

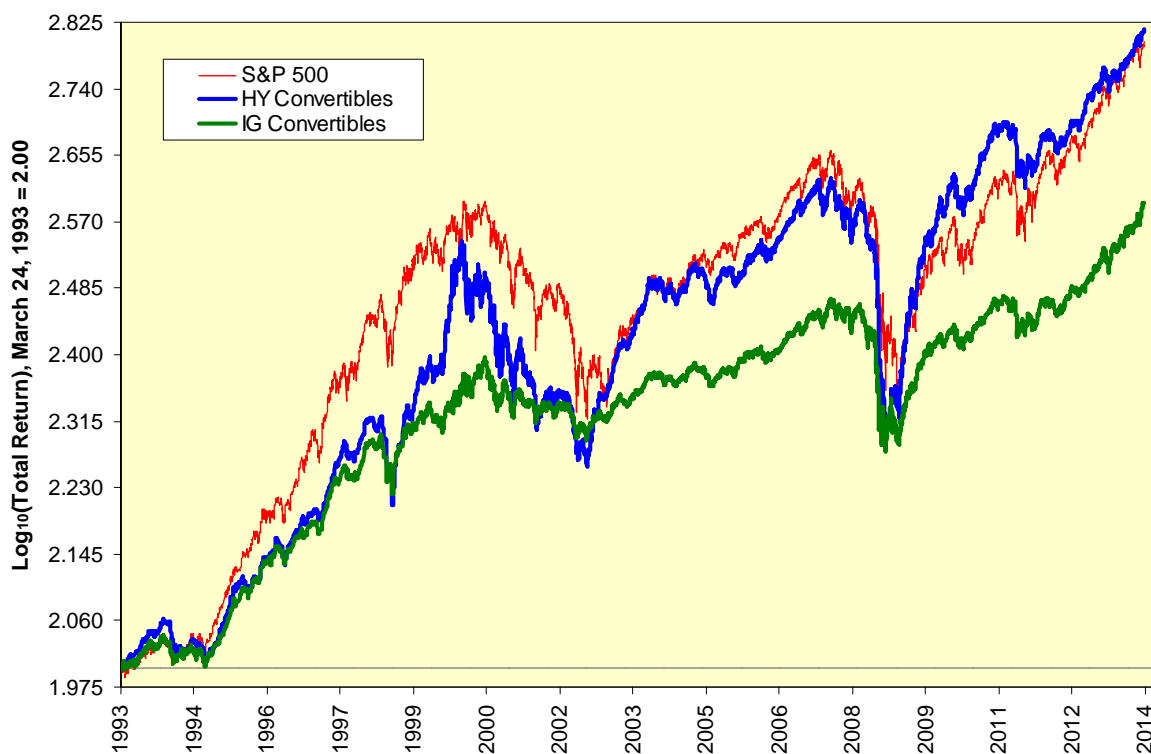
## Convertibles Have Turned Into Equities

Back in the days when Hollywood released more films than were nominated for Best Picture awards, society was struggling still with the “redeeming social value” standard for what was and was not considered obscene. We could apply the notion of redeeming social value to markets as well. Let’s grant the two great bear markets of the past fourteen years redeeming social value status for demonstrating what happens to convertible bonds during downturns and rallies.

As these bonds embed a call option on the equity to which they can convert, their delta or expected movement as a function of the stock price will fall toward zero when the stock price drops; these bonds are said to be “busted.” Conversely, if the stock price moves well over the conversion price, the bond’s embedded call option becomes deep in-the-money and the delta moves toward its limit of 1.00.

This has been especially true for high-yield convertibles, accessible via closed-end funds such as Calamos Convertible & High-Income Fund (CHY). If we map the total returns of the S&P 500 and the Bank of America-Merrill Lynch indices for high-yield and investment-grade convertibles on a common logarithmic scale, we see how high-yield convertibles have outperformed the S&P 500 for the past twenty-one years. More critically, the beta or relative volatility of high-yield convertibles to the S&P 500 during the taper era has been very close to 1.00. The beta of investment-grade convertibles has been 0.923. Both markets’ deltas are approaching 1.00.

### High-Yield Convertibles At Unitary Delta In Taper Era



### A Lamentable Loss Of Optionality

The inside story is the downside of this shared upside is the gamma of convertible bonds is approaching zero. Gamma is the rate at which delta changes as a function of price. Gamma is what gives options leverage on the upside and lower losses, subject to changes in volatility, on the downside. As convertible bonds tend to be issued by firms with weaker balance sheets who hope to one day replace the fixed interest rate coupon of the bond with the variable dividend of the stock, convertibles’ move toward unitary delta and zero gamma mean investors are getting all of the potential downside of the potentially lower-quality associated equities and none of the leveraged upside of the call option.

This is what happens when the sweet smell of bull market success gets left out in the sun too long.