Fixed Income Insight: why invest in European convertible bonds?

Convertible bonds are a hybrid asset class offering both equity and credit exposure. In this piece, we review the technicalities of the convertible bond asset class. We argue that convertible bonds are well positioned to benefit from continued moderate growth in the euro area and accommodative monetary policy. Our bottom-up process which favours balanced risk-profiles and small and mid-cap companies should help to extract value from the market.

The euro area economy returned to growth in mid-2013 after a prolonged double-dip recession. GDP is forecasted to expand at a moderate 1.5 to 2%ya pace in the next two years (source: Natixis AM Economic Research). Unemployment rate has been trending down since 2012 albeit considerable labor market slack remains in several countries. Fiscal imbalances have diminished as aggregate public deficit decreased further to 1.5% of GDP last year (source: Natixis AM Economic Research). Monetary policy also played a role in fostering a recovery in the euro area although inflation has yet to respond to stronger domestic demand. For this reason, ECB monetary policy is likely to remain highly accommodative at least until 2019. Quantitative easing includes purchases of public-sector and private-sector debt securities (covered bonds, asset-backed securities, non-bank corporate bonds). Improved growth conditions have led to outperformance of growth-sensitive asset markets. Furthermore, retiring large quantities of low-yielding safe bonds from the market provides incentives for investors to rebalance portfolios into higher-yielding and riskier securities. Rebalancing has indeed benefitted equities, high yield and convertible bonds. Convertible bonds entail conditional exposure to equity markets. As economic growth improves, convertible bonds will tend to outperform a broadly-diversified fixed income portfolio.

Convertible bond gives its holder the right to convert a bond into a predetermined amount of shares. Convertible bonds offer an exposure to both credit and equity risk. This hybrid nature of convertible bonds makes them an appealing asset class in its own right. Statistical studies show the interest of convertible bonds in comparison with other asset classes as well as the benefit of holding convertible bonds in a credit portfolio for the purpose of diversification.

- As an asset class: When the underlying stock price is far above a predetermined conversion price, the convertible bond behaves mostly like the stock because the conversion, as profitable, is likely. When the stock price is far below the conversion price, the convertible bond behaves like a bond and is therefore exposed to credit risk and to a lesser extent to equity risk. In the neighborhood of the conversion price, there is a balanced exposure of convertible bonds to credit and equity risk. The passive investment in convertible bonds with a mixed profile therefore offers the possibility to gain future rises of the underlying stock while limiting the downside risk thanks to the bond floor. The delta hedging of these convertible bonds with a mixed profile and therefore a large gamma may also increase the profit in falling equity markets. The active management of convertible bonds is also an efficient way to implement views on equities. Since the delta of a convertible bond quantifies its exposure to the underlying stock, a market view can drive the selection of convertible bonds with appropriate delta. Moreover, convertible bonds often embed additional options which can be relevant in active strategies. For example, some convertibles bonds hold a put option, in particular when issued in Asia. This offers additional protection to the holder against downside risk.

- Versus other asset classes: It has been shown[1] that the statistical properties of convertible bonds make them a profitable asset class in comparison with others. A standard indicator of risk-adjusted performance is the Sharpe ratio. On the long run, Sharpe ratio is higher for convertible bonds than for equities but lower than for High Yield credit (see Table 1). Besides, an indicator of forecastability shows that between 2006 and 2016, high yield credit is characterized by long-memory feature in daily price returns, followed by convertible bonds and lastly equities. High forecastability makes active management of convertible bonds quite relevant.

- For diversifying a credit portfolio: As mentioned above, though convertible bonds are statistically well forecastable, high yield bonds are even more forecastable. However, convertibles have an advantage over high yield: they are indeed not much correlated with investment grade bonds (-8% at a one-day horizon, see Figure 1), whereas high yield bonds are close to the investment grade market (30% correlation at a one-day horizon). This makes convertible bonds a more efficient way of diversifying an investment grade portfolio.

[1] "*Investing in global convertible bonds – stylized facts, pricing and strategies*", Natixis Asset Management, Research Paper 8. Illustrations for the Sharpe ratio and the correlation are from this paper.

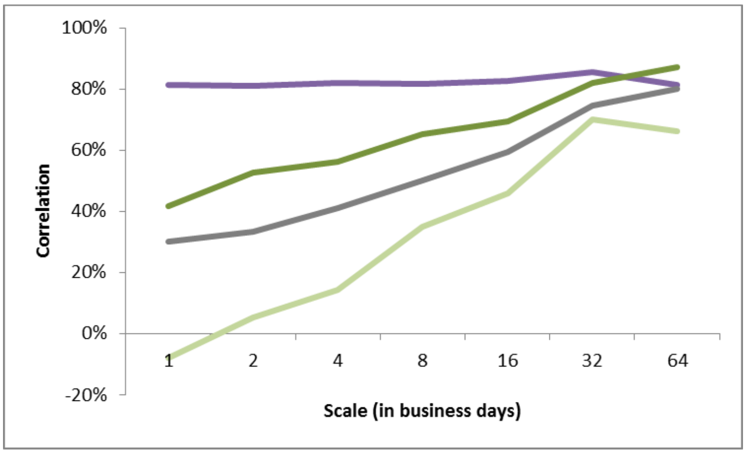
	Annual total return	Annualized volatility	Annual Sharpe ratio
Bloomberg Barclays Euro high yield index	7.38%	5.65%	1.31
Exane convertible Euro index	3.83%	6.85%	0.56
Stoxx Europe 600 index	5.35%	20.05%	0.27

Source: Natixis AM, Bloomberg. Data as of 22.01.2016

The figures given refer to previous years. Past performance is not a reliable indicator of future performance

Table 1: Performance, risk and Sharpe ratio between 03.07.2005 and 22.01.2016 of investment grade, high yield, convertibles and equities indexes.

Correlation comparison



Source: Natixis AM, Bloomberg. Data as of 31.03.2017

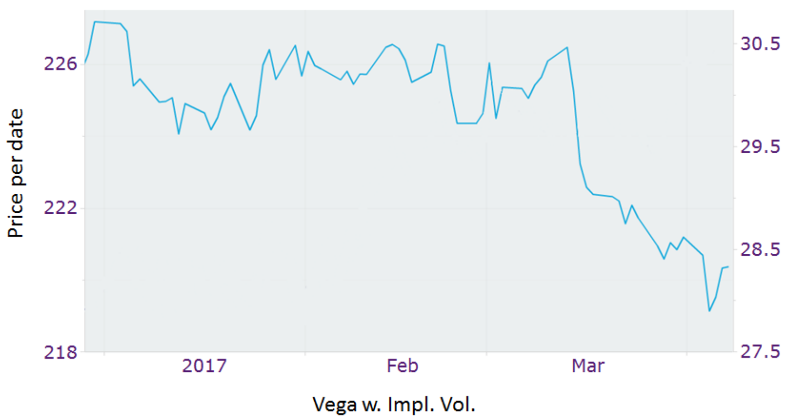
Figure 1: Correlation for convertible bonds *vs* IG credit (in light green), convertible bonds *vs* HY credit (in dark green), convertible bonds *vs* equity (in purple) and HY *vs* IG (in grey), estimated between July 2005 and January 2016. The scale, in abscissa, indicates the horizon of the returns. For example, for the scale 1 the plot shows the correlation of daily returns, for scale 2 the correlation of two-day returns.

Convertible bonds in the early of 2017: Implied volatility and equity appreciation potential

Nowadays, in a context of low interest rates, European convertible bond markets are supported by a flurry of new issues and attractive valuation.

The implied volatility of the asset class fell in the first quarter of 2017, from 31% to 28% as of the end of March 2017. At this level of implied volatility, European CB valuations are cheap in our opinion.

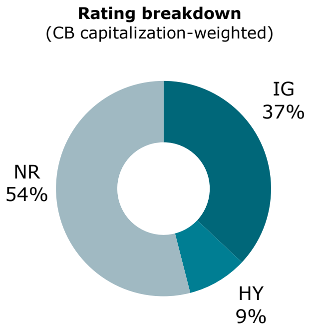
Evolution of the Convertibles bond Implied Volatility over Q1 2017

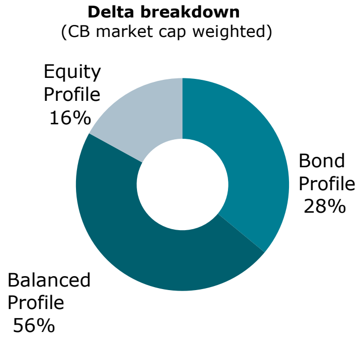


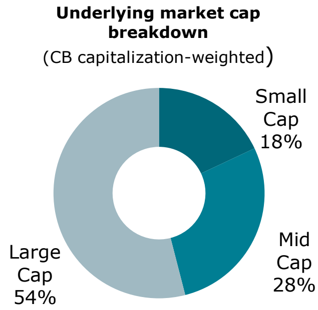
Source: CBInsight, Barclays Live. Data as of 31.03.2017

The European primary market is off to a strong start of year in 2017 at EUR 7 billion as of end of March. As a reminder, 2016 was also a dynamic year with EUR 25 billion new issues. It is essentially driven by issuance of large caps and blue chips companies with investment grade ratings, low-coupon yields and delta (sensitivity to equity) less than 30%. So, in this environment, we pay particular attention to equity and volatility levels. For instance, Michelin launched a bond with a 2022 maturity and a coupon of 0%. We have not bought it on the primary market but on the secondary market after equity prices have adjusted lower.

Nonetheless, **balanced profiles and yielding bonds continue to dominate European convertible bond markets**. For instance, we invested in Rallye/Casino 5.25% 2022, unrated with 35% delta and 5.25% coupon. The CB universe remains diversified across both large cap and mid & small cap markets.







Source: BNPP and Natixis AM. Data as of 31.03.2017

Natixis Asset Management 2017 outlook on the European CB market

Portfolio managers expect total return between 7 and 9% in 2017. This positive view on convertible bonds reflects equity market valuations and investor risk appetite. In addition, it is important to note that convertibles' implied volatility is at all-time low.

Factor	Contribution	Rationale
Credit	1%	Carry and very modest credit spread tightening
Equity	5 - 7%	Investors expect an improve of earnings due to a strong ECB support and European GDP growth around 1.7% for 2017
Convertible bond implied volatility	1%	Volatility is historically low
Total expected return	**7 - 9%**	

Source: Fixed Income Investment Division of Natixis Asset Management

This data should not be interpreted as having any contractual value. It is produced for information purpose only. Natixis AM will not be held responsible for any decision taken on the basis of this information.

Natixis Asset Management Investment philosophy:

With bond yields making new all-time lows, investors are seeking upside opportunities. While investor risk appetite remains elevated, equity markets are always vulnerable to market corrections. Convertible bondholders in turn benefit with a built-in parachute effect.

Our investment philosophy is to build portfolios with a mixed convertible bonds profile (delta between 25 and 75%), in order to benefit from potential upside on stock prices whilst limiting downside risk thanks to the bond backing.

For 2017, consistent with their positive view on the asset class, fund managers hold overweight delta exposure in their portfolios vs. benchmark. Maintaining delta +5% to +10% above benchmark, Natixis AM's Euro/Europe convertible bonds expertise should benefit from any rise in equity markets.

In the same time, portfolio managers favor small-and-medium-sized companies in order to benefit fully from convexity and attractive growth in this market.

The portfolio management process has proven successful in recent years. The bottom-up process is based on the risk assessment of issuers (leverage, default risk, bond liquidity...), assessed potential upside of the convertible bond (spread, volatility and equity level) and the calibration of the issue in the portfolio.

Convertible bond expertise at Natixis Asset Management

Strong resources and sound risk management are top priorities:

- **Two experienced co-lead portfolio managers**, Denis Passot and Philippe Garnier, **averaging 20 years of convertible bond investment experience**, within a team of specialized credit portfolio managers. The co-managers have been with Natixis AM for 24 years and 14 years, respectively.
- A track record 20 years for our flagship convertible bond fund.
- Complementary experience in arbitrage and directional strategy in convertible bonds.
- A large in-house credit research team of 24 analysts who analyze convertible debts as well as straight issues, and **two dedicated desk analysts**.
- A total of EUR 1 billion in assets under management for Natixis AM's convertible bond expertise[2], very significant assets under management for this hybrid asset class.
- Natixis AM's Convertibles expertise has outperformed the benchmark in both falling and rising markets.

Expertise features

	Europe Convertible bonds Strategy	Euro Convertible bonds Strategy	Global Convertible bonds strategy
MAIN CHARACTERISTIS			
Investment universe	Convertible bonds issued mainly by European issuers (OECD)	Euro-denominated convertible bonds from OECD issuers	Global
Investment objective	Outperform ECI Euro[3] over a recommended investment period of 4 years	Outperform ECI Europe[4] over a recommended investment period of 4 years	Outperform TR Convertible Global Focus Hedged[5] over a recommended investment period of 4 years
Investment philosophy	A conviction-based philosophy integrating risk management		
ALPHA DRIVERS			
Active delta management	✓	✓	✓
Issuer and security picking	✓	✓	✓
Relative Value	✓	✓	✓
Volatility	✓	✓	✓
Credit/Interest Rate	✓	✓	✓
Currency	✓		
MAIN RISKS			
Equity market risk	✓	✓	✓
Sensitive to volatility movements	✓	✓	✓
Credit/Interest Rate risk	✓	✓	✓
Currency risk	✓		

[2] Source: Natixis Asset Management, as of 28/03/2017.
[3] Exane Convertible Index Euro
[4] Exane Convertible Index Europe
[5] Thomson Reuters Convertible Index - Global Focus Hedged

Legal information

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