High-Yield Convertibles Should Underperform

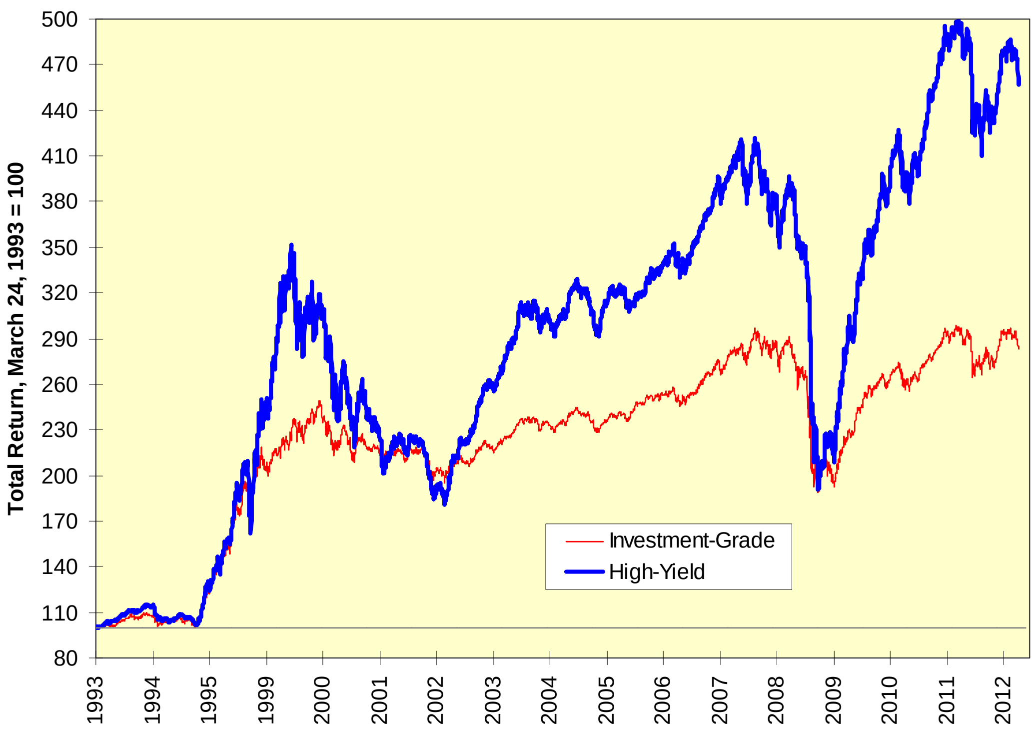
Convertibles' Relative Performance Defines Market State Well

Such is the state of affairs in the world today: Increasingly I find myself advising on some variation of "You might as well go for broke, as you are going to get there anyway." In a world where you have to go out past six years on the Treasury curve to find a whole number on the left side of the decimal point and where our good friends at J.P. Morgan Chase (JPM) demonstrated that when elephants play games with corporate bonds you had best watch where you step, the safest source of cash flow is not some negative real-yield sovereign bond backed with a smile, a shoeshine and a printing press nor an illiquid corporate bond nor an even more illiquid municipal bond but rather a stock backed, perhaps, with real profits.

This is both a variation on the idea money as both a medium of exchange and a store of value need not be the sole province of governments: Private banknotes can circulate and often did during 19th century America. More important, though, is the concept all stocks can be broken into a short put and a long call option. If you detach that embedded call option and slap it onto a corporate bond with the option the bond can convert into a stock, you have what sometimes is the best of both worlds, an instrument with both upside participation and downside protection.

Oddly, even though the real upside kick in any convertible comes when the call option component approaches or exceeds in-the-money status, it is the high-yield convertibles whose total return has a greater interest-rate component, that outperform in bull markets. In fact, a mere glance at the relative total returns of the two classes since 1993 gives you a pretty good indicator of whether we were in a bull market or not. As high-yield's outperformance has been eroding over the past year, the answer is given as "or not."

Relative Convertible Importance



As we seem to be in little danger or entering a rip-roaring bullish move anywhere right now, the prospective relative performance of high-yield convertibles vis-à-vis their investment-grade cousins is tempered. The only thing that could rescue it would be the unlikely combination of higher volatility without a market collapse. Such a combination is not as unlikely as it might seem at first blush: Take a look at the chart above from the late 1990s: As the bull market of the time accelerated, doubters kept pushing the price of options higher in the certainty the market was cruising for a bruising. It was; it just did not happen for years. The best course of action, then, is to stick with investment-grade convertibles if you want to play in this asset class.