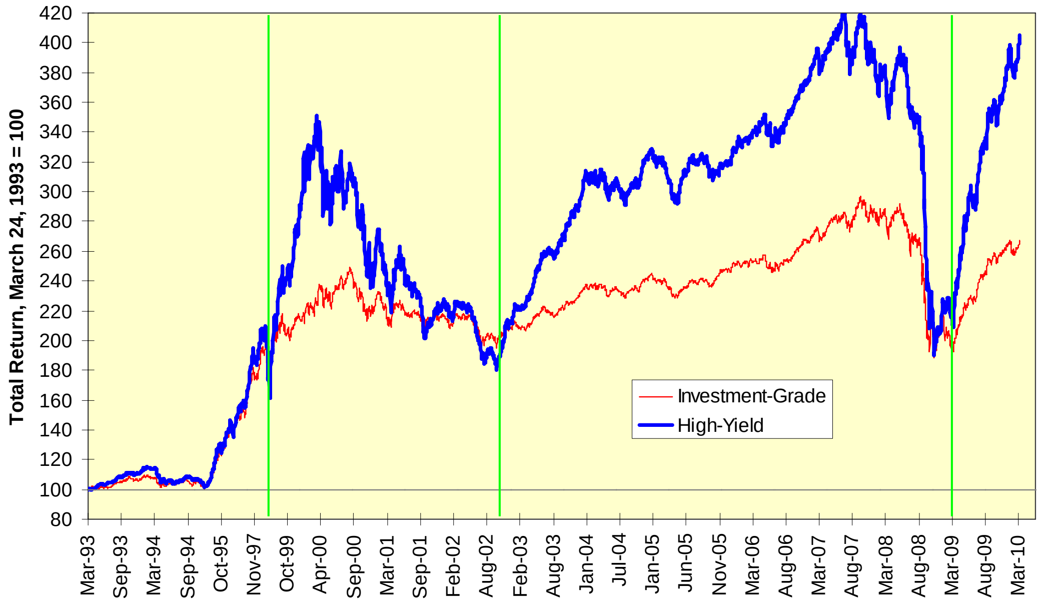
Convertible Bonds In The Bull Market

If the dividing line between growth and value, our subject **the other day**, is hard to define, the dividing line between a bull and a bear market is not. While people can and do get fancy in this regard, you really cannot go wrong with calling a series of higher highs and higher lows a bull market and a series of lower highs and lower lows a bear market.

Has anyone ever expanded the definition of a bull market in equities to include periods when high-yield convertibles outperform their investment-grade cousins? If not, perhaps we should start doing so: In each of the three bullish phases since the data became available, the total return on high-yield U.S. convertibles (yes, of course we excluded Rule 144 and mandatory convertibles; this is all that separates us from the beasts on most days) surged well ahead of a comparable index for investment-grade convertibles.

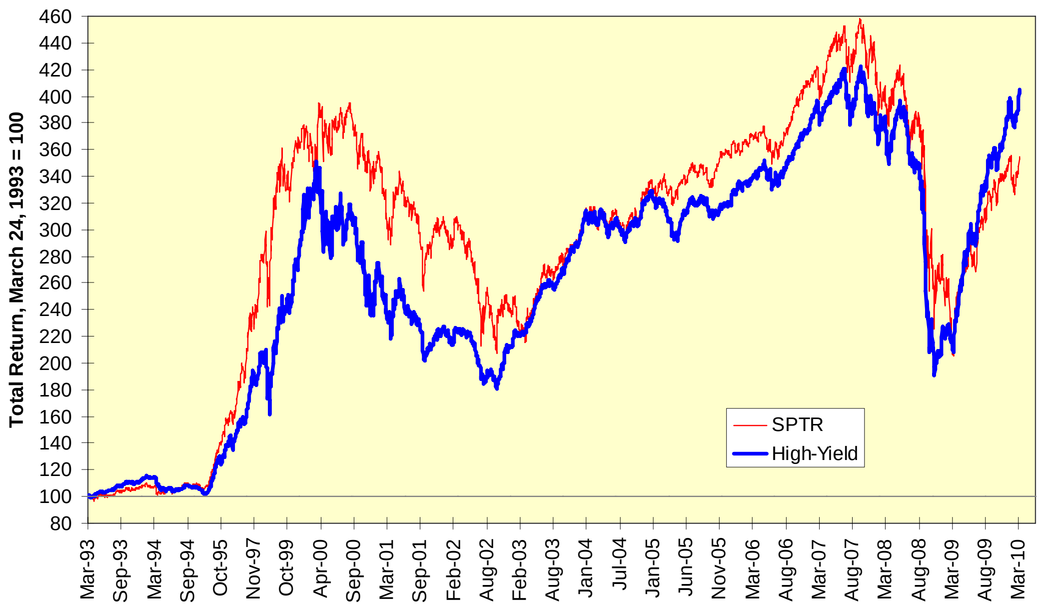
Investment-Grade Convertibles Underperformed In Bull Markets



The reasons why this is can be traced back to the very nature of a convertible bond. Think of them as a regular corporate bond with a call option. Those call options are well out-of-the-money or "busted" in convertible parlance at the end of a bear market. As the market rises, the call becomes increasing valuable and expands along the familiar S-shaped delta curve until the convertible eventually starts acting more like the stock than the bond. The lower the quality of the convertible to start, the more room it has to ride along this delta curve.

Even more interesting, though, is the relative performance of high-yield convertibles relative to the total return of the S&P 500 itself. The convertibles underperformed significantly during the tech bubble of the late 1990s, underperformed less significantly during the 2005-2007 period, but have been outperforming stocks during the current bull market.

High-Yield Convertibles Outpacing S&P 500



If you need more evidence the present bull market is more an artifact of financial liquidity looking for a home than of underlying economic and earnings growth, just let me know. While a call option is more leveraged than a stock, the owner of that call starts out in the hole by the amount of the premium paid. Once the call becomes increasingly in-the-money, the stock should regain its performance advantage.

Volatility

Higher volatility should lead to relative outperformance by the convertibles by virtue of their optionality. While the maps are not shown in the interests of space, the present readings for the relative performance of both high-yield and investment-grade convertibles differ vis-à-vis the VIX. The high-yield bonds' relative performance is "over trend" whilst the investment-grade bonds' performance is "under trend" or cheap.

This particular state of affairs is not sustainable. If the bull market continues, we should expect the high-flying high-yield convertibles to regress toward normal performance relative to both the stocks and to the VIX. If credit spreads have been contracting as a function of low interest rates and money flowing heavily into corporate bonds that trade has a logical end once the spreads compress…unless we really get back to the giddy credit bubble of early 2007. If you are heavily long high-yield convertibles, it is probably time to lighten your position.