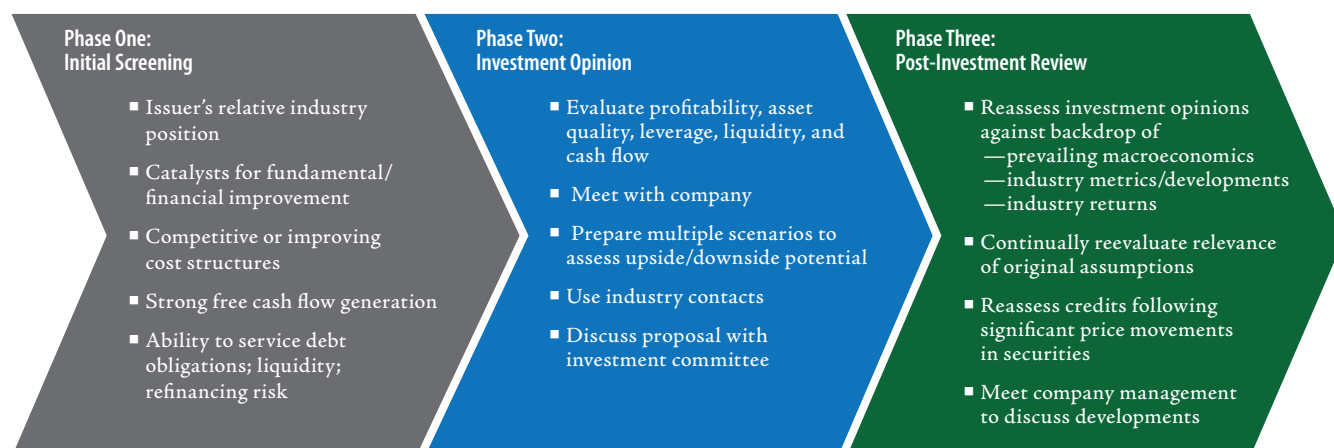
Logic of Portfolio Strategy

We identify further reasons to include convertible bonds in a portfolio:

2. Reduced volatility. Convertible bonds tend to underperform equities in a healthy stock-market environment, but they likewise tend to outperform equities in more difficult situations. We challenge the statistician to assess standard deviations between the two asset classes over the long-term. We accept the short-term distortion in the price series induced by the Lehman bankruptcy. Presumably we have now learned that bigger is not always better, at least when it comes to risk management.

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Identifying Compelling Investment Opportunities



Source: Lydian Asset Management.

3. Investment style alternatives. We appreciate the flexibility that an established manager of credit vehicles can bring to the convertible space, ensuring prudent allocation to sub-strategies as fundamentals evolve. Many retail-oriented managers are simply buy-and-hold players, but the institution-focused names can offer traditional arbitrage, asset swaps, new issuance, as well as event-driven opportunities within the same portfolio. Particularly in this environment, we suggest investors should look for a short-duration portfolio to reduce interest-rate and recession risks.

4. Diversification. The role of convertible bonds in a global portfolio is commonly misunderstood; accordingly the asset class has seen relatively muted growth in recent years. One reason is that major institutional investors are never quite sure in which “bucket” (i.e. investment decision unit) to put coverage responsibility. Trends in convertible-arbitrage assets, weakening since 2001-03, may mimic lack of enthusiasm for the asset-class in general. While a detailed correlation analysis supporting the diversification argument is beyond the scope of this report, the hybrid nature of the asset class begs a more prominent role in portfolio holdings.

Asset-Class Trends

We identify trends in the asset class, supporting institutional interest:

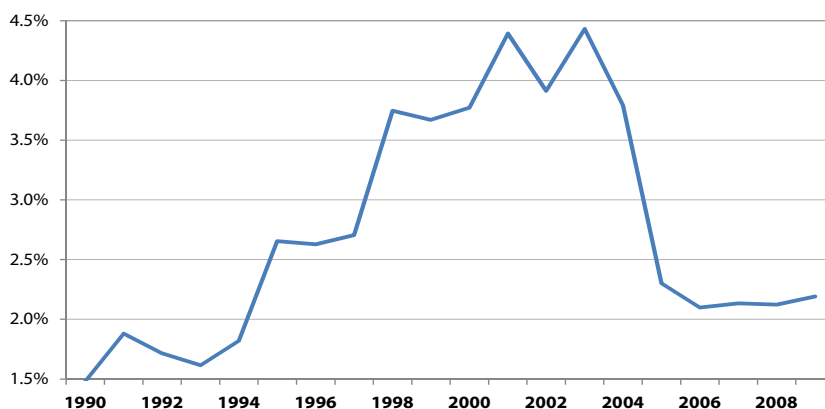
5. Improved liquidity. We expect to see more new issuance from higher quality names, helping to deepen the market. While robust investment opportunities may still exist in lower-grade corporates, it is the marquee names coming into the market that will support liquidity flows into the asset class, in our view. We note Microsoft's convertible debt issue in which the firm raised some \$1.25 billion in June 2010 through the qualified institutional buyer market (Rule 144A). It was their first such convertible note in years.

6. Globalization. The convertible bond business is a bit like the water fountains at the Emirates Palace Hotel in Abu Dhabi. You never quite know where you will find a new water plume and which way it will be shooting. The focus of the business has long been the US and European markets, but over the years there has been substantial opportunity elsewhere, like Japan and India. We note with interest the volume of new convertible issuance coming out of Vietnam this year. It is a tiny market, but indicative of the ongoing trend toward emerging-market opportunities.

Convertible Arbitrage Has Limited Following

Typically included in the relative value space, alongside other styles such as volatility and multi-strategy, convertible arbitrage has typically been the domain of niche investors. Interest in the strategy increased dramatically through the early 2000s, but diminished after 2003 when stock prices showed more buoyancy. Assets in convertible arbitrage have held steady over the past five years.

Convertible Arbitrage Assets as Percent of All Assets in Relative Value Category (1990-2009)



Source: HFR, Codexa Capital.

7. Cheap universe. While convertible bonds, in general, are certainly not as cheap as in October 2008, the asset class continues to offer some of the best value seen over the past decade. There may be many reasons for such value, starting with the simple fact that the strategy is out-of-favor cyclically because of extreme volatility over the past two years. Convertible arbitrage was one of the worst performing hedge-fund strategy in 2008, and one of the best performing in 2009. Given the asset class's relatively small size and attractive value, a modest allocation by institutional managers should lead to healthy price gains.

Investment-Management Trends

The evolution of the business itself may favor broader interest in the strategy:

8. Use of in-house research. In the pre-credit crisis era, fixed-income managers seemed to forget the basic rule of credit analysis: How likely is a company to pay back its debt with interest? Many simply outsourced such research to the credit-rating agencies—and we know where that led. Still others fail to distinguish between earnings analysis and cash-flow analysis. We likely will now see a trend to better independent research, which in turn should lead to better clarity across more opportunities.

The diagram illustrates the in-house process at one established manager.

9. Conservative use of leverage. Despite the improved availability and lower cost-of-funds in the wake of the credit crisis, convertible managers have cut back substantially on their use of leverage. Deutsche Bank estimates that managers in the convertible arbitrage space were typically leveraged at almost four times prior to the Lehman bankruptcy. The number may now be half that amount, with the trend reflecting both caution and confidence. Reduced leverage should certainly help to satisfy more rigid due-diligence criteria now typical among institutional investors, especially those based in non-traditional markets.

10. Smaller number of players. With maybe \$500 billion in convertible bonds outstanding worldwide, the industry has never been large. The gut-wrenching effects of the credit crisis on the investment management business have extended to the convertible space, as marginal names shut down funds if not entire operations. Specialists argue that the convertible arbitrage universe probably has only five-to-seven managers capable of sustaining their business over the long-term. Fewer managers will likely lead to improved investment and trading opportunities.

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