

CONVERTIBLES REV UP

These hybrid instruments could provide a much smoother ride in the spring if markets recover

In northern climates, where winters are hard and long, convertibles are relegated to the garage for a good part of the year—at least until restless owners begin kicking the tires at the first sign of the spring thaw. The same may be true of another type of convertible this year: convertible bonds. The capital markets are preparing to dig out.

Convertible bonds have suffered along with the overall market, but they also have been affected by some very specific forces over the past several quarters.

Convertibles are hybrid instruments that are often issued by companies that are credit-challenged in some way. In exchange for the ability to convert the bond into stock, the holder of the bond accepts a lower coupon rate. So the company issuing the convertible bond saves on interest expense (compared to issuing a traditional bond) and the holder hopes to benefit from a potentially profitable equity conversion. (The equity-conversion features are unique to each bond issue.)

To be sure, plummeting equity prices have reduced the likelihood of converting bonds into equities, leaving convertibles more, rather than less, bond-like. In addition, the past year has seen a reduction in both leverage and risk appetite across global markets that has affected many, if not most, asset classes.

The impact, along with structural changes such as global short-sale restrictions and increased margin costs, has been magnified for convertible bonds in part because hedge funds have been a major participant—and a major source of liquidity—within the convertible market.

Many hedge funds short the underlying common stock associated with a convertible

bond as part of an arbitrage strategy, and cheap borrowing is often the lever that enables a profitable trade. However, hedge funds backed away from the convertible market as the expense of hedging equity exposures grew. That was due to the scarcity of available leverage and increased market volatility.

Moreover, roughly half the capital raised within the convertible bond market in 2008 was in the financial sector. As the credit crisis worsened, hedge funds were confronted with the inability to short the stocks of financial institutions. Unfortunately, neither financial sector issuance nor convertible bonds held up well in a market flocking to high quality bonds.

Why, then, might investors expect a smoother ride from convertibles in the spring? Valuations and yields may point toward an attractive risk/reward opportunity for patient investors. A return to a more conventional market with more liquidity should herald an opportune time to consider a hybrid asset that carries an equity option along with contractual interest payments.

Also, capital flight from hedge funds will staunch at some point to be replaced, perhaps, by long-only funds seeking a measured pace back into the equity markets. Market turnarounds have on occasion been marked by an abrupt reversal in risk preference where, as in 2003, lower quality and less liquid assets led the charge.

Current market valuations make a repeat of such a scenario plausible, but a more probable path is a gradual reengagement with risk. Assuming inflation stays in check and credit spreads do not skid out of control, a portfolio of well-selected convertibles could provide a very nice spring welcome. ■



* *Plummeting equity prices have reduced the likelihood of converting bonds into equities.*

* *Valuations and yields may create an attractive risk/reward scenario for investors.*

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