

The outlook for convertible bonds

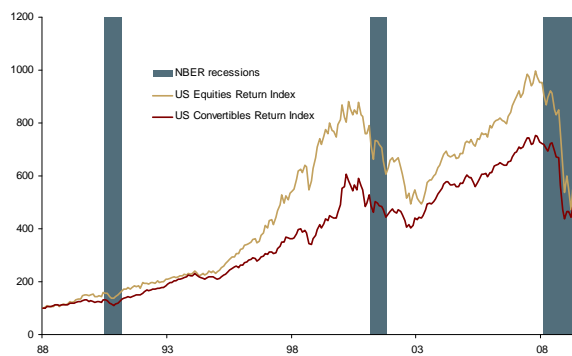
Convertible bonds are likely to post positive returns over the next 12 months as equity markets keep recovering in fits and starts and as liquidity, which evaporated from the convertibles market after the collapse of Lehman Brothers, continues to return.

A convertible is a corporate bond that can be exchanged, at the option of the holder, for a specific number of shares in the company. In short, convertibles are a hybrid between a corporate bond and an equity. Consequently, around two thirds of their returns can be explained by the direction of equity markets and the direction of corporate bond yields. Typically, when equity markets rally, convertibles rise in value, because the option to convert to equity becomes more valuable; when equities fall, convertibles tend to decline in value. As yields on corporate bonds fall, convertibles generally rise in value, and vice versa. Of these two factors, the direction of the equity market has much the stronger influence. Indeed, convertibles' correlation with equities tends to increase to close to one during equity bear markets as liquidity evaporates and fear dominates all asset prices. Like equities, convertibles fell sharply in value after Lehman Brothers collapsed last autumn.

There is a clear link between the performance of convertibles and the economic cycle. In and around US recessions, convertibles deliver negative returns in absolute terms, but they outperform equities, which fall in value further than convertibles. The bond element of the convertible offers some protection but is not enough to shield them fully against the fall in value of their embedded option to convert. Indeed, convertibles do not offer as much protection during recessions as pure corporate bonds, let alone government bonds.

In periods when the economy is growing, convertibles usually deliver stronger positive returns than pure corporate bonds, but they lag

Convertible bond and equity returns and US recessions



Source: Datastream, Coutts

behind rising equity markets, with which they have a beta of 0.22 – in other words, when equity markets return 10%, convertibles on average return 2.2%. There is some evidence that, in the early stages of an economic recovery, convertibles can sometimes outperform both corporate bonds and equities. Yet, as the recovery becomes more established, equities tend to deliver superior returns.

Having a good handle on what tends to drive the absolute and relative performance of convertible bonds allows us to form an educated view of their prospects for the year ahead. We expect equity markets to deliver positive returns over the next 12 months. Given that the main driver of returns from convertible bonds is the direction of the equity market, we also expect convertibles to post positive returns over the same period, although their returns would be lower than those from equities. This expectation is reinforced by the fact that convertible bonds were hit particularly hard as liquidity dried up after the collapse of Lehman Brothers. The continuing process by which liquidity is returning to markets should be beneficial for convertible bonds.

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