Convertibles For The Adventurous

The difference between investing in 2008 and rearranging the deck chairs on the *R.M.S. Titanic* is the chairs actually performed as expected. And let's face it, even for those of us who were cautious and who love to dig back into market history, who really believed they would be overlaying charts of the present market on top of 1929-1932?

In the eventuality humanity will make prove the late Jim Morrison wrong and get out of here alive, perhaps now is the time to quit fiddling with the deck chairs, find a lifeboat and start planning what to do with the rest of your financial life.

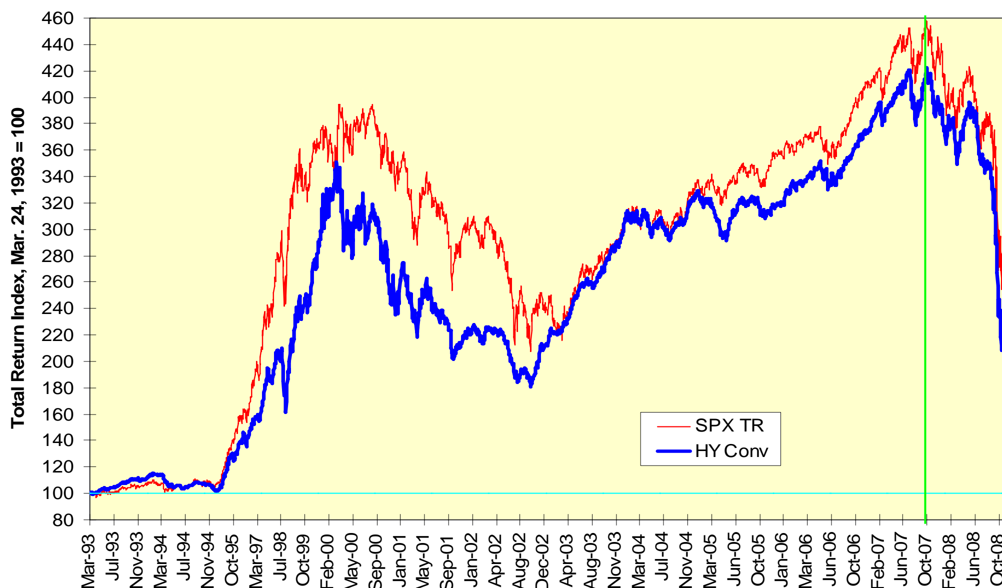
Some have suggested corporate bonds as the first step out of the hole, and there is much to be said for this as a choice. The Merrill Lynch index of A-rated corporates is yielding 8.8%, a rate not far from the historic long-term returns on equities. The yield on their high-yield index is a stunning 22%, implying you could have default rates near 50% and still come out near historic equity returns. For purposes of comparison, the yields on Moody's Baa bonds peaked at 11% in May-June 1932, a time when unemployment was nearly 25%.

Returning To Convertibles

I last took up the issue of convertible bonds in the context of market volatility at the end of July 2007, a period which then seemed pretty scary but might qualify for "good old days" now. I concluded high-yield convertibles were just as good as the S&P 500 once the market bottomed. True; I neglected, however, to ponder just how badly these bonds would perform in a flight from all risk.

The results have not been pretty for high-yield convertibles, not that investment-grade convertibles have done very well, either. While the total return on the S&P 500 since October 12, 2007 has been -47.5%, high-yield and investment-grade convertible bonds have lost 54.7% and 36.1%, respectively. The downturn in high-yield convertibles matched that of stocks going back into 2007.

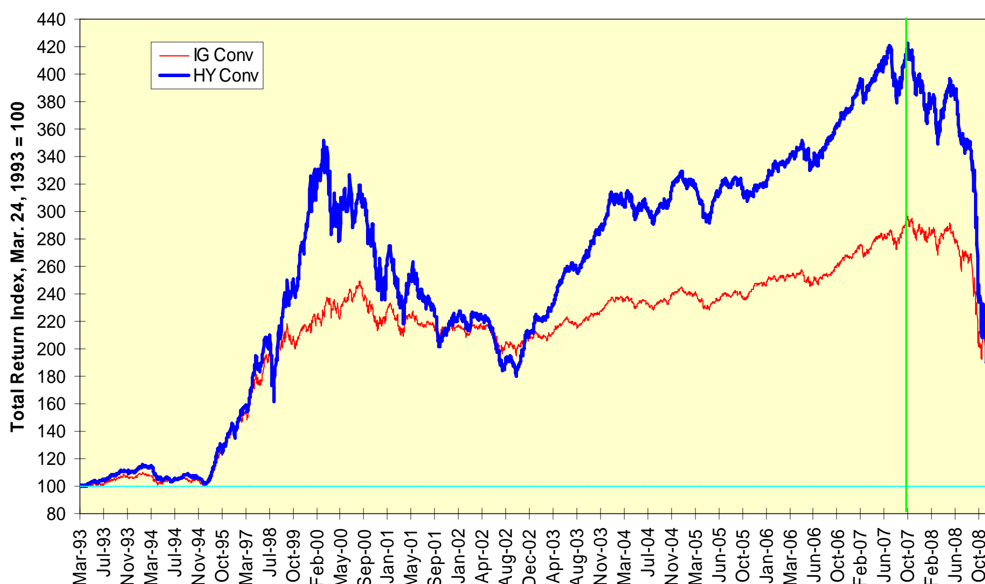
High-Yield Convertibles Underperformed Stocks After Market's Peak



Investment-grade convertibles held their own until the de facto nationalization of Fannie Mae and Freddie Mac this past September. It seems the high-handed expropriation of preferred shareholders in the mortgage giants led to forced selling of investment-grade convertibles. Who knows; perhaps bondholders wondered if their covenants and other supposed legal protections actually meant anything anymore?

A second factor figured prominently into the sharp downturn in convertibles, and that was the ban on short-selling. A whole class of hedge funds is devoted to convertible arbitrage, a trade involving the purchase of the convertible and the sale of the common stock as a hedge. Just as the short-sale ban clobbered market-neutral, long-short and 130-30 hedge funds, not to mention option market makers and a large segment of the ETF industry, it clobbered the convertible arbitrage industry. The Credit Suisse/Tremont convertible arbitrage index declined 12.2% in September

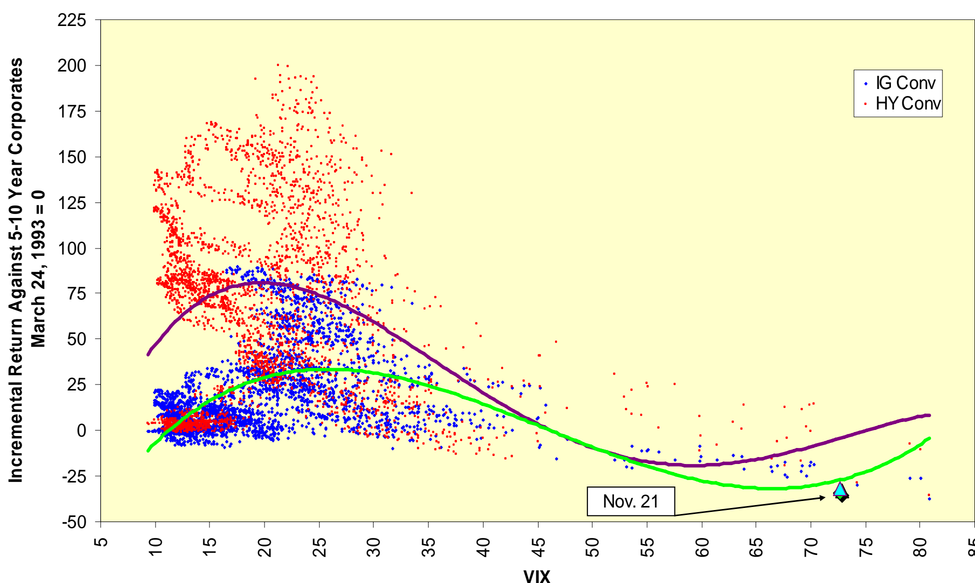
and another 12.6% in October. The data for November cannot be much better given the redemption pressures on the hedge fund industry in general.



Volatility And Busted Issues

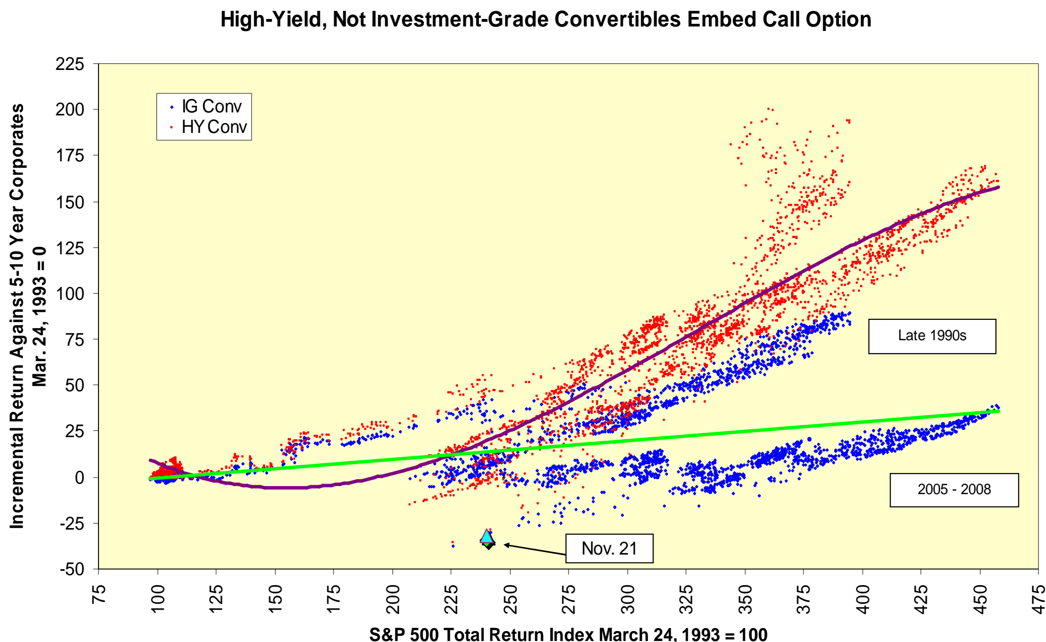
A convertible bond can be viewed as a bond plus a forward-starting call option on the underlying stock. In normal times and in normal market conditions, higher volatility increases the value of the embedded call option and supports the convertible, all else held equal. However, when the stock's price falls so far below the conversion price that conversion seems unlikely, the bond is said to be "busted," a serious condition for weaker borrowers who hoped to close their interest-due obligations once the bond converted into stock.

This is why the incremental total return for both high-yield and investment-grade convertibles relative to 5-10 year corporate bonds is near 15-year lows despite stock volatility as measured by the VIX is near its all-time high. The embedded call options are now so far out of the money that higher volatility is irrelevant.



However, time may be on your side if you wade into the pool of busted and high-yield convertibles. Let's assume for the sake of argument much of the violent selling of the past three months has been forced liquidation by those with short-term time horizons such as hedge funds facing redemptions. If you buy a diversified pool of high-yield convertibles, you will get paid to wait; the gamble is defaults do not rise to the point where higher yields are offset.

If the world does not end anytime soon, a development sufficient to derail any investment plan, any recovery in stock prices will accrue more to high-yield than to investment-grade convertibles. The incremental return of high-yield convertibles to 5-10 year corporate bonds, the red markers below, describe a call option on the S&P 500 far more than the incremental return on investment-grade convertibles, the blue markers below, does. Investment-grade convertibles' profile in the late 1990s described the embedded call; they have not done so from 2005 onwards.



If the name of the game is buy low and sell high, this is an asset class that has taken a virtual perfect storm of bad news in recent months: Collapsing stock prices, busted issues, deteriorating credit quality, hedge fund redemptions and general mass flight from risk. An allocation of 5-10% of your portfolio, preferably in a tax-deferred account, seems reasonable at this juncture.