Insights
Fixed Income

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Global Convertible Bonds — Why Now? Why Global?

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- Global convertible bonds exhibit a balance between growth and protection thanks to their hybrid nature.
- A global exposure can help to diversify away from the regional bias many European investors have in their portfolios.
- Currency risk should not be underestimated and using hedged exposures can be an elegant way to ride the growth in a still uncertain environment.

Overview

Uncertainty remains as countries reopen post the Great Lockdown. The health crisis persists, however, as countries rush to develop a vaccine. Economic data has been atrocious and PMIs have cratered around the world; growth expectations for 2020 have been revised down by 9% from c. +3% to -6%. As investors wait for improvement, we continue to favour global convertible bonds for three reasons:

- The three engines of performance for convertible bonds are activated via higher coupon issuance, equity sensitivity and volatility protection.
- A global allocation helps diversify away from the 'regional' bias and spread exhibited across the more equity-sensitive US market. Adding balance through a quality-tilted Europe, relative cheapness from Asian issuers and the strong credit profile of Japanese corporates, could provide a more balanced, four-pronged regional strategy for investors.
- As volatility has receded, convertible bonds can help build further convexity (without undue duration risk) as a hedge against negative news while benefiting from surprise improvement as developed economies reopen post the Great Lockdown.

Portfolio Backdrop

In equity markets, North American equities are favoured for three main reasons.

- Although it will be some time before analysts' assessments of the COVID-19 impact are fully reflected in earnings assessments, North American companies have so far downgraded earnings less often than their counterparts elsewhere.

- North American equities tend to be overweight quality. In the aftermath of the Global Financial Crisis, balance sheet strength was a leading indicator of equity performance. We believe the same principle will hold as this crisis unfolds.

- We expect the lower-for-longer interest rate environment to broadly benefit defensive sectors, where the US also has an advantage over other regions.

In fixed income, we see opportunities in both high yield (HY) and investment grade (IG) credit, as spreads between Treasuries and both HY and IG corporate issues have widened during the crisis.

Prudent investors can find relatively attractive opportunities in this environment, which may allow them to benefit from the subsequent tightening of spreads as conditions return to normal. Of course, it is important for investors to be well informed of potential risks when seeking to invest in times of crisis.

Advantages of Convertible Bonds in the Current Environment: Drawdown Management

As markets wait for improvement, a global convertible bond allocation helps blend these two stances (equities and credit) and thus makes sense in the medium term given its profile and three main engines of performance:

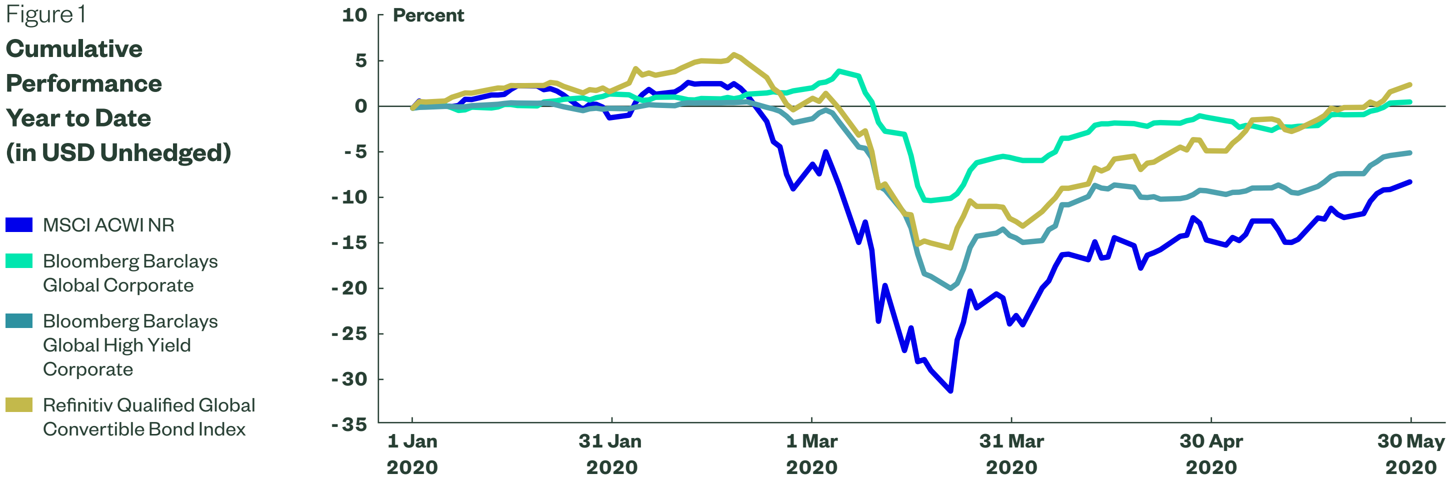
- Credit via spreads and coupons.

- Equity via the optionality.

- Volatility, as VIX receded close to the 30s (after jumping above 70) but remains well above 1 standard deviation versus its long-term average.

Year to date, the performance of global convertible bonds has worked as expected thanks to their asymmetric profile and the bond floor protection. As we can see in Figure 1, convertible bonds outperformed in USD-unhedged terms versus global equity, global high yield corporate and global corporate investment grade indices.

Figure 1
Cumulative Performance Year to Date (in USD Unhedged)

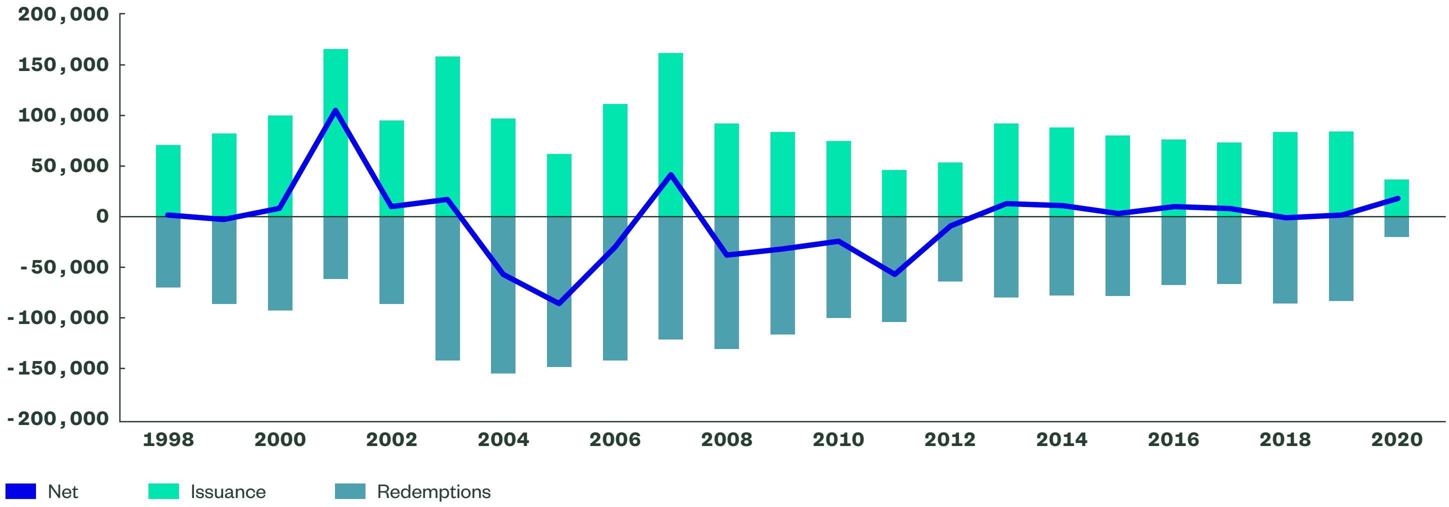


Source: State Street Global Advisors, Bloomberg Finance L.P., as of 31 May 2020. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

Issuance: April 2020 Witnessed the Strongest Issuance Since 2008

Year to date through 22 May 2020, convertible bond issuance has exceeded $61 billion and, as such, represents the highest net growth seen since 2008. The 2020 issuance has shown a meaningful skew towards typical convertible sectors, including technology and health care (which are higher than in traditional equity and straight global corporate bond indices). In addition, issuance from a handful of other sectors, including consumer discretionary (retail, leisure) and transportation, has also spiked over the past few months, providing further opportunity.

Figure 2
Gross and Net Issuance — Global Convertible Bonds (in USD mn)



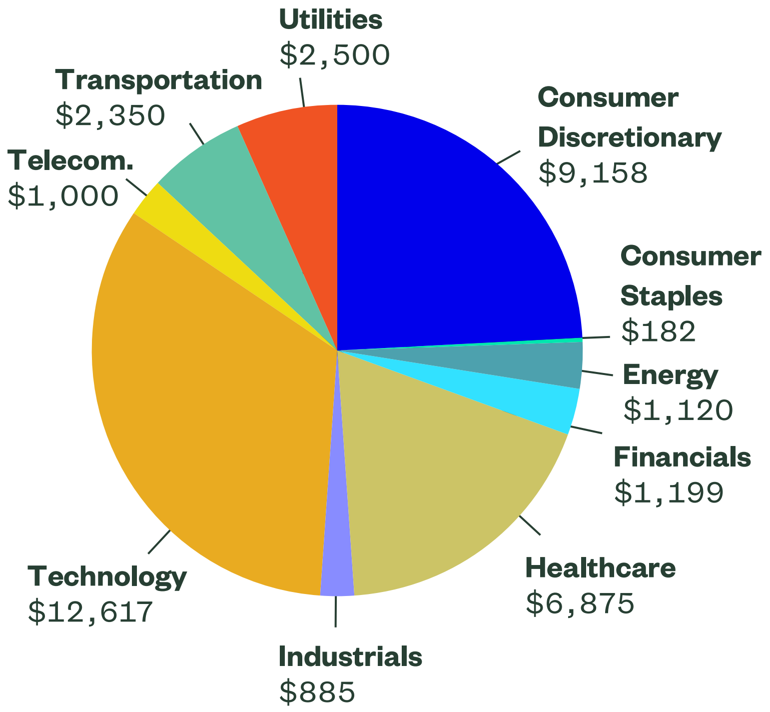
Source: Bank of America Merrill Lynch, as of 30 April 2020. Amounts are USD millions.

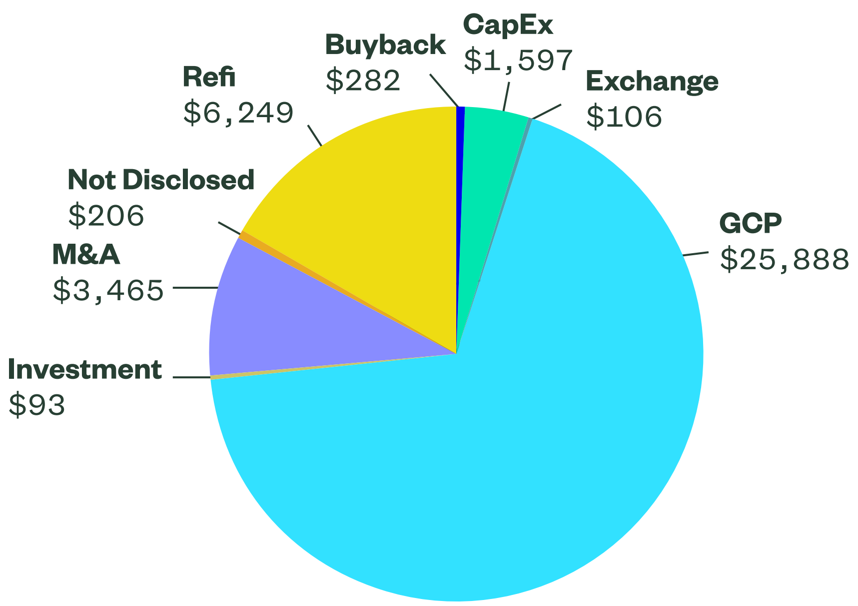
As of 22 May 2020, the market had seen the following breakdown of issuance:

- US: $45.0 billion
- Europe: $8.6 billion
- Asia: $7.3 billion
- Japan: $0.3 billion

Based on current trends and expected issuance, 2020 could see up to $110 billion in issuance, representing the highest issuance year since the Global Financial Crisis.

Figure 3
Issuance Breakdown per Sector and Use of Proceeds (in USD mn)





Source: Bank of America Merrill Lynch, as of 30 April 2020. Amounts are USD millions. Characteristics are as of date indicated and shouldn't be relied thereafter.

Why Such a Good Level of Issuance and Why are Investors Responding to the Supply?

The traditional IG and HY bond markets are open and functioning thanks to actions taken by central banks in major markets. So why are issuers choosing to tap the convertible bond market instead? There are two main reasons.

1. First, for the lower cost of debt. Because convertible bonds have an equity option embedded in their structure (which offers potential upside), they typically pay lower coupons to investors. For example, the average coupon for 2020 convertible debt deals in the US has been 2.95%, or well below the average coupon on this year's HY deals of 6.35%. The HY coupons on recent deals for borrowers in heavily disrupted sectors (e.g. cruise lines, car rentals, movie theaters) have been as high as 10.5% to 13%. The lower cost of funding offered by the convertible bond market may be relatively attractive for issuers — especially those facing tight liquidity constraints as a result of the twin oil/virus disruption.

   Given that dilution could be a concern for some, because the equity conversion would happen at a later date (presuming the required conditions are met), the structure is not immediately dilutive to equity holders.

2. Investors have found the convertible debt market to be increasingly attractive on a relative basis given elevated volatility and relatively cheap valuations when excluding the main drivers of the rally (FAANGs). As hybrid securities, convertible bonds allow their holder to capture upside in equity performance while also retaining the capital preservation features of straight bonds.

   In periods of elevated volatility, the asymmetrical profile of convertible bonds is therefore generally appealing to investors. Higher equity prices boost the value of the convertible bond. On the other hand, lower equity prices push the conversion option out of the money and make the convertible bond behave like a lower volatility straight bond.

   In this context, the pace of supply in the convertible debt market could remain elevated, especially for those sectors at the epicenter of the disruption. On the margin, this may shift some funding away from the traditional HY bond market.

Additional Notes

Recent issuance has provided an opportunity for the profile of the global convertible market to adjust and reset to align to the current economic climate.

- Companies now need to prepare for a prolonged low revenue operating environment. This has allowed for an increase in more investor-friendly convertible bond terms, with both coupon payment increases and equity premium reductions adding attractiveness to new issuance.
- A recent BAML study illustrated that, in the six months following the blow-out in volatility and spreads seen in 2002, 2008, 2011 and 2016, new US convertible issuance launched in these periods showed outperformance versus the broader existing US convertible market.
- Therefore, softer and more relatively attractive terms from cash-strapped corporates can often offer enticing opportunity for investors looking to gain exposure amid relatively cheaper convertible valuations.

Why Global Makes Sense — Regional and Sector Exposure to Growth

Overall, an allocation to a global diversified portfolio of convertible bond issuers might offer the most relatively attractive profile for European investors. A four-pronged regional approach to a convertible bond strategy encompassing the US, Asia, Japan and Europe could offer the most compelling proposition. Indeed, while the US continues to move ahead with new issuance and offer strong equity growth stories, including Tesla and ServiceNow, Europe brings balance to the equation with lower equity sensitive exposures that are more heavily skewed towards quality, investment grade issuers.

Once coupled with the relative cheapness of the Asian convertible market, given its healthy allocation to enticing first-time issuers and to Japan's stronger credit bond-floor profile, a well-diversified investment prospect can be provided for the investor seeking an effective crossover hybrid exposure.

Using the Refinitiv Qualified Global Convertible Index, the pockets of valuation as expressed by the equity sensitivity (or delta) highlight how the US market helps drive performance. In the event of a more rapid than expected rebound on the back of improving health news (vaccine, medicine) and faster economic recovery, the higher equity sensitivity should help capture upside in risk markets. Meanwhile, the balanced nature of the overall global convertible bond universe (excluding mandatories) provides a level of downside protection, as we have seen year to date. Overall, the profile is well split between more defensive and more equity-like type of bonds.

Figure 4
Delta Profile Split Between Bond-Like, Balanced and Equity-Like

INDEX DELTA PROFILE	TOTAL
BALANCED (20<D<60)	28.6
BOND-LIKE (D<20)	19.5
EQUITY-LIKE (D>60)	49.8
CASH	2.1
TOTAL	100

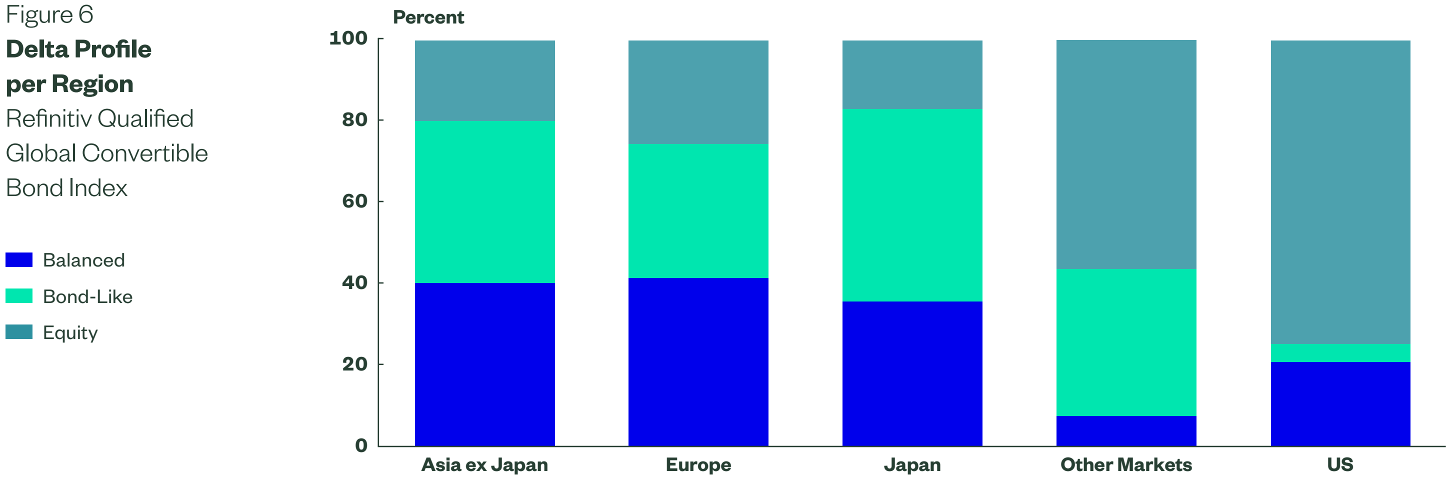
Source: State Street Global Advisors, Refinitiv, as of 29 May 2020.

Figure 5
Delta per Region

REGION	WEIGHT IN %	AVERAGE
ASIA EX JAPAN	9.25	33.4
CASH	2.07	–
EUROPE	27.07	39.1
JAPAN	7.89	30.1
OTHER MARKETS	1.89	54.0
US	51.5	73.1

Source: State Street Global Advisors, Refinitiv, as of 29 May 2020. Characteristics are as of date indicated and shouldn't be relied thereafter.

Figure 6
Delta Profile per Region
Refinitiv Qualified Global Convertible Bond Index



Source: State Street Global Advisors, Refinitiv, as of 29 May 2020.

Figure 7
Delta Profile per Sector — Ranked by Average Delta

SECTOR	WEIGHT %	DELTA
BANKING/FINANCE	2.97	31.9
CASH	2.07	0.0
CHEMICALS	3.31	23.3
CONSTRUCTION	2.19	51.9
ELECTRONICS	9.87	67.4
FOOD & DRINK	0.56	44.3
INDUSTRIALS	10.45	61.6
INSURANCE	0.58	31.2
IT	25.04	69.6
LEISURE	1.53	74.0
MEDIA	0.86	65.9
OIL & GAS	2.17	21.8
OTHER	1.11	83.7
PAPER & PULP	0.11	42.3
PHARMACEUTICAL	8.61	59.4
PROPERTY	5.35	34.2
RETAIL/WHOLESALE	7.35	56.7
SERVICES	3.03	59.8
STEEL/METALS	1.21	40.1
TELECOM	7.03	45.2
TRANSPORT	1.69	28.0
UTILITIES	2.91	32.9
GRAND TOTAL	100.00	55.0

Source: State Street Global Advisors, Refinitiv, as of 29 May 2020. Characteristics are as of date indicated and shouldn't be relied thereafter.

Skewed towards IT and electronics, the global convertible bond universe exhibits a profile of growth and defensiveness that appears attractive in the current environment. Names like Akamai (60 delta), Atlassian (99 delta) or ServiceNow (99 delta) — or others that have been supported by the shift in working pattern due to COVID-19 — can be found in the index.

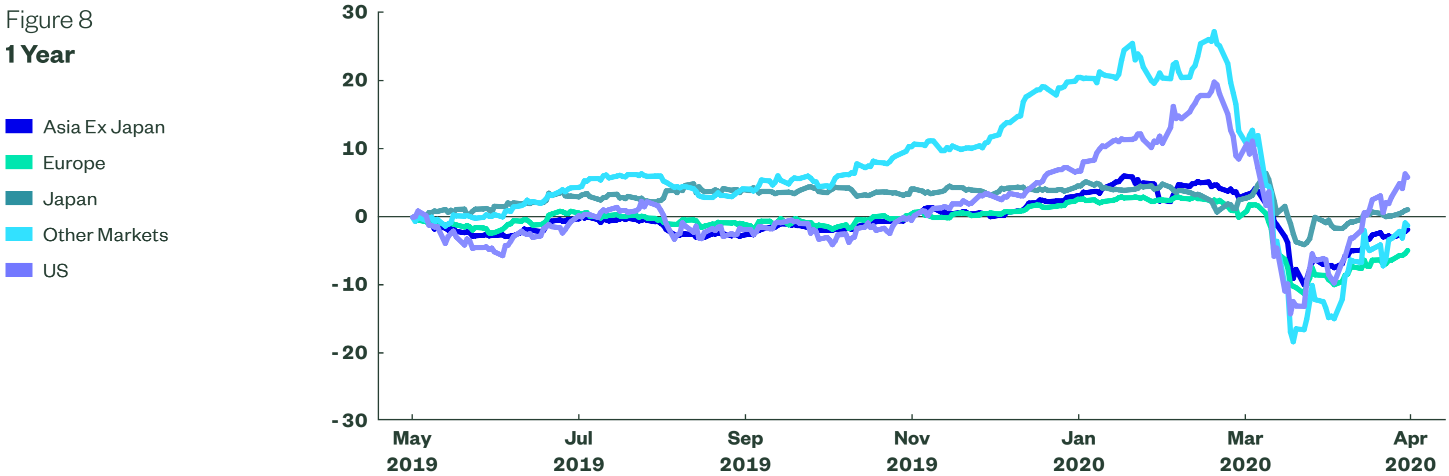
Meanwhile, exposure to more distressed names in the oil and gas sector is relatively low at 2.14% and compares favourably versus a global high yield index. Deltas of the banking and finance sector highlight the 'value' profile of the sector, which has suffered over the past few years and lags this year in performance.

Pharmaceuticals, at 57.7, represent a more heterogenous group of issuers from Horizon Therapeutics, which are boasting a delta of 100, to Teva at 0.7. Larger issuers such as BioMarin and Illumina trade above 60. Chinese group Sino Biopharma is more balanced at 42. In Europe, Fresenius, a German name with a Xover rating, trades at bond-like levels of 15, offering a potential for bargain hunters.

Historically, the Performance of a Global Index Has Often Outperformed That of a More Europe-Focused Exposure

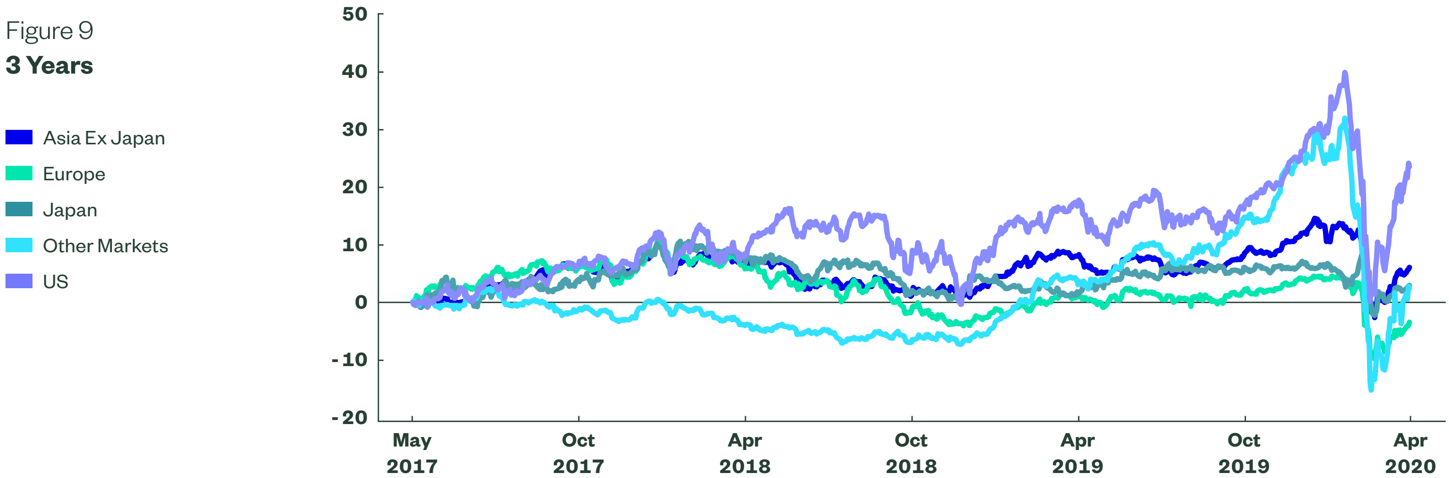
In the below charts we look at the regional performance of the components of the Refinitiv Qualified Global Convertible Bond Index (in USD-unhedged terms).

Figure 8
1 Year



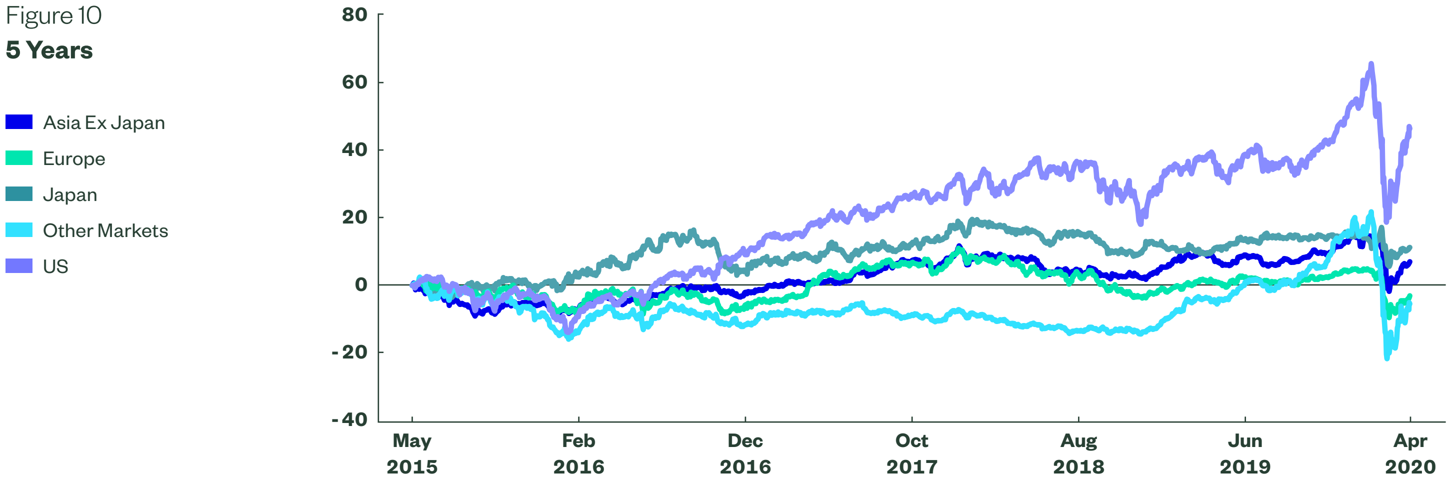
Source: State Street Global Advisors, Refinitiv, as of 30 April 2020.

Figure 9
3 Years



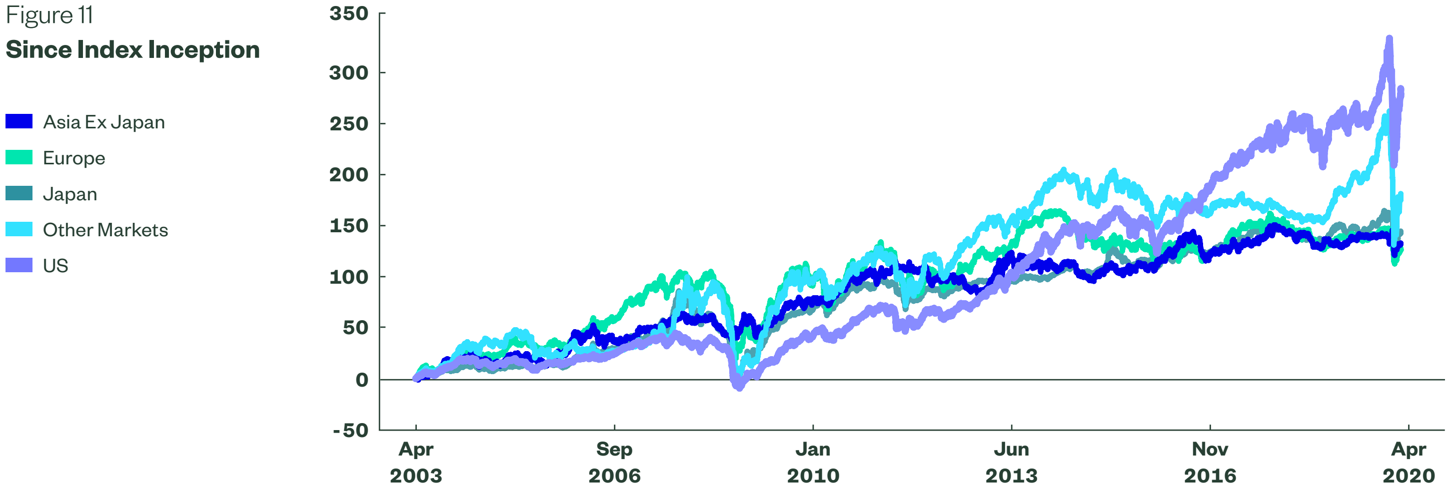
Source: State Street Global Advisors, Refinitiv, as of 30 April 2020.

Figure 10
5 Years



Source: State Street Global Advisors, Refinitiv, as of 30 April 2020.

Figure 11
Since Index Inception



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In Such a Context, Where the Case for Going Global Appears Interesting, Mitigating Exposure to the Dollar Could be Worthwhile

From a Swiss franc and euro investor standpoint, global convertible bonds offer a diversifying, asymmetric profile in portfolios. Beyond the credit risk attached to the asset class, which should be weighed against other asset classes, the primary point to consider would be a currency-hedged exposure. With more than 60% in USD issues, currency risk is worth considering when making a global convertible bond allocation.

Indeed, while safe-haven currencies have rallied strongly during the crisis, we are only seeing timid selling of the Swiss franc as investors continue to weigh uncertainties and wait for improvement in numbers. In the event of a negative development, a second wave of pandemic or an escalation of trade tensions, the franc may strengthen versus other currencies while underlying securities weaken. As most central banks' short rates have now fallen, in particular Fed fund rates, the cost of hedging currency risk has diminished (estimated at around 0.8% annualised rolling 1-month forward).[1]

Meanwhile, for a euro-based investor, the case for hedging currency risk may be different. A slower growth trajectory, resurging concerns about the strength of the union to speak with one voice, and lingering debates about debt mutualisation and support between countries weaken the euro relative to the dollar. Nevertheless, any sign of relative improvement on these political matters, or any deterioration of US standing as elections near, may warrant a 'neutralisation' of that risk. Since the Fed cut the Fed fund rates lower bound to 0%, the cost of hedging a global convertible bond portfolio has come down significantly from 2.4% a year ago to 0.6% currently.

Hedging Methodology: Taking Hedge Ratio Into Account

The hedging process uses forward currency contracts to incorporate currency hedging into the calculation of index value. The hedging process follows a monthly cycle; the two key dates in the cycle are the Roll Date and Rebalance Date.

The Roll Date is the working day prior to the Index Review Effective Date.

The Rebalance Date is the Index Review Effective Date.

At end of day on the Roll Date, all open forward contracts are closed and the Base Currency cash is adjusted to reflect the crystallised P&L. New contracts are opened; the new contracts reflect the net position of contracts closed in each currency. The new contracts are referenced in the index documentation as the 'Roll Contracts.' On the Rebalance Date new contracts are opened to provide the overall net exposure required in each currency based on the anticipated Index currency profile following the index review. The new contracts are referenced in the index documentation as the 'Rebalance Contracts.'

The Index value calculation incorporates the mark to market (MTM) valuation of all open forward positions. The Hedge Ratio of the Index is monitored and if the Hedge Ratio exceeds 105% or falls below 95% then additional forward contracts will be incorporated into the calculation of the Index value. The new contracts are referenced in the index documentation as the 'Reset Contracts.'

Given the more volatile nature of convertible bonds, in order to satisfy ESMA guidelines, the hedging methodology incorporates the Hedge Ratio ensuring UCITS investors tracking such an index meet these objectives, by resetting the Hedge Ratio to 103% if the Hedge Ratio is greater than 105% and 97% if the Hedge Ratio is lower than 95%.

Comparing a Global Convertible Exposure Hedged to Euro vs. a Euro-Focused Index

While we highlighted that the regional drivers of performance showed that a broad exposure had been a source of return, in the below table we can see that this diversified exposure has performed better than a European or pure euro-focused index over the long run. Over 10 years, the Refinitiv Qualified Global Convertible Index (hedged to euro) has outperformed the Exane Eurozone Convertible Index by 2.51% (annualised in euro).

Figure 12
Index Performance and Volatility Comparison

31/05/2020	Annualised Return (%)				Annualised Volatility (%)			
	Refinitiv Qualified Global Convertible Bond Index	Exane Eurozone Convertible Index	Refinitiv Europe Focus Convertible Bond Index	Refinitiv Global Focus Bond Index	Refinitiv Qualified Global Convertible Bond Index	Exane Eurozone Convertible Index	Refinitiv Europe Focus Convertible Bond Index	Refinitiv Global Focus Bond Index
Last 12 months	9.07	0.15	0.67	7.83	16.14	9.56	10.18	13.34
Last 3 years	2.99	0.33	-1.98	1.92	10.57	6.28	6.75	8.80
Last 5 years	3.16	0.97	-0.94	1.51	9.18	6.41	6.62	7.81
Last 10 years	6.35	3.84	3.42	4.78	8.16	6.71	7.28	7.09

Source: State Street Global Advisors, Bloomberg Finance L.P., as 31 May 2020. Figures are in euro-hedged terms. Past performance is no guarantee of future results. It is not possible to invest directly in an index. Index performance does not reflect charges and expenses associated with the fund or brokerage commissions associated with buying and selling a fund. Index performance is not meant to represent that of any particular fund.

And while the volatility of a global index has been historically higher, the sharpe ratio shows that additional risk has not harmed the risk/return over most periods.

Figure 13
Sharpe Ratio Comparison

31/05/2020	Sharpe Ratio			
	Refinitiv Qualified Global Convertible Bond Index	Exane Eurozone Convertible Index	Refinitiv Europe Focus Convertible Bond Index	Refinitiv Global Focus Bond Index
Last 12 months	0.59	0.07	0.11	0.62
Last 3 years	0.32	0.12	-0.23	0.27
Last 5 years	0.38	0.21	-0.09	0.24
Last 10 years	0.78	0.57	0.47	0.67

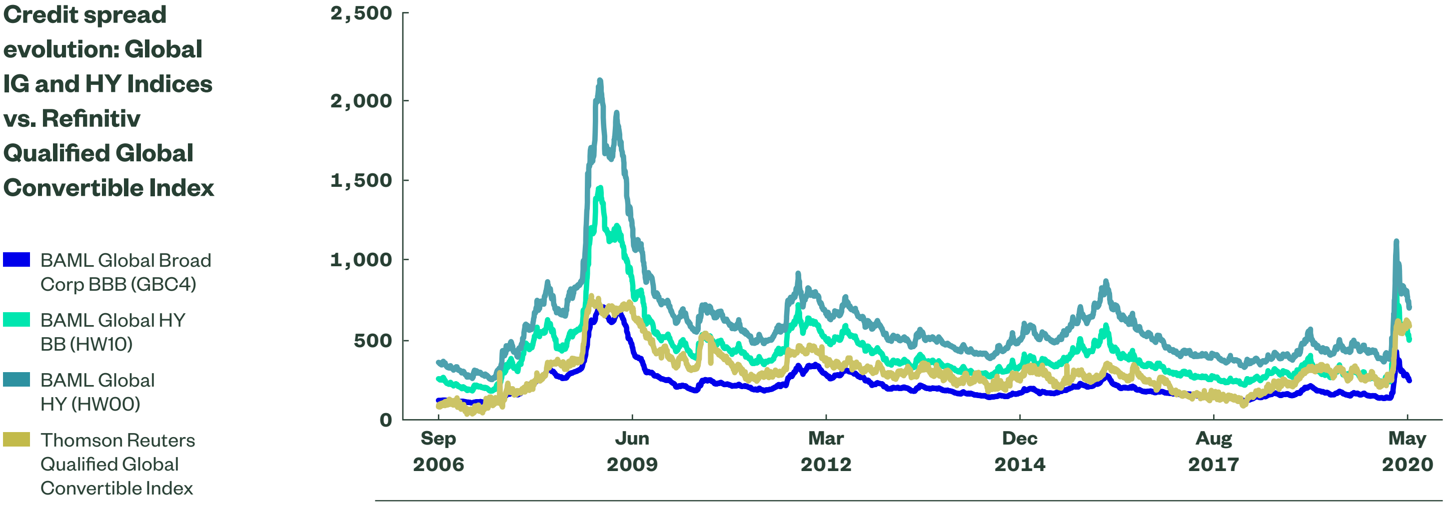
Source: State Street Global Advisors, Bloomberg Finance L.P., as 31 May 2020. Figures are in euro-hedged terms.

Risk Considerations

Quality: Convertible Bonds — Between Investment Grade and High Yield

While not immune from default risk, the profile of global convertible bonds can appear like a relatively attractive place to harvest some of the credit spread offered to compensate for some of the risk of lending to these issuers. While spreads have tightened from the peak, the overall quality of the index is averaging BB levels. This is confirmed both via the spread and using independent fundamental data ratings (such as the ones provided by FinAPU). The split between IG and HY is skewed towards IG in overall weight terms (c. 57% IG versus 43% HY) while a default weighted rating would err towards an average rating of BB (which matches the spread levels of such a Global HY BB index).

Figure 14
Credit spread evolution: Global IG and HY Indices vs. Refinitiv Qualified Global Convertible Index



Source: State Street Global Advisors, Refinitiv, Bloomberg Finance L.P., as of 29 May 2020.

Summary

Global convertible bonds exhibit an interesting balance between growth and protection thanks to their hybrid nature. Companies tapping the market range from faster-growing tech and health care companies to cash-strapped retailers offering potential upside value as they turn to the market with concessions. There are regional differences, with the larger US exposure providing growth and higher equity-like opportunities, while Europe and Japan can provide quality and defensiveness. The relative cheapness of Asia helps to provide investors with convexity and diversification, as volatility has receded to the low 30s.

We believe a global exposure can help to diversify away from the regional bias European investors may have in their portfolios. But currency risk should not be underestimated and using hedged exposures can be an elegant way to ride the growth in a still uncertain environment.

The three engines of convertible bonds (rates, equity and volatility) are re-ignited. Investors could consider this an 'auto-allocation' tool while we wait for further improvement and scrutinise all leading indicators and confirmation that recovery is coming.

Endnote

1 Source: Bloomberg Finance L.P., using the Refinitiv Qualified Global Convertible Index currency weights.

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Past Performance is not a guarantee of future results.

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