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INVESTMENT INSIGHTS

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Global Convertibles: Opportunities for uncertain times

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Introduction

Convertibles are often favoured by investors for their attractive risk and return characteristics, particularly during periods of market stress. During the intense market volatility of August and September 2011, as equity markets fell sharply, credit spreads widened and asset class valuations came under severe pressure, convertibles showed some defensive characteristics, providing additional levels of diversification to investment portfolios. Also, while market liquidity has been impacted by the recent volatility, liquidity remains sufficient and is not close to the low levels witnessed in 2008.

In this investment insight Antony Vallee and Robin Dunmall, members of the dedicated convertibles team with our Global Multi-Asset Group, examine the performance of global convertibles over the turbulent summer of 2011, analyse current valuations in the convertibles market following the equity market selloff, and then consider the outlook for the asset class against an uncertain macroeconomic backdrop.

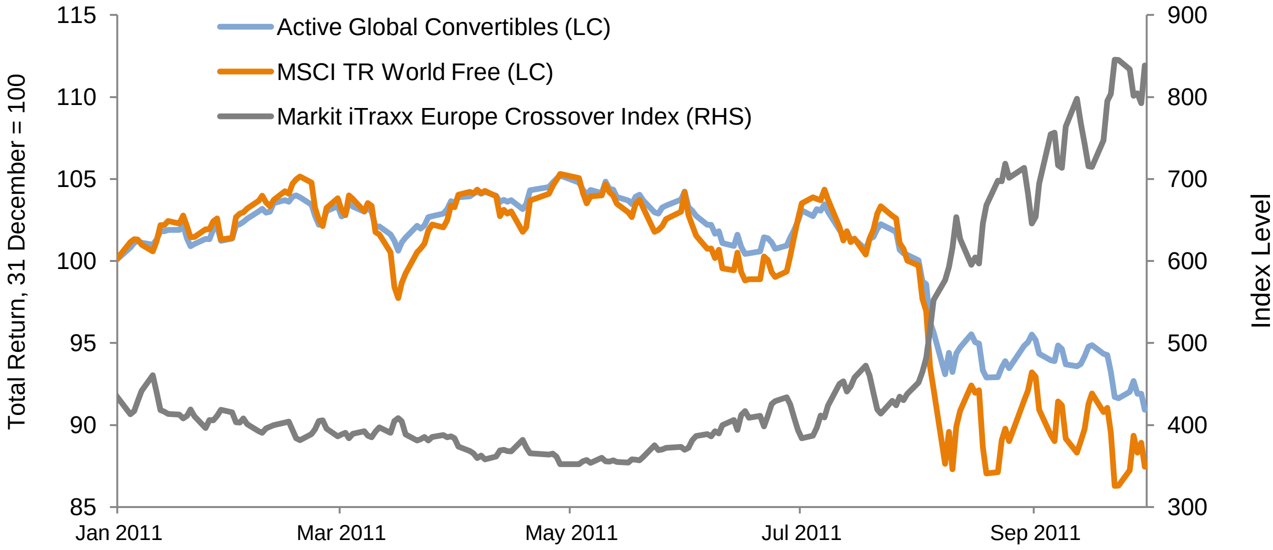
Convertibles are moving in line with expectations

The summer of 2011, and particularly the intense market volatility of August and September, has provided convertibles with their first serious test since their disappointing performance in late 2008. During the global financial crisis, the forced deleveraging of hedge funds, among other factors, led to declines in convertible valuations of a similar scale to the fall in equity indices.

In contrast, convertibles have held up better than equities during the market turbulence seen so far in 2011, providing investors with some of the downside protection expected of the asset class. The estimated -9.0% return from the global convertibles market between 31 December 2010 and 30 September 2011 compares favourably with a 12.6% decline in the MSCI World TR index[1] and a 91.8% widening in the iTraxx crossover index (a gauge of credit conditions). It should also be noted that the MSCI World Index is not representative of the universe of convertible issuers, which is more concentrated in smaller, high-beta names.

[1] All returns quoted are in local currency and to the end of September 2011 unless stated.

Exhibit 1 – **Year-to-date performance of convertibles vs global equities**[2]



Source: J.P. Morgan Asset Management, Bloomberg. Data as at 30 September 2011.

The comparatively defensive performance of convertibles so far in 2011 suggests a reassuring return to normality. There is now less leverage in the system and a far wider range of market participants, both of which help support convertible valuations and promote protection on the downside.

2011 year-to-date performance breakdown

By region

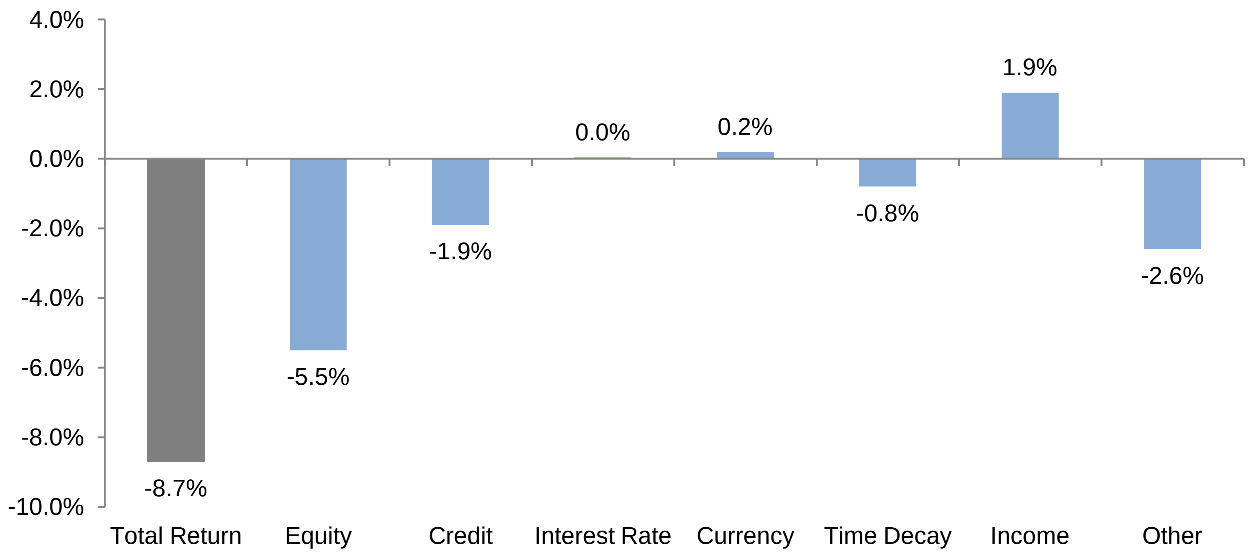
- Japanese convertibles have proved to be the most defensive year to date. This is likely the result of the higher credit quality and lower equity sensitivity of many Japanese names, while Japan has also provided investors with a safe haven in this period of heightened volatility and market uncertainty.
- After comparatively strong returns in the first half of the year, we calculate that European convertibles have fallen sharply over the summer as concerns over the fiscal sustainability of eurozone sovereigns led to a decline in risk appetite.
- However, Asia has been the worst performer year-to-date. This is due to a lacklustre start to the year followed by aggressive selling in September, due to the lower overall quality of the Asian space compared with other regions[3].

By sector and credit quality

- As a consequence of the deteriorating economic outlook, cyclical sectors have been the poorest performers so far in 2011.
- Unsurprisingly, the strongest performers over the period have been utilities and consumer non-cyclicals.
- High-beta, sub-investment grade credit securities have underperformed, despite a strong start to 2011. Poor returns over the summer have left speculative grade convertibles posting a year to date return of -12.8% versus an investment grade return of -7.3%[4].

[2] The 'Active Global Convertibles' index consists of all convertibles that the team consider to be actively traded.
[3] The Asian convertibles universe has a higher proportion of small, unrated issues than other regions.
[4] It should be noted that the distinction between investment grade and sub-investment grade convertibles masks a number of other factors, such as the profile of the security (bond-like vs. equity-like, etc.) and the capitalisation of the issuer.

Exhibit 2 – **Year-to-date performance decomposition[5] of the global calibrated universe[6]**



Source: J.P. Morgan Asset Management. Data as at 30 September 2011.

By market capitalisation

- Convertibles issued by small- and mid-capitalisation companies have outperformed large cap issuers, despite typically being sub-investment grade and with higher equity betas.
- Although the impact of credit spread widening has been felt more acutely in the small-cap space, this has been more than offset by the higher income paid on the small-cap names and a larger negative equity impact on large-cap securities.
- One explanation for the significant equity impact felt by the large cap convertibles is the higher concentration of equity-like names in this space[7].

Drivers of returns from convertibles in 2011

Our universe of calibrated convertibles has returned -8.7% over the year-to-date period. The calibrated universe represents the subset of the global convertible universe for which the team actively control the necessary model inputs in order to generate accurate and reliable factor sensitivities.

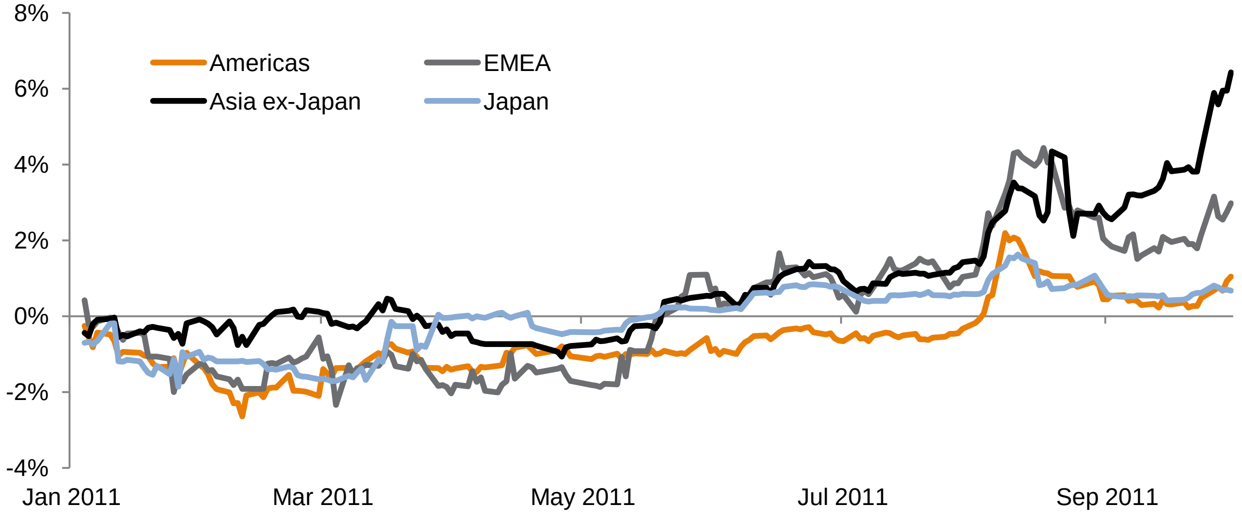
Within this universe, it is possible to break down the components of return, and we estimate that the key driver of convertible performance year-to-date has been the decline in equity markets. The impact of equity market declines on the total return of the global calibrated convertible universe was -5.5%, compared with an impact of widening credit spreads of only -1.9%. These effects were partially offset by coupon income, which we believe added back 1.9%.

Valuations have improved meaningfully

One notable development following the recent selloff in equity markets and decline in investor risk appetite has been a meaningful improvement in convertible valuations. In the first half of the year, convertibles were trading at best around fair value (compared to the theoretical valuation derived from our convertible analytics model), but this has eased in recent months to the point that the universe now looks cheap.

[5]Definitions: Equity-like = convertibles with premium < 15%; Balanced = convertibles with a premium < 100% and an annualised premium < 20%; Bond-Like = convertibles with a premium > 100% or annualised premium > 20%; Busted HY = convertibles trading at a price < 50% of par.
[6]As at 30 September 2011, the calibrated universe represented 45.3% of the global convertibles universe.
[7]Equity-like names are those trading with low premiums and high deltas.

Exhibit 3 – **Discount to theoretical value within the calibrated universe**



Source: J.P. Morgan Asset Management. Data as at 30 September 2011.

The cheapening in valuations has been particularly apparent in Europe and Asia. Back in early July, Europe and Asia were moving in step with one another. Following a slight easing of investor nervousness regarding sovereign debt sustainability in the eurozone, Asian convertibles have subsequently diverged to become the cheapest region by some distance. This is likely to be a consequence of the lower levels of liquidity in the region and the larger proportion of unrated issues, which have been sold heavily by investors seeking to de-risk their portfolios.

In addition, weakening macroeconomic data from China and concerns regarding the real estate sector (traditionally a big issuer of convertibles in Asia) have weighed on the region. This stands in stark contrast to Japanese valuations, which have not cheapened as dramatically since the region has been viewed as a safe haven for investors in times of market stress.

A potentially attractive entry point with cheap optionality

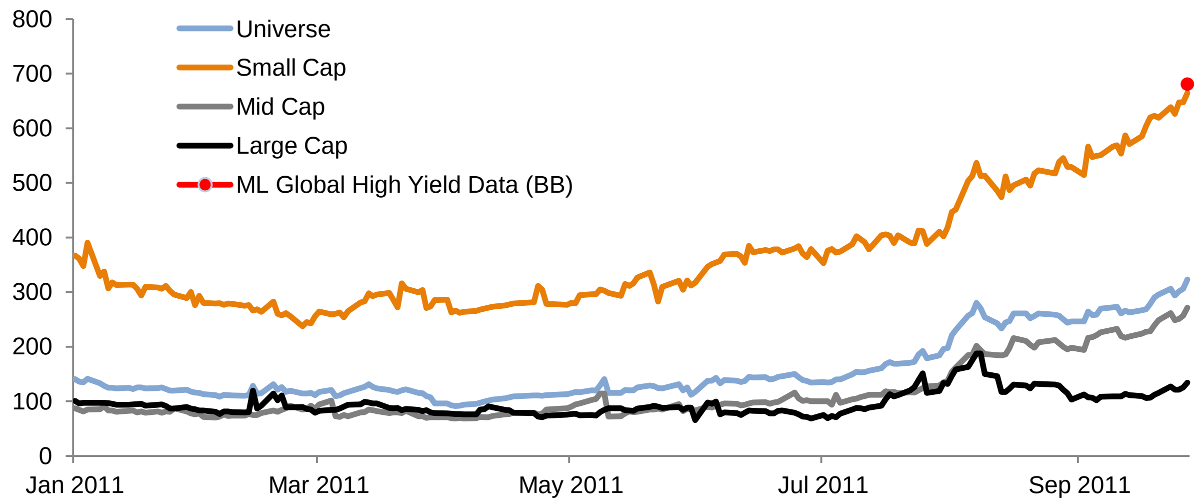
The improvement in convertible valuations can be considered to provide investors with an attractive entry point into the asset class. We have continued to see demand from non-traditional convertible investors seeking higher yielding securities, and believe this trend is likely to strengthen with an increase in the quantity of convertibles now trading below par value.

Another measure of the attractiveness of the asset class is the option adjusted spread (OAS), which captures the spread above the swap rate after removing the embedded equity optionality. An expansion in the OAS has been noticeable over the past few months, and has been particularly evident within the small cap and speculative grade space. The OAS on small-cap securities is now broadly equivalent to the OAS on BB-rated corporate bonds as represented by the Merrill Lynch Global High Yield Index. We estimate that the average rating of small-cap convertibles in broadly in line with this, suggesting that convertibles offer investors cheap optionality.

The attraction of convertibles in uncertain times

Equity markets remain highly volatile, as a result of weak macroeconomic data in most major developed economies and concerns over the potential resolution to the eurozone sovereign debt crisis. However, equities are also prone to strong rallies on the back of any improvement in news flow or macroeconomic data. In this environment of market uncertainty, we believe convertibles are an attractive asset class due to their combination of upside participation and downside bond characteristics.

Exhibit 4 – **Option adjusted spread by issuer capitalisation, basis points**

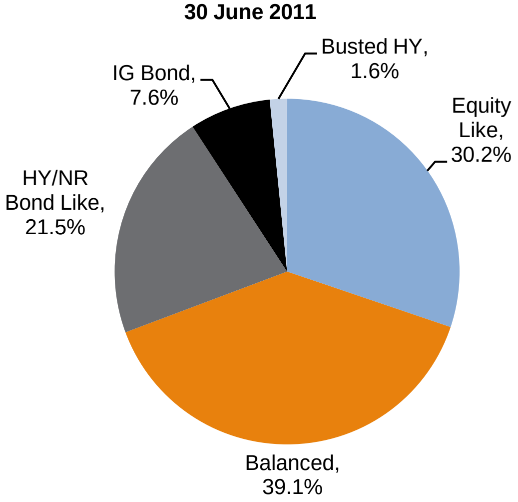


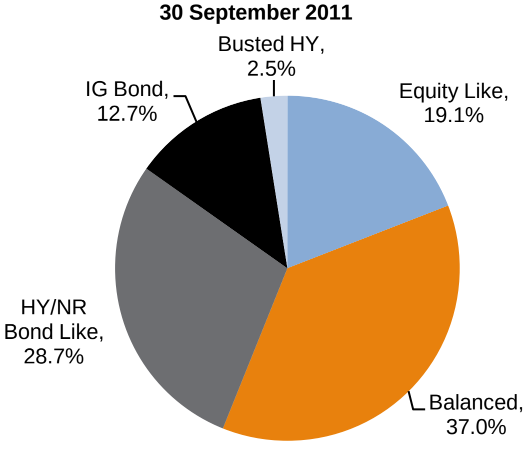
Source: J.P. Morgan Asset Management. Data as at 30 September 2011.

The recent market volatility on equity markets has led to an expansion in the premium afforded to many convertibles, which has brought about a change in the composition of the convertibles universe away from equity-like convertibles. As equity markets have declined, convertibles have lost some of their equity sensitivity and thereby provided investors with a higher degree of protection against further declines.

However, we remain cautiously optimistic on equities. In particular, we believe that the recent round of easing measures announced by several central banks should provide support to share prices. Consequently, we would look for opportunities to increase risk levels on any further declines in equity markets, as convertibles would pick up delta quite quickly should markets rally.

Exhibit 5 – **Changing composition of actively traded vanilla convertibles universe**[8]

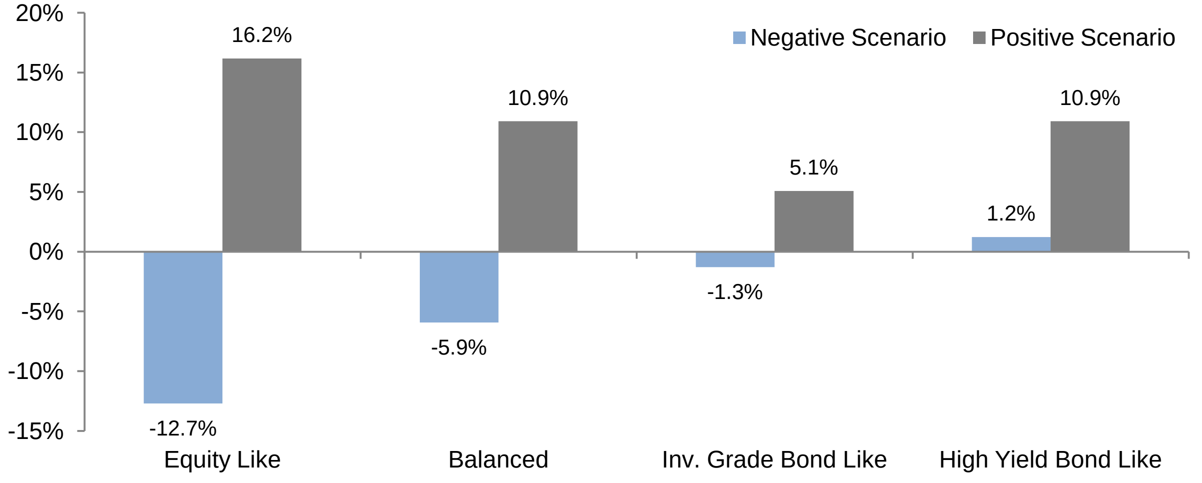




Source: J.P. Morgan Asset Management. Data as at 30 September 2011.

[8]Definitions: Equity-like = convertibles with premium < 15%; Balanced = convertibles with a premium < 100% and an annualised premium < 20%; Bond-Like = convertibles with a premium > 100% or annualised premium > 20%; Busted HY = convertibles trading at a price < 50% of par.

Exhibit 6 – **Simulated calibrated universe returns over one year**[9]



Source: J.P. Morgan Asset Management. Data as at 30 September 2011.

Balanced securities offer best risk/reward trade off in the current environment

In light of our market outlook, we favour the balanced securities over the extremes of the highly equity sensitive or out-of-the-money securities. The primary reason for this is that these balanced convertibles will provide investors with an asymmetric trade-off between participation in any equity upside and protection on the downside via the bond floor. We would advocate complementing these positions with some high-yielding bond-like names, which are currently trading at very attractive valuations. The yield component on these bond-like names can be considered to compensate for the lack of participation on the upside.

In contrast, we consider the most equity sensitive names to be too vulnerable to further declines in market sentiment and lacking in the desired return asymmetry, while the conservative investment grade bond-like securities are now so far out of the money as to miss out on any meaningful participation during a subsequent recovery.

Returning to our calibrated convertibles universe, we have simulated the likely performance of these profile types under two different scenarios for the global economy. In the 'Positive Scenario', we speculate that equity markets could rise by 20% alongside a tightening in credit spreads of 15%, whereas the opposite is hypothesised in our 'Negative Scenario': a decline of 20% in equity markets combined with a 15% widening in credit spreads.

As can be seen, balanced securities provide an attractive trade off between participation in both the 'Positive Scenario' and the 'Negative Scenario'. This analysis supports our view that a combination of balanced and high-yielding securities could provide investors with an attractive degree of asymmetry in the current climate. These simulated returns should be considered as indicative only, and do not include any factors other than those discussed (eg rising default rates, changes in interest rates).

One point to note is that, while the Balanced and High Yield Bond Like profiles are simulated to return an equivalent amount over the one-year horizon under a 'Positive Scenario', the drivers of these returns are very different. Of the 10.9% simulated return for both categories, 5.5% of the High Yield return is driven by income and yield, whilst only 1.6% of the balanced return is derived from this source. The remaining 9.3% of the balanced return is explained by the instantaneous impact of the improvement in equity and credit markets. For this reason, we feel that the balanced bonds would be better positioned to benefit from a sharp recovery in risk appetite, and so warrant a greater allocation within convertible portfolios.

[9]The return over a one year horizon is calculated using the simulated returns for an instantaneous change in credit and equity markets, which is then adjusted to reflect the impact of coupon income, accretion to par value, and the time decay of the optionality.

We believe that the Equity Like and Investment Grade Bond Like securities represent sub-optimal investments at this stage of the cycle. The Equity Like names lack the downside protection that we think is desirable given the current market uncertainty, while the Investment Grade Bond Like names are sufficiently out of the money to preclude significant upside in a positive scenario[10].

In this climate of market uncertainty and heightened volatility, we believe that convertibles are an attractive asset class for investors. This is primarily a consequence of the asymmetry of the return profile, which we consider makes a compelling investment case for the asset class, especially when taken into consideration alongside current valuations.

Antony Vallee, *managing director*, is a senior portfolio manager in the Global Multi-Asset Group ("GMAG"), based in London, with primary responsibility for convertible bond portfolios. He is a member of the Global Strategy Team, responsible for deciding asset allocation for the GMAG's balanced portfolios. An employee since 2006, Antony previously was head of convertible arbitrage and equity linked strategies at SYSTEIA Capital Management, responsible for investment strategy including gamma trading, convertible as well as credit arbitrage, and directional investments. Prior to this, Antony worked as a fixed income and convertible bond asset manager at HSBC Asset Management. Antony obtained an MSc in Finance from the HEC School of Management at the University of Montreal, and graduate and post-graduate degrees in Applied Mathematics and Economics from the University of Lyon and is a CFA charterholder.

Robin Dunmall, *associate,* is an analyst in the Global Multi-Asset Group, based in London, focusing on convertible bond portfolios. An employee since 2008, Robin joined the firm as a graduate trainee having obtained a BA (Hons) in Economics from the University of Cambridge.

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[10]Given a sufficiently flexible opportunity set, we would consider straight bonds a more attractive investment than Investment Grade Bond Like convertibles, since the latter requires paying for optionality that has a very low probability of conversion.

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