# CONVERTIBLE BONDS

ISSUE 4

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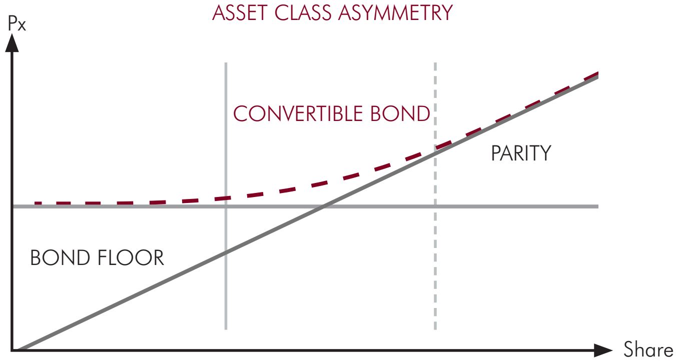
## AN INTRODUCTION TO THE ASSET CLASS

Currently the share and bond markets are approaching all-time highs. In view of low interest rates, bond investors in particular are faced with the problem of achieving appropriately risk-adjusted yields. Convertible bonds are therefore well positioned due to their asymmetrical structure.

### SHARES WITH STABILISERS

Convertible bonds combine key features of shares and bonds. Basically, a convertible bond is a bond with a fixed repayment sum and defined term.
In addition it offers the holder the possibility of participating in a rise in the price of the issuing company's shares. Moreover, during the term the holder can convert the bond into a number of shares specified in advance in the prospectus. Due to the option embedded in the convertible bond, the price behaviour profile is therefore asymmetrical, as illustrated by the diagram opposite. This profile is comparable with a combination of holding a bond and a call option.

ASSET CLASS ASYMMETRY

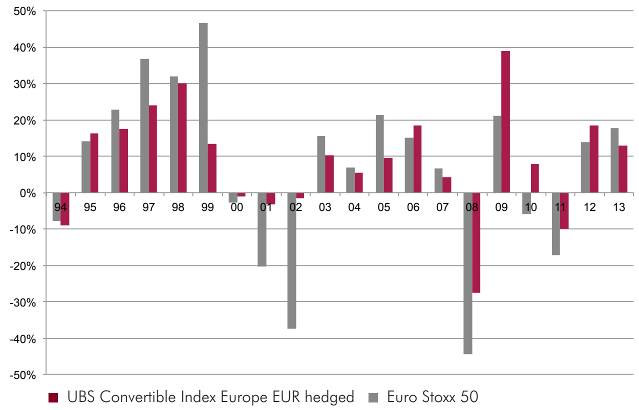



Source: CONVERTINVEST

## SHARE MARKET AS KEY DRIVER

The convertible bond asset class exhibits the best absolute performance in good years for shares, but also shows its strengths in negative years. In bull phases convertible bonds increasingly reflect a rise in their share sensitivity (=% delta); the share price movement (change in what is known as "parity") is the key driver here. If, on the other hand, the underlying share's price falls, the risk of a fall in the convertible bond's price is above all determined by the issuing company's creditworthiness. The bond floor reflects the bond aspect of the convertible bond without option and limits the risk. The resulting convexity leads to attractive long-term performance. Since 1994, for example, European convertible bonds' participation in rising stock markets has been 79%, but just 45% in falling markets.

STOCK MARKET PARTICIPATION

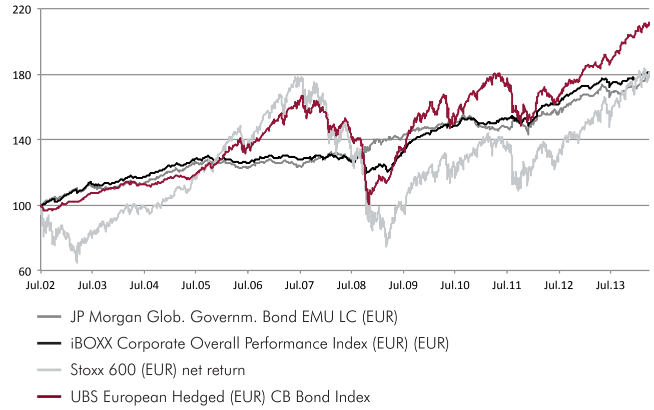



Source: UBS, Bloomberg

## CONVERTIBLE BONDS COMPARED TO OTHER INVESTMENT CLASSES

Convertible bonds are in demand for their hybrid nature, especially in the current environment. Whilst the opportunities for yields from classic corporate or government bonds are slight in low interest conditions, convertible bonds can profit from rising stock markets. Unlike direct investments in shares they are much less volatile. If interest rates do not significantly rise in the foreseeable future, bond investors will either have to revise their yield expectations significantly downwards, accepting heavy cuts in rating quality. In this respect the inclusion of convertible bonds in a bond portfolio may provide an additional source of returns. The following diagram shows convertible bond performance compared to other asset classes. What is striking is much smaller setbacks compared to shares in particular, with a more positive, long-term performance.

LONG-TERM OUTPERFORMANCE BY CONVERTIBLE BONDS



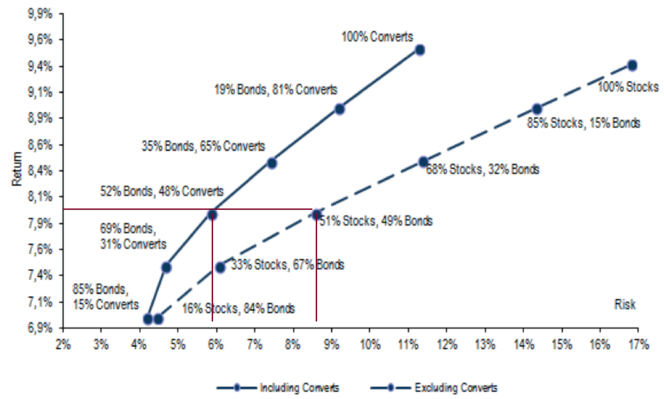

Source: TIPAS/CONVERTINVEST

The good performance compared to other asset classes is also a consequence of idiosyncrasies in the prospectuses. Any intervention by the issuer during the term is advantageous for the investor. Dividend and takeover protection clauses, which have become fixed components of issue prospectuses, are an example of this. These compensate investors for higher dividend payments to shareholders, or for the loss of the residual term in the event of a takeover. The latter is very important in view of increasing M&A activities. The consequence of favourable prospectus conditions is that convertible bonds' performance cannot be replicated by the combination of shares and bonds.

## CONVERTIBLE BONDS IN ASSET ALLOCATION

Convertible bonds are also suitable for inclusion in mixed strategies. Including convertible binds demonstrably reduces the portfolio volatility, without cutting the opportunities for yields, or conversely increasing the yields whilst the portfolio risk remains the same. Diversification has this effect on portfolios in various risk classes, as shown by the diagram below. For example the risk, expressed as volatility, in a mixed share and bond portfolio (51%/49%) can be reduced by approximately three percentage points by the alternative combination of bonds and convertible bonds (52%/48%). Expected yields remain the same.

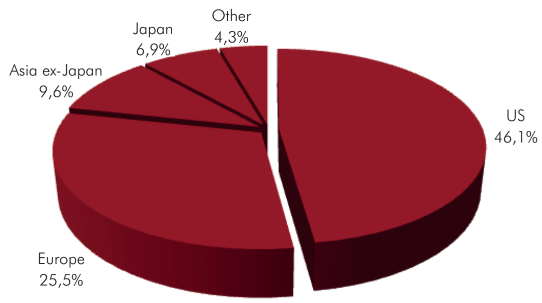
EFFICIENT FRONTIER




Source: Merrill Lynch, April 2014

## THE CONVERTIBLE BOND UNIVERSE

Convertible bonds have existed as an investment class since the 19th century. Today the market is globally diversified across all regions and sectors. The global convertible bond universe currently consists of almost 1,000 securities, with a total volume of approximately EUR 341 billion.
The majority of issuers, approximately 64%, are from the USA, followed by Europe with 22% and Asia, including Japan, with approximately 14%. Due to their complexity convertible bonds are almost exclusively handled by specialist, active asset managers.




Source: BofA Merrill Lynch Convertibles Research, February 2015

## CONVERTIBLE BONDS FROM THE ISSUER'S VIEWPOINT

Convertible bonds also offer the issuing companies a range of advantages. Because of the embedded option, the coupon that the issuer has to pay is much lower than for a classic corporate bond. Furthermore the company also has the option of making the company's creditors owners in the even of positive business, and therefore share performance, resulting in a reduction in the interest burden and debt capital. The capital call which has been postponed furthermore acts as a much more moderate signal to the markets than an immediate call for capital. This is why, from the issuing companies' point of view, convertible bonds are used to optimise the balance sheet structure and to finance future growth.

## GLOSSARY

| | |
|---|---|
| Asymmetry | Asymmetry If the price of the share to which the conversion right is attached rises, the convertible bond's owner benefits. If, on the other hand, the share price falls, the investor receives the yield on the bond only. As the price of the convertible bond rises more than it falls, depending on performance by the underlying share, this is called an asymmetrical chance-to-risk profile. |
| Bond floor | The bond floor is the convertible bond's value without the option components. |
| Delta | Delta is the term for the sensitivity of the convertible bond's share. A delta of 50% means, for example that a convertible bond moves by 5% if the underlying share changes by 10%. |
| Parity | Parity describes the underlying share's market value, expressed as a percentage of the convertible bond's value. |
| Premium | Convertible bonds are issued with an option to convert into shares at a price which is higher than at the time of issue. The difference is called a premium. If the share price rises over the term, the premium falls and the option increases in value. |
| Volatility | Volatility measures the range of fluctuation in an underlying security compared to the long-term trend (in %). The greater the fluctuation, the higher the volatility and thus the risk. |

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