Convertible Divergences, Return Convergences

Options on futures are a relatively new development – mid-1980s – and to say they were viewed skeptically by the old-timers then would be an understatement. I can still recall a wizened grain broker saying to a customer, "That's all you can lose," followed immediately and under his breath by, "And I'll guarantee you'll lose it." Yes, there are old traders and there are bold traders, but there are no old, bold traders.

There are some in the stock-and-bond world who take the same jaundiced view of convertible bonds, those hybrid securities that pay a coupon like a bond and then can be converted into the common stock under certain conditions of price and maturity. A garden variety convertible can be decomposed into a standard corporate bond plus a call option on the underlying stock. The decomposition can be extended further by breaking the corporate bond into a risk-free bond plus a credit default swap, as addressed here in March, but let's stick to one complex topic at a time.

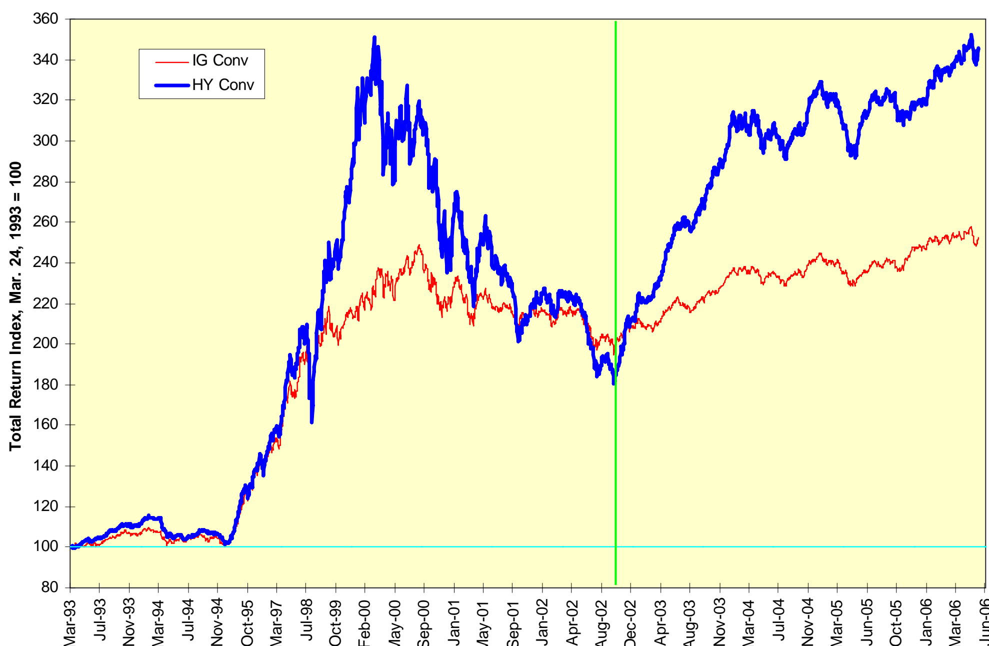
Why the cocked-eyebrow? Convertibles implicitly promise the best of both worlds, the greater downside protection of a corporate bond plus the upside potential of a stock. But there are times, generally when long-term interest rates are rising or when credit spreads are widening or when stocks are plunging when convertibles perform dreadfully.

But convertible bonds are rich in information about the returns amongst competing asset classes, a topic now sufficiently obvious it has been picked up by the popular business press. Before we see the Magazine Cover of Death proclaiming all assets are really the same, let's see what convertibles are telling us.

The Yield Sign

The performance measurement and benchmarking industry has been thoughtful enough to split the world of convertible bonds into high-yield (HY) and investment-grade (IG) issues. The HY bonds are issued by companies willing to pay both a higher coupon yield and give their investors a claim on equity if they are successful. These are very equity-like instruments indeed, and the total return path for them differs markedly from that of the IG bonds. Note how their performance surged during the late 1990s bull market, cratered during the 2000-2002 period and then rebounded smartly after October 2002.

High-Yield Convertibles Outperformed After Bear Market Ended

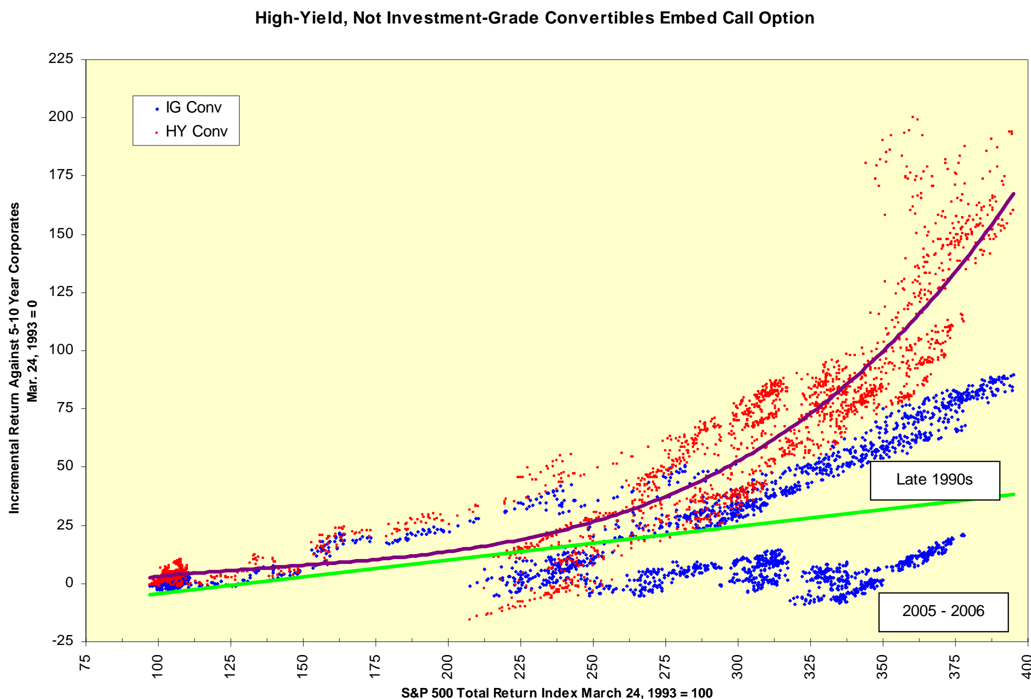


The Embedded Call

We can see the greater equity-like character of the HY bonds in another way. Stocks can be viewed as the combination of a call option on further price appreciation plus a dividend payment plus a corpus representing the recoverable assets on the books, voting rights and other folderol. If we map the incremental return of both the HY and IG indices versus an index of 5-10 year corporate bonds against the total return of the S&P 500, we can see a rather distinct call option profile emerge for the HY index. IG convertibles outperformed corporate bonds during

strong stock markets, but in a much more linear manner. More tellingly, the rate of the IG bonds' outperformance relative to corporate bonds was far greater during the late 1990s bull market than it has been in 2005-2006. IG convertibles were not the best of all possible worlds over the last two years; far from it.

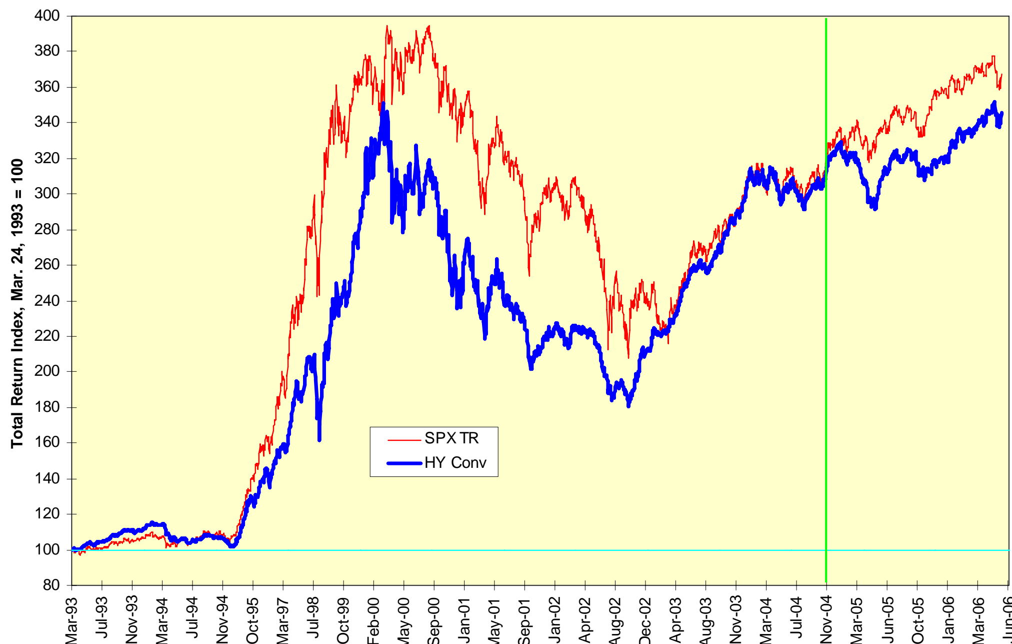
High-Yield, Not Investment-Grade Convertibles Embed Call Option



Liquidity

The HY bonds' performance trailed the total return of the S&P 500 during the bull market and led it downward during the bear market. The combination of deteriorating credit quality and plunging stock prices was poisonous to this asset class during that period; this is why many investors disdain convertibles.

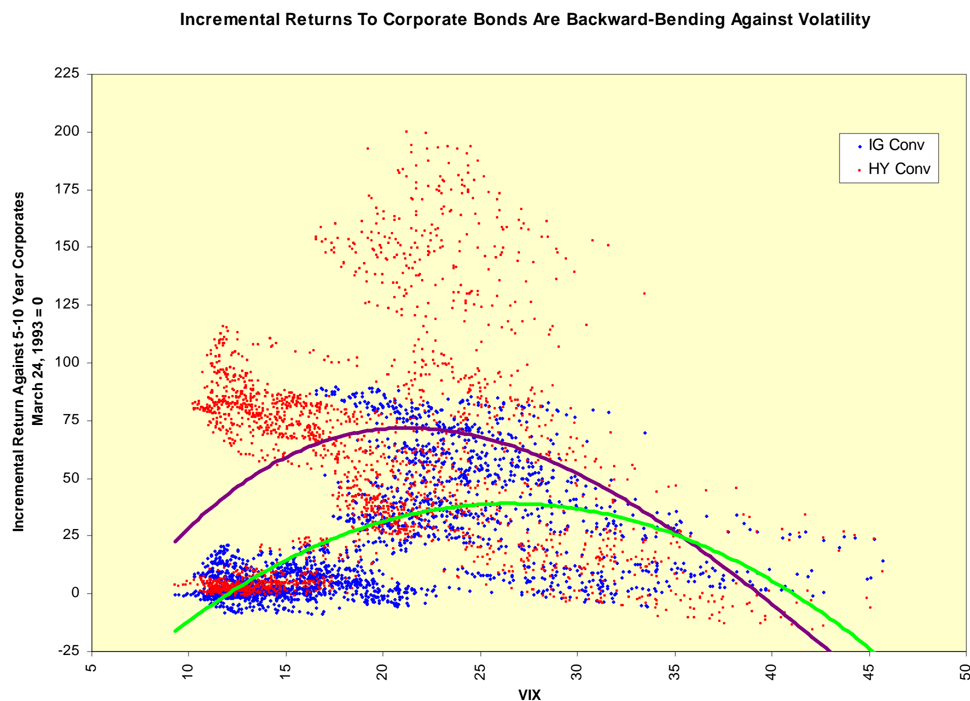
Will High-Yield Convertibles Lead Next Downturn?



Once the Federal Reserve's current course of action became apparent in late 2004 – remember some of the chatter at the time they were going to "pause" at a 2% federal funds rate to assess the situation? – the HY bonds started to underperform stocks. This suggests the HY bonds have suffered from either higher interest rates, lower financial

liquidity or both. It also raises the question whether a downturn in HY bonds will lead the next downturn in stocks, as was the case in 2000.

What About Volatility?
All else held equal, the value of any long call option should rise during a period of higher volatility. The VIX moved higher in recent weeks, so shouldn't this redound to convertibles' advantage? Yes and no: All else is never held equal. The incremental return on convertible bonds versus corporate bonds has a backward-bending relationship to the VIX. As volatility rises, HY bonds see their maximum advantage between 20 and 25 on the VIX while IG bonds see their maximum advantage between 25 and 30 on the VIX. Higher VIX readings than this are associated with sharp stock market downturns, which offset in price (delta) the advantage obtained from volatility (vega).



Closing The Loop
It was telling indeed how the performance of certain HY convertible closed-end funds, such as the Calamos Convertible & High Income fund jumped after Friday's employment report. This asset class appears to be a sensitive barometer of whether the Federal Reserve and other central banks are going to go too far in draining financial liquidity. Their high-risk and option-dependent return profile makes them an outstanding miner's canary for monetary policy.