RBC BlueBay
Asset Management

Diversification is making a comeback: time to buy convertible bonds

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"When volatility rises, convertible bonds tend to outperform equity markets."

- Markets are transitioning to a new investment landscape where diversification will be a key focus. Convertible bonds are one of the asset classes that should benefit from asset allocation flows looking for diversification.
- We expect a rise in equity volatility in 2024 and believe this will be a key theme for financial markets. When volatility rises, convertible bonds tend to outperform equity markets.
- Another powerful argument for equity investors to allocate to convertible bonds is the income component, which has recently switched back in favour of convertibles, offering better coupons than dividends.
- The fixed income features of the convertible bond universe continue to offer an attractive profile with a low sensitivity to interest rates and a strong credit quality (more than 40% investment grade). The diversification benefits of convertible bonds for traditional fixed income investors remain in place.
- We expect the primary market to continue to expand in 2024. Historically, a pickup in new issuance has been a positive catalyst for the convertible bond asset class. We expect the coming period to be no exception.

Why buy convertibles now: the (ultra) short version

Have market participants adapted to the post-Covid world? We do not think so. Inflation is likely to stay elevated for the next few years, bringing monetary policy into a new regime. Long-term interest rates will remain volatile as many countries have adopted a more accommodative fiscal policy approach. The range of potential outcomes for economic growth has never been so wide - from recession to re-acceleration! In the face of this new, highly uncertain investment landscape, the keyword for asset allocation in the coming years will be 'diversification'. To put things bluntly, in the days of quantitative easing (QE), 'everything was going up', and volatility was always low. In that environment, the benefits of diversification were hard to defend; large-cap ETFs and high-carry strategies were all the rage.

However, things have changed, and in the future, investors will have to think a lot more about the risk profile of their portfolios. Outperformance is likely to come from unexpected, overlooked segments of the market. We believe this shift towards a higher degree of diversification has only started. Convertible bonds, from their hybrid nature, are a natural candidate to contribute to portfolio diversification. We expect this theme to drive renewed interest in the asset class and a re-rating.

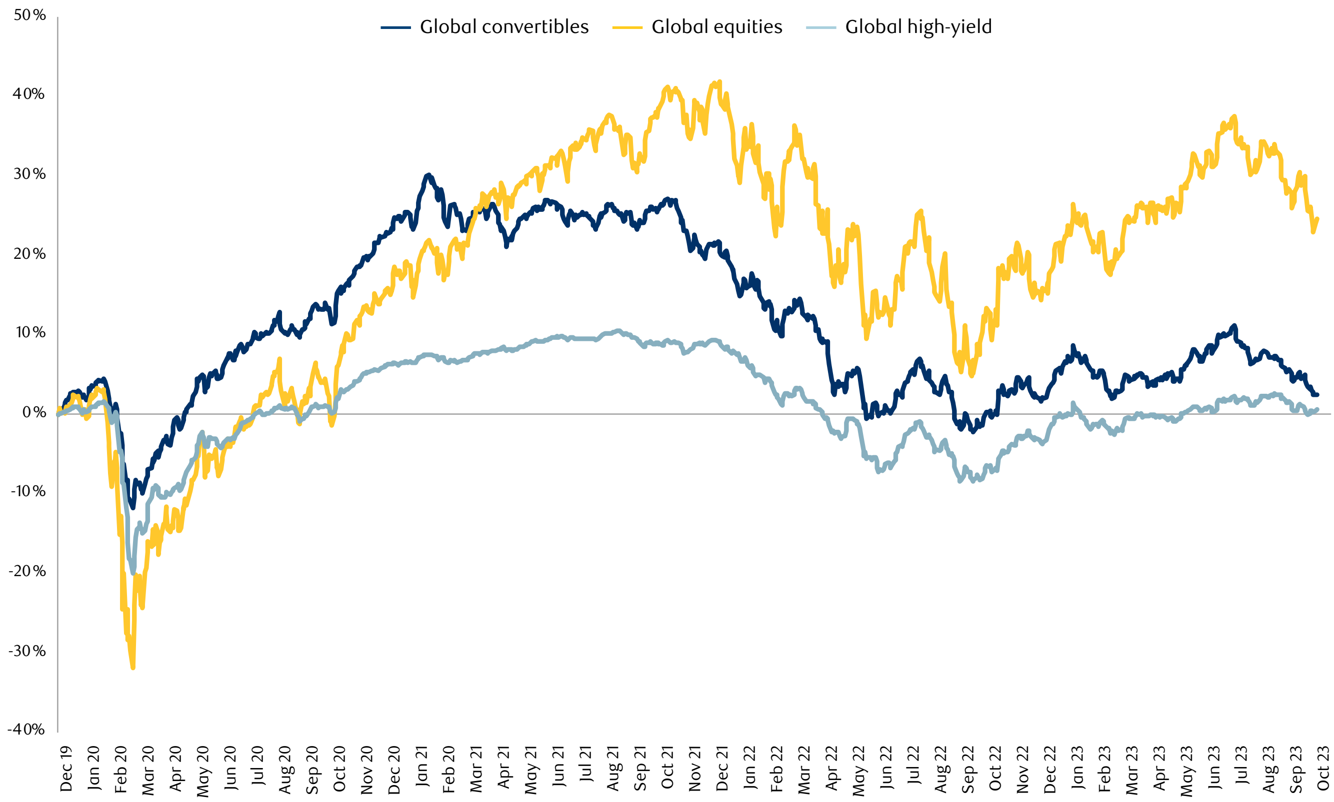
What happened?

Medium-term performance: better than bonds, behind equities

When assessing the recent performance of various asset classes, we think the period starting in 2020 is most relevant as it captures the complete monetary cycle from extreme central bank stimulus during the Covid crisis to the most recent aggressive hiking cycle to fight inflation. Over this period, Global Convertibles have underperformed equities and have outperformed high-yield credit (see Chart 1). The lack of mega-cap exposure was a negative driver. It was hard for the asset class to capture the latest upside leg in equity indexes as most of this rally was driven by mega-caps. On the positive side, the low effective duration of convertible bonds offered some protection vs the rise in rates that has hurt traditional fixed income investors.

> "Long-term interest rates will remain volatile as many countries have adopted a more accommodative fiscal policy approach. The range of potential outcomes for economic growth has never been so wide - from recession to re-acceleration!"

Chart 1: Asset class comparison (total returns in USD)



Source: Bloomberg as at 31 October 2023.

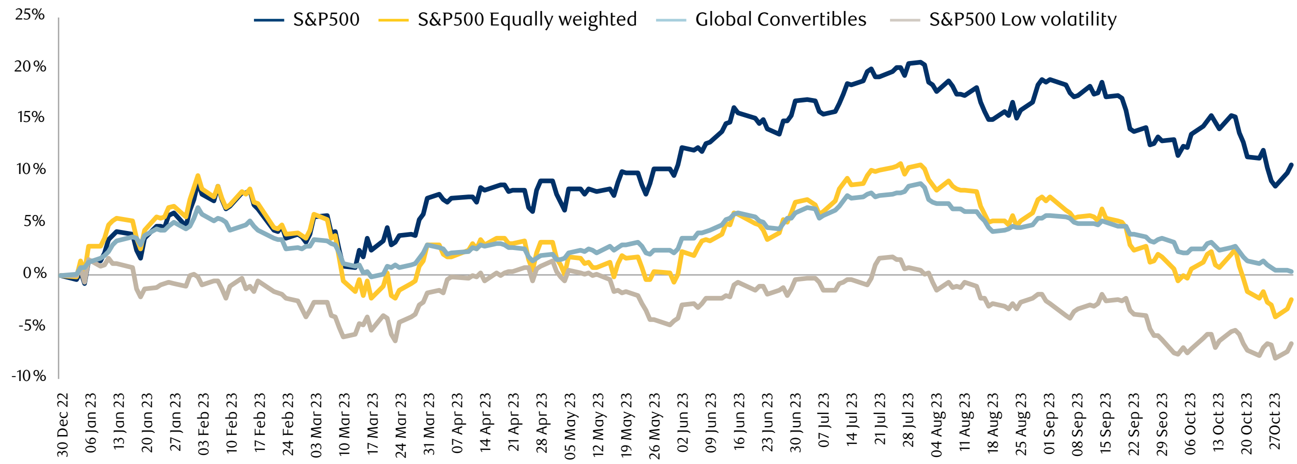
Under the surface, convertible bonds have started outperforming

Looking at headline large cap indices, it seems that equity markets have had a great year in 2023. In fact, this headline performance has been driven by US mega caps, while the performance for other stocks, for different sectors and factors, has been mixed and, even at times, negative. Some styles regarded as long-term outperformers have underperformed meaningfully – 'low vol' equities being a key example. From the lens of a broad equity market investor, not narrowly focusing on mega caps, convertible bonds have been a good investment and have offered outperformance (see Chart 2). In the coming years, we expect this high dispersion in equity-style performance to be the norm. Convertible bonds will be an efficient way for equity investors to invest in a 'low vol' asset class while avoiding value traps and vicious de-ratings.

Our key view for the coming years: the return of volatility in equities

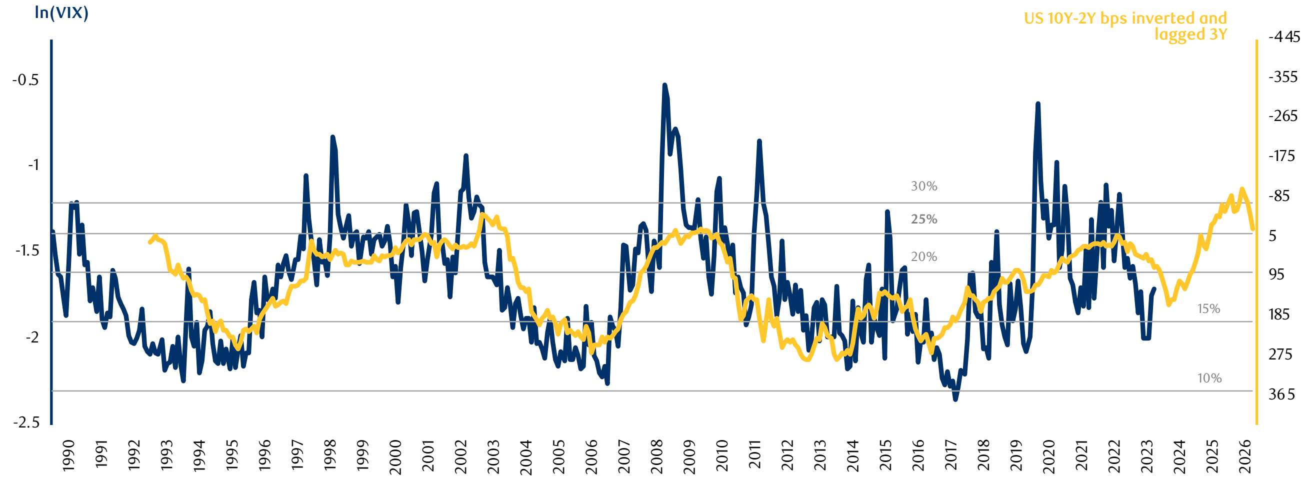
While bonds and FX markets have shown record high levels of volatility in 2023, equity markets' volatility has been remarkably low. This is surprising as one would expect the current uncertainty among market participants to translate into higher volatility. Using the same argument with a more quantitative approach, one can see that, historically, a period of inverted yield curve has corresponded to a rise in volatility (see Chart 3). We expect these dynamics to play out in the coming years leading to a higher volatility regime. Put bluntly, we think implied volatility for the S&P should be closer to the 20% to 25% band in those markets rather than the current 10% to 15% band. This view has implications for both equity and credit investors. In both cases, convertible bonds offer some mitigation to the negative impact of the rise in volatility on portfolios.

Chart 2: Short-term performance since end of December 2022 (total returns in USD)



Source: Bloomberg as at 31 October 2023.

Chart 3: Long-term history of the VIX and the market cycles



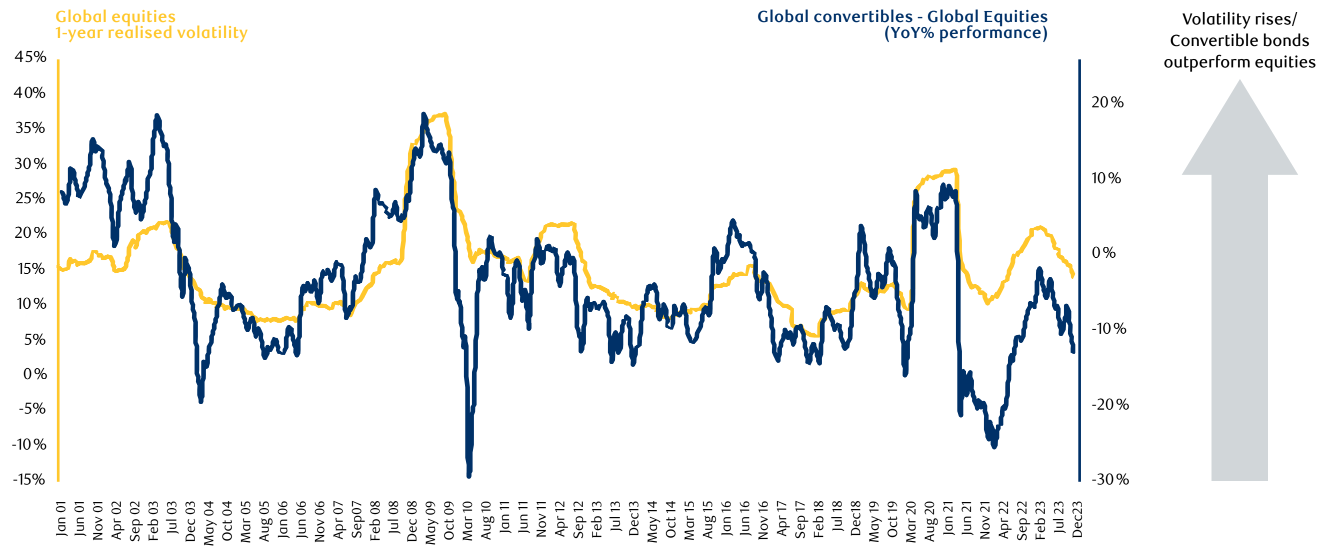
Source: Bloomberg. Monthly data from 31 January 1990 to 31 October 2023.
Indices: USYC2Y10 Index and VIX Index.
For illustrative purposes only. There is no assurance that any of the trends depicted or described herein will continue.

Equity portfolios: investing in convertible bonds as a way to take profit and reduce risk

When engaging with equity investors, we find a lot of support for our call for higher equity volatility. The expensive valuation of large-cap stocks in developed markets is an understandable source of concern and an additional argument favouring higher volatility. Convertible bonds effectively allow equity investors to reduce their equity risk and generate outperformance. This is illustrated in Chart 4, which clearly shows convertible bonds tend to outperform equities, in times of higher volatility. We think this chart is one of the most compelling argument for the asset class.

An additional powerful argument in favour of convertible bonds as an equity replacement is the return of the income component of the asset class. Over the past few years, convertibles have had low coupons and a lower income than the dividend yield. In the past few months, the situation has reversed so that convertible bond investors are now paid more in fixed coupons than equity investors in potentially fluctuating dividends (see Chart 5). We expect this income advantage to grow over time and trigger further flows out of equities into convertibles.

Chart 4: Relationship between realised equity volatility and the outperformance of convertibles vs. equities



Source: Bloomberg, Refinitiv, MSCI. Daily data from 1 January 2001 to 31 October 2023.
MSCI World Net Total Return USD Index. Refinitiv Global Focus Convertible Bond Index (USD).
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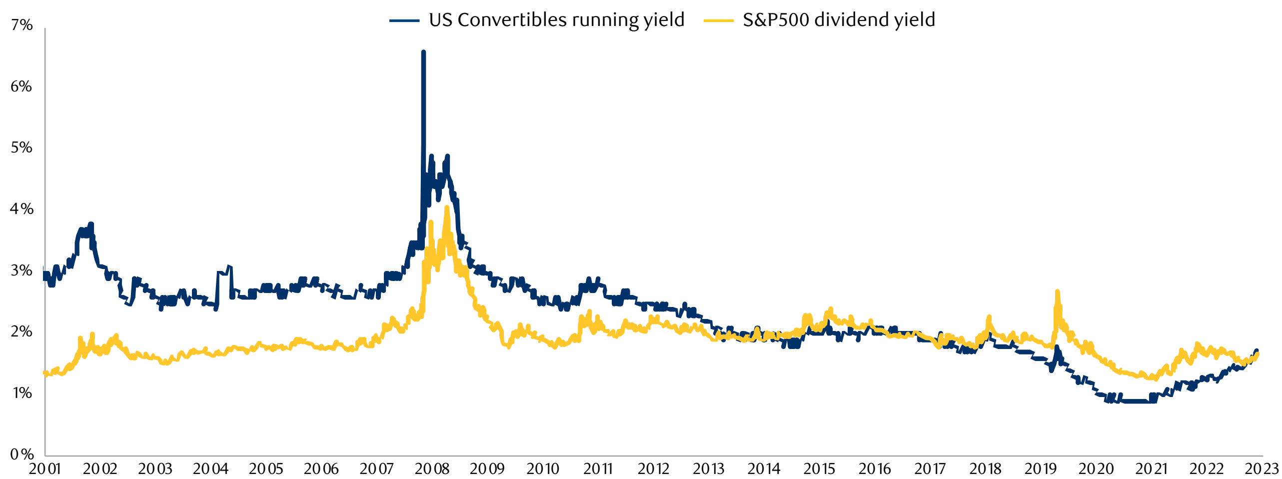
Chart 5: Comparison of US convertible bonds' average running yield (coupon over dirty price) and the dividend yield of the S&P 500



Bloomberg, Refinitiv. Daily data from 1 January 2001 to 31 October 2023.

Fixed income portfolios: key diversification benefits of convertibles

Low effective duration mitigates the impact of rates volatility

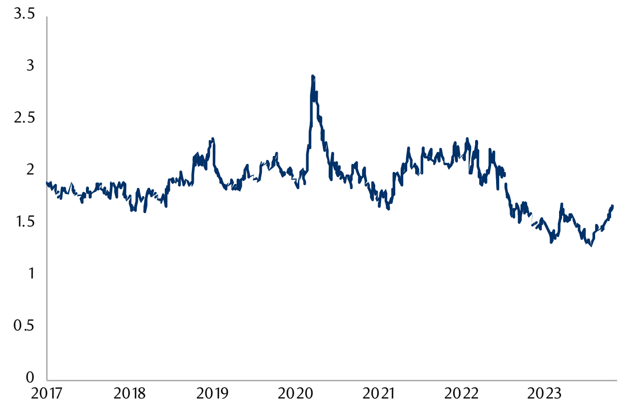
Convertible bonds are issued with shorter maturities than traditional bonds, which tends to limit their rate sensitivity. In addition, embedded options increase in value when interest rates rise, reducing the overall exposure of the instrument. Overall, the average effective duration of the convertible bond universe has historically been close to the 1.5 to 2 range (see Chart 6). In an environment where interest rates are likely to stay volatile, this short effective duration is desirable for fixed income investors.

Credit risk: convertibles should outperform carry strategies when volatility rises

There are two risks for credit investors. The first risk is a pickup in default risk. Although this is not our base case, we note that many investors are worried that the slow degradation in credit fundamentals and the potentially large amount of debt refinancing could push default rates higher in 2024. We expect these dynamics to maintain a preference among credit investors for safer credit quality. Convertible bonds should benefit from this bias as the universe with 43% of investment grade (IG) issues and 36% of BB issues offers a strong credit quality (see Chart 7).

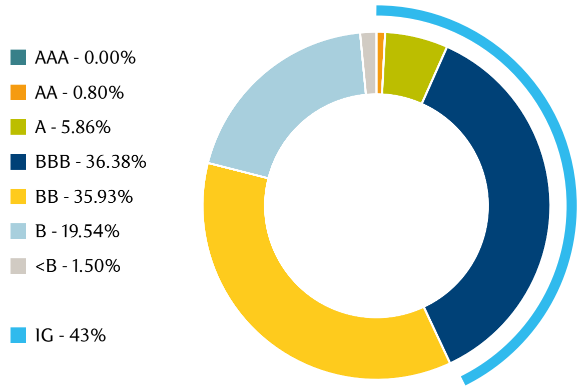
The second worry is a repricing of the credit risk premium, i.e. wider spreads for the same unchanged credit quality. Such a move in credit spreads would be consistent with our view that equity volatility should rise (see Chart 8). Why are Global Convertibles attractive in this context? 1) convertible bonds tend to have shorter maturities, making the asset class less exposed to spread widening 2) convertibles, thanks to their embedded options, can be positively impacted by higher volatility.

Chart 6: Effective duration for the Global Convertible bond universe



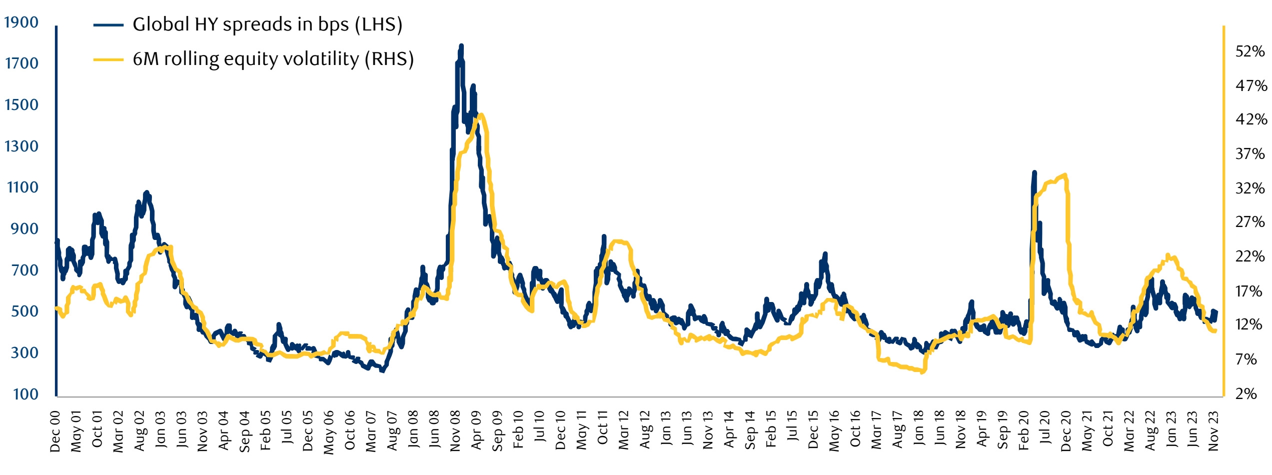
Source: Refinitiv Global Focus index; RBC Global Asset Management, BlueBay's fixed income platform's calculations based on internal assumptions.Data as at 31 October 2023.

Chart 7: Rating breakdown of the Global Convertible universe



Source: Refinitiv, Bloomberg and RBC Global Asset Management. When instruments are not explicitly rated, we are showing BlueBay's fixed income platform's internal calculations. Breakdown is for the Global Focus Convertible Bond index from Refinitiv as at 31 October 2023.

Chart 8: Relationship between realised equity volatility and credit spreads



Source: Bloomberg, MSCI. Daily data from 1 January 2001 to 31 October 2023
MSCI World Net Total Return USD Index. Refinitiv Global Focus Convertible Bond Index (USD)
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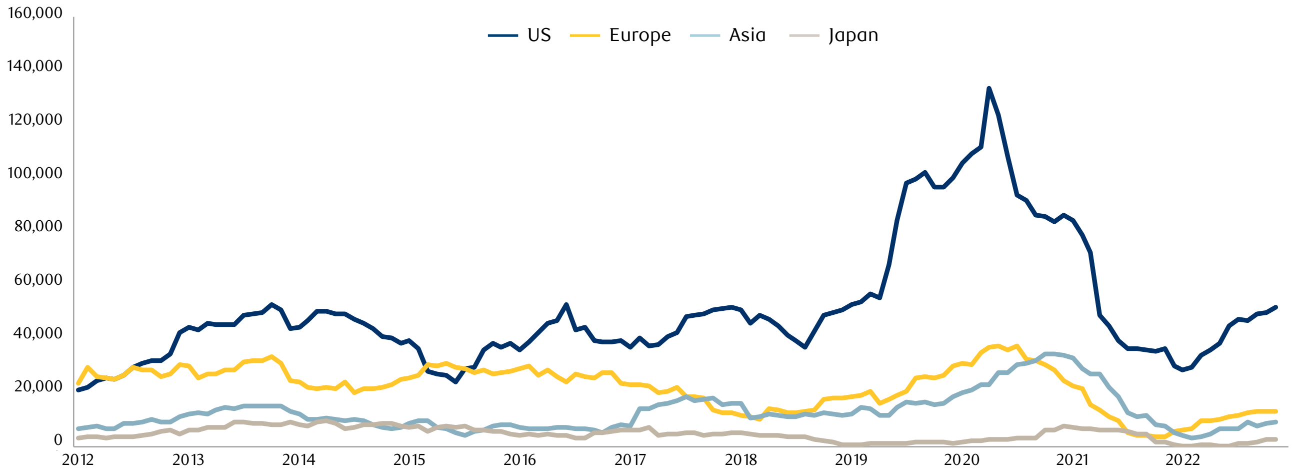
The primary market: the catalyst for a full re-rating of the asset class

Unlike most other asset classes, more supply has historically been a good thing for convertible bonds. When new issuance picks up, investors from the equity and credit worlds are attracted by the cheap optionality. It also helps reprice optionality in the secondary market in instruments that had seen the value of their embedded options drift lower. It finally broadens the opportunity set for active investment. For all these reasons, market participants are looking for a pickup in the primary market as a trigger for the asset class to outperform.

In 2023, we have seen a healthy pick-up in issuance in the US, boosting sentiment. New issues have been well received as many of the issuers were in the investment grade space. We note that other regions have only seen a tentative improvement in the volume of new issues (see Chart 9).

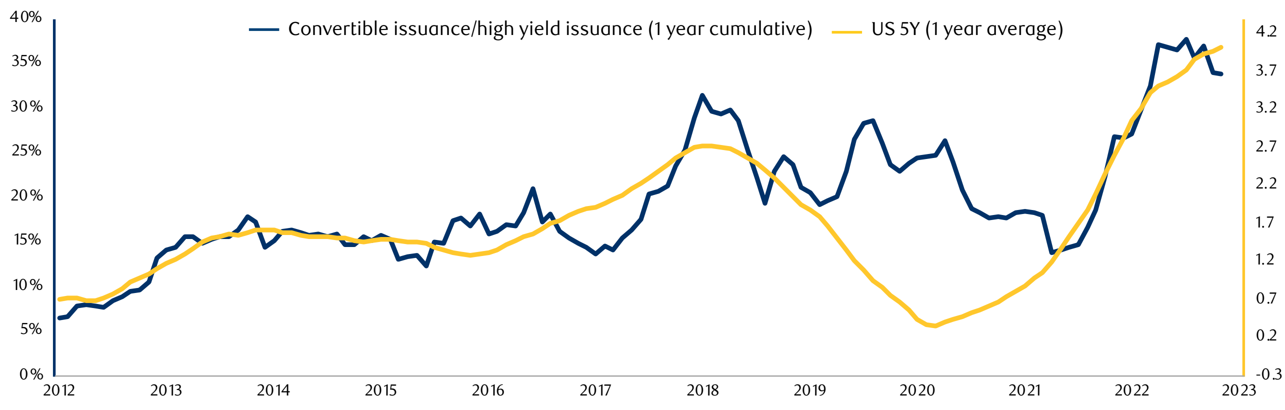
We think the bounce in the volume of primary market issuance will continue in 2024 in the US and gather pace in other regions. The reason is simple: 'higher rates'. Put simply, when a company issues a convertible bond, it pays a lower coupon and gives away equity optionality in exchange. In periods of low rates, there is a preference to issue straight debt with a low level of coupon and return value to shareholders. With rates where they are, many companies have seen their cost of debt increase meaningfully. When the time to refinance comes, the incentive to reduce the coupon payment will be greater than it has been for the past 10 years. This makes convertible bonds attractive to issuers in the investment grade and high-yield segments (see Chart 10). Our view is that we have only seen the beginning of this shift in corporates' attitude to funding, and we expect the primary market to be strong in 2024 both in terms of volume and performance.

Chart 9: Convertible bonds – primary market issuance over the past 12 months (USD millions)



Source: BofA Convertible Research, as at 31 October 2023.

Chart 10: Link between the relative strength of the convertible and high-yield primary market and the level of interest rates



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