Sweet Spot Investing with Convertible Bonds

By Jim Buckham CFA, Portfolio Manager

Convertible bonds are sometimes considered the "Swiss Army knife" of financial products because they can provide investors with principal protection (barring default), income, and equity-like returns. The combination of a corporate bond with a call option can provide investors with asymmetrical returns: when stocks rise, the returns are more equity-like; when stocks fall, the returns are more bond-like. A convertible bond's value is the potential to increase returns in a fixed income portfolio and dampen volatility in an equity portfolio. ***The secret to enjoying these benefits is investing in what convertible bond managers refer to as the*** "***sweet spot.***" This means investing in convertible bonds trading close to par that have a balanced profile. Here at Wellesley Asset Management, we look to invest in the sweet spot of convertible bonds to unlock the many benefits this financial instrument can provide to investors.

Options traders use the term "delta" to describe the change in price of an option in relation to the change in price of the underlying security. For example, if a call option in Apple, Inc. is trading on a 50 delta (the delta is the ratio of the change in price of an option to the change in price of the underlying asset) and Apple stock moves favorably by $1.00, then the option's value will increase by $.50. Similarly, the convertible market uses delta to compare changes in stock prices to changes in convertible bond prices. Balanced convertible bonds typically have deltas ranging from 45 to 65 while "in-the-money" convertibles typically have deltas higher than 70. "Out-of-the money" convertibles have deltas below 40. Where convertible bonds are trading on the delta continuum has a big impact on their risk/return profiles.

As a stock moves higher, the company's convertible bond price and delta move higher. The further the convertible bond moves above par value, the lower the yield to maturity and current yield. In other words, the bond is gaining more equity sensitivity and losing its bond characteristics. This bond profile is not without its risks. Consider a bond trading at 115 compared to a bond trading at 180. Knowing that the bond-like protective features are not realized until the convertible trades close to 100, it is easy to see that the bond trading at 180 has more downside equity risk. One could make an analogy to insurance policies where the bond trading at 180 is like a high deductible policy. That is, investor insurance isn't realized until the investor suffers a large loss. In this example, an investor suffers about a 44% loss before getting any "insurance" benefit. However, the premium the investor pays for the insurance is not large (in the case of the convertible bond, this translates to greater equity upside).

A bond trading at 115 is more like a low deductible insurance policy. Here, the investor doesn't have to endure a great loss before they approach par value. In this example, the investor suffers only a 13% loss before getting an "insurance" benefit. However, the insurance policy costs more in the form of lower equity upside for the investor.

The opposite holds true when a stock moves lower. The convertible bond's price and delta move lower while the yield to maturity and current yield move higher making the convertible less equity sensitive and more bond like. However, this profile is not without its drawbacks as the stock price can move so far that the convertible's embedded option becomes worthless. These bonds are often referred to as "busted" because the stock has very little chance of reaching the conversion price (strike price of the call option) before the bond matures. Another concern for lower priced convertibles is they are more sensitive to credit metrics and interest rates. Unfavorable changes in a company's balance sheet or interest rates can have a larger impact on a lower priced convertible.

This brings us to the sweet spot of convertible investing – *balanced convertibles*. Balanced convertibles trade around 90 to 110 and have a little bit of something for everyone. For equity investors seeking capital appreciation, these bonds usually trade with deltas ranging from 45 to 65. For income investors, these bonds usually have positive yields to maturity. And for investors concerned about risk, these bonds trade close to 100 which means they are close to the bond-like protective features of a convertible bond.

At Wellesley Asset Management we manage our portfolio risks so that the average bond profile is in the sweet spot. We typically buy bonds that are trading at a positive yield to maturity, guaranteeing the return of principal (barring a default). Many convertible managers buy deeply appreciated securities with double digit negative yields to maturity. In this scenario, if the stock falls significantly, the investor could realize more than 10% annual losses for the life of the convertible. We rarely establish new positions in bonds trading significantly below par for risk of exposing our investors to negative credit events and unfavorable moves in interest rates.

Though we may hold 60 to 80 positions in our mutual funds, we manage the portfolio risk on a global basis. Each day we look at the average bond price and yield to maturity in our funds. The average bond price typically ranges from 95 to 110. Once it approaches 110, we typically look to sell some deeply appreciated securities to bring the average bond price lower. Additionally, we monitor the yield to maturity with the aim of keeping it positive. When the yield to maturity approaches zero, we typically sell off highly appreciated securities in an effort to keep it positive. By taking these steps, we target our investors to stay in the sweet spot of convertible investing.

Given the recent volatility we have seen in the markets, including a full market cycle in less than two months, we think the time is right to be investing in convertible bonds. ***But how you invest in convertibles is equally as important as your decision to invest in convertibles.*** Investing in a strategy that has a high average bond price and a high delta will leave you exposed to downturns in the equity market. Conversely, investing in a low price, low delta strategy could leave you vulnerable to credit events, unfavorable moves in interest rates, and little exposure to possible equity upside.

Wellesley Asset Management has been investing in convertible bonds for nearly 30 years. We initially fell in love with the potential safety and optionality the product can offer to investors. We remain focused on buying bonds in the sweet spot as we believe that a portfolio of balanced convertible bonds can provide investors with attractive asymmetric returns.