Risk-Aversion Continues For Convertible Bonds

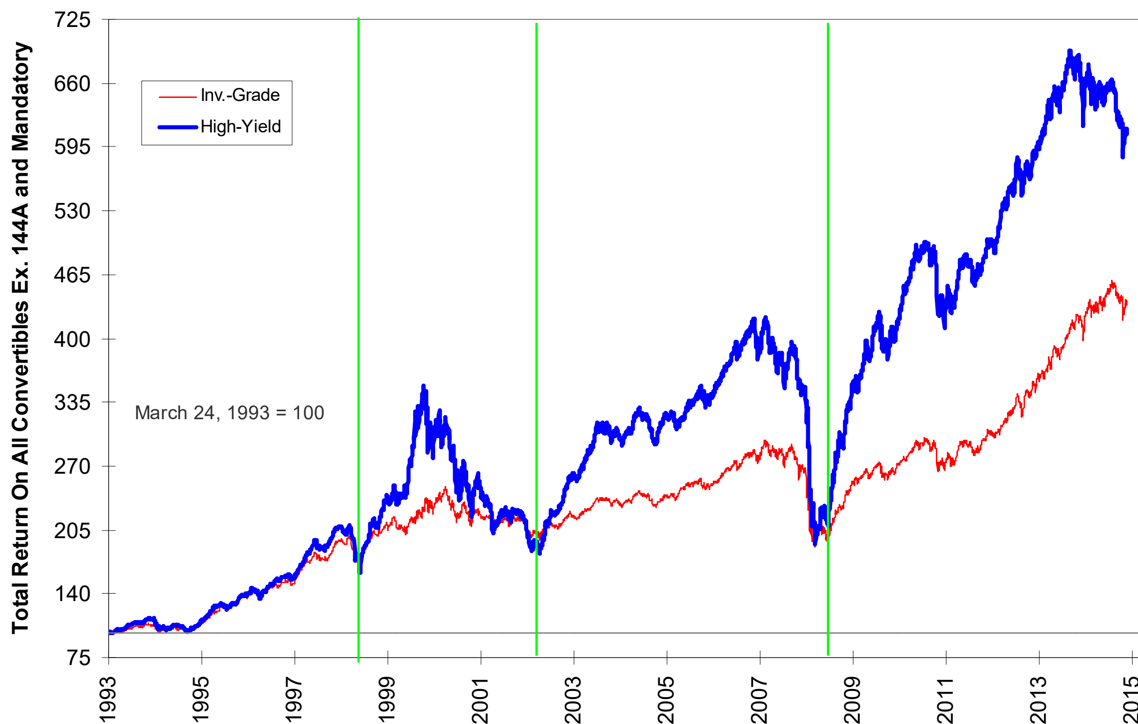
One of the better and better-hidden working definitions of a bull market is when high-yield convertible bonds outperform investment-grade convertible bonds. Investors in high-yield convertible bonds are taking on greater credit risk and most likely are accepting greater implied volatility to buy the out-of-the-money equity call option embedded in the bond. This gives high-yield convertibles a lower call option delta against the stock and therefore a higher gamma. If these bonds outperform it is because risk-seeking investors feel more confident about the underlying stocks.

By this working definition, the bull market in equities started to come undone at the beginning of July 2014, shortly after the bear market in crude oil began. Investment-grade convertibles have outperformed their high-yield counterparts significantly since then, 5.59% to -12.16%.

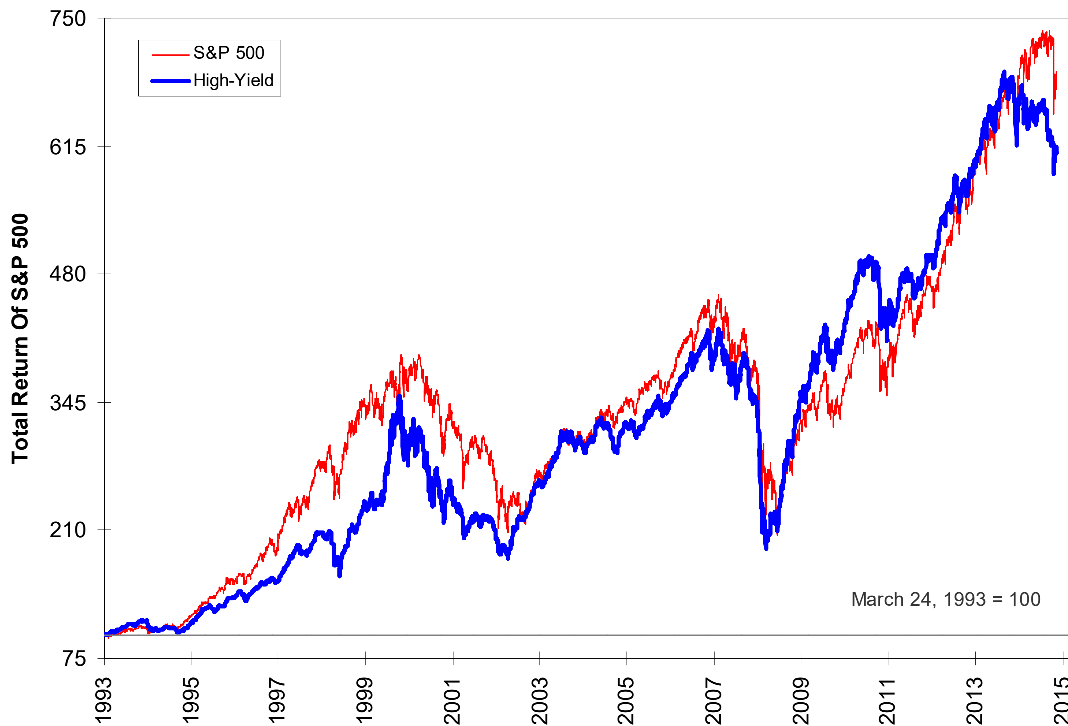
Local maxima in high-yield convertibles' returns in July 1998, March 2000 and October 2007 coincided with the start of equity bear markets. The lows of the subsequent bear markets and the association upturns in high-yield convertible returns are noted with green vertical lines.

The absolute total return for investment-grade convertibles peaked on July 1, 2015. Their 5.58% decline since then indicates investors remain uninterested in the embedded call option. Needless to say, the greater -8.24% loss for high-yield convertibles over the same period indicates avoidance of credit risk in addition to lower risk-seeking behavior. For purposes of comparison, the total return for the S&P 500 has been -4.88% over this period.

In fairness, no one can say an equity bear market started in July 2014, only a bear market in the energy sector. Technically, we are not in a general bear market yet even though the thrashing underway since mid-August certainly feels like we are headed in that direction. The second chart shows very clearly how unusual the decoupling between high-yield convertibles and the S&P 500 since July 2014 has been because of the energy sector's decline. Not even the technology sector's decline in the dotcom bear market produced such an outsized divergence.



High-Yield Convertibles And. Equities
As is always the case in any selloff, lower prices create future opportunity. The greater loss for high-yield convertibles relative to equities since July 2015 has taken the bonds out of their near-unitary delta position and raised their gamma accordingly. The higher volatility that has accompanied the stock market's downturn has contributed to this effect as well. Unless corporate credit deteriorates significantly from here, the greater relative losses for high-yield convertibles should start to abate.



However, no one pays the bills with lower relative losses, only with greater absolute gains. The first chart above is pretty clear: You have to wait for an equity bear market to end and for many of the high-yield convertibles to be "busted," or trading so far out-of-the-money from their conversion strike price that their delta is near zero to begin the trade. Once you do, you can ride it for years.