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Insight: Convertible bonds

A useful tool in volatile markets

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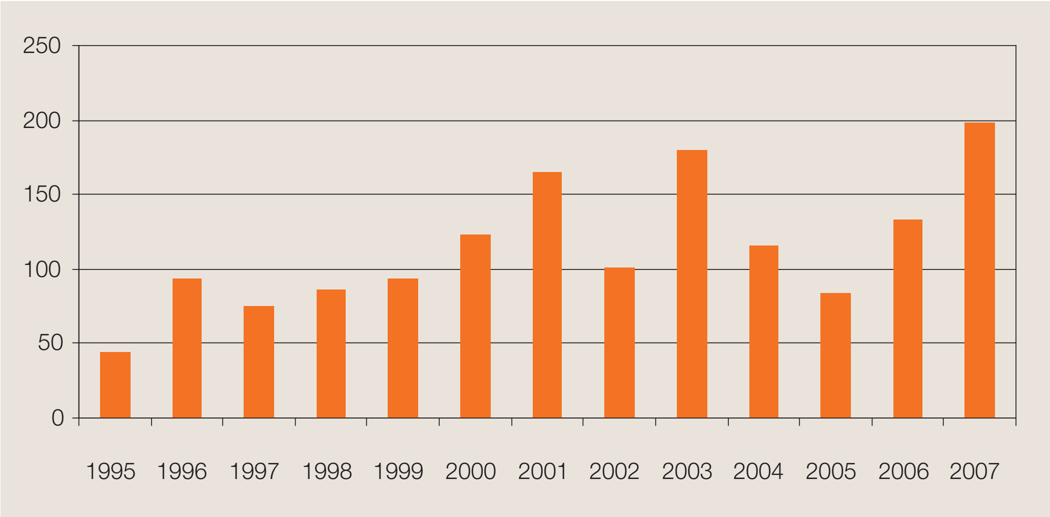
JPMorgan Asset Management

Convertible bonds – a useful tool in volatile markets

Convertible bonds have played a key role in helping banks deal with the repercussions of the global credit crunch. UBS and Citigroup are among those to have issued convertibles to shore up their balance sheets following subprime-related writedowns. And in March, when Lehman Brothers was hit by rumours it faced funding issues following the near-collapse of Bear Stearns, it issued USD 4 billion in convertible preferred stock to reassure investors of the stability of its capital position. The deal was heavily oversubscribed – testament to the strength of the convertibles market.

As chart one shows, global convertible bond issuance hit an all-time high in 2007, reaching around USD 198 billion[1], an increase of 47% on 2006. And with ongoing financial uncertainty, this trend looks set to continue in 2008.

Chart one: Global convertible bond issuance 1995-2007



Source: UBS Convertibles Marketing/MACE

The surge in convertible bond issuance has been fuelled by equity market volatility. But why does issuance peak when markets are volatile? And why does this present an opportunity for investors?

Attractive for investors and for issuers

From the point of view of the issuer, the current market climate makes convertibles an attractive option. With credit conditions tight, other sources of funding may be expensive, or, in some cases, not available at all. Convertibles allow companies to seek finance relatively cheaply, because the possibility of conversion into equities means investors will accept a lower coupon than for corporate bonds. This explains why so many banks, in particular, have turned to convertibles, both to bolster capital and to finance mergers and acquisitions, while debt markets have been effectively closed due to the credit crunch.

For investors too, convertibles become more appealing in times of volatility. When markets experience large fluctuations, there is a greater chance that a convertible bond will reach it's conversion price, making the option to convert into an equity more valuable. In addition, the price of the convertible is supported by the fact that it may pay a regular coupon and will also pay the fixed face value of the bond at redemption – in practice, the face value acts as a 'floor' below which the convertible is unlikely to fall, as long as the issuer remains solvent. As a result, convertible bond prices can be more stable than equity prices.

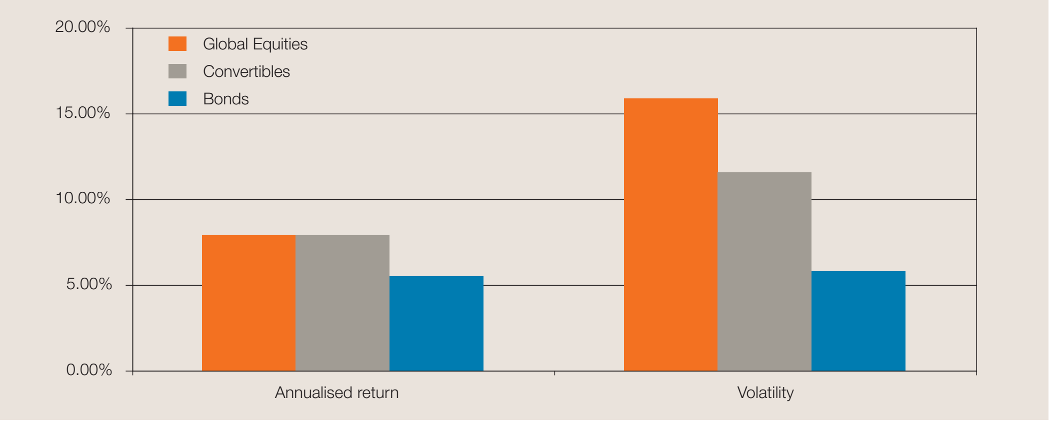
The benefits of investing in convertibles were compellingly illustrated in 2007, when the asset class provided investors with a shelter from the turbulence that affected other assets. While global equities ended a volatile year 9.0%[2] higher and global bonds fell 0.5%[3], convertibles returned 10.3%[4] (all returns in USD terms) – testament to their ability to withstand short-term volatility.

[1] Source: Bloomberg. [2] MSCI World Total Return Net.
[3] Lehman Brothers Global Aggregate Bond Index. [4] UBS Global Focus Convertible Index.

The best of both worlds

In current market conditions, the decision between equities and bonds is a difficult one. Convertibles can be viewed as offering investors the best of both worlds: access to the upside potential of stock markets, but with a similar level of downside protection to bonds. In fact, as chart two shows, since 1995, convertibles have delivered returns in line with global equities, but with significantly lower volatility.

Chart two: Annualised return and volatility of global equities, convertibles and bonds (1995-2007)



Period 31-Dec-94 to 31-Dec-07. Equity index = MSCI World, Bond index = JPM Global Gov't Bond Index, Convertible index = UBSW Convertible Index. Total return indices, all in EUR.

Since convertible bonds can be converted into equities, a rise in the value of the underlying equity tends to cause the price of a convertible to increase, meaning that convertibles offer access to the upside potential of equity markets. However, because of their bond-like characteristics, they provide greater peace of mind in uncertain market conditions.

This means that convertibles are a natural total return product, which explains their appeal for many fund managers, particularly in multi-asset and other total return funds.

Using convertibles in a portfolio

Convertibles have long been used by investors looking to generate a higher return than bonds, but at a lower risk to capital than equities. When added to a portfolio, they offer strong diversification benefits, allowing investors to pursue higher risk-adjusted returns with lower volatility.

In fact, in volatile markets, a portfolio made up of 100% convertible bonds can potentially deliver a return well above the standard frontier, as we have seen in 2007. It's this asymmetric risk profile that provides a persuasive reason for investors to consider an investment in the asset class.

Supportive economic backdrop

The current economic backdrop, characterised by jittery stock markets and uncertainty over the outlook for global growth, provides a buoyant environment for convertibles as investors seek security of returns. With issuance at a record high, the asset class also presents more opportunities than ever before.

However, convertibles are not only popular during times of uncertainty. Their underlying equity exposure means they are also well placed to benefit from stock market resurgence, making them an excellent long-term addition to a portfolio.

Convertible bonds: key points

- Debt securities that can be converted into equities
- Can participate in strong equity markets
- Bond-like characteristics provide downside protection
- Natural total return products
- Issuance is at a record high, offering greater choice

For more information contact your usual JPMorgan Asset Management representative or call the dedicated brokerline **0800 727 770**
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