

## An evangelist for convertible bonds sings their praise

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By Steve Johnson

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More than a century after their invention, the market for convertible bonds still only amounts to about \$500bn (£315bn, €380bn), compared with something like \$26,000bn for corporate bonds and \$42,000bn for equities.

To an impartial observer this might suggest convertibles – corporate bonds with an embedded option allowing the holder to exchange them for equity at a pre-agreed price – have been a relative flop.

Adrian Hope, head of asset management at Jefferies, a niche investment bank and asset manager, would beg to differ with this assessment.

Mr Hope, who heads a 12-strong team managing \$2bn of convertibles, is an evangelist for the asset class, which he believes delivers better risk-adjusted returns than the mainstream equity and bond markets.

"We have outperformed equities by 4 per cent per annum over 10 years, after fees. How many equity managers have done that?" he asks. "But we are not being geniuses, it's the product itself. I think every convertibles fund should be ahead of equities, and the risk is about a third less."

Convertibles, as measured by the Merrill Lynch Global 300 index, have generated total returns of 42 per cent since the start of 2000, outstripping the admittedly meagre total returns of 13 per cent and 5 per cent produced by global equities and developed world equities, respectively.

Mr Hope attributes this outperformance to repeated mispricing of the equity options embedded in convertibles. The correct pricing of this optionality is hard for existing shareholders to determine, he believes.

This gives companies the green light to price deals "to sell", particularly if they would struggle to service the interest payable on a traditional corporate bond and thus would prefer to issue a convertible, which carries a lower coupon.

"For cash-burn companies, cutting their cash flow from 8 per cent to 3 per cent is good. To sell convertibles you give the volatility away too cheaply – which shareholders may not always fully understand. It's a nice way of concealing a discount. If you own optionality too cheap, you will beat the market," says Mr Hope.

"Every form of fundraising has to tempt investors, it's just that the form of this cheapness is less quantifiable to the existing shareholders."

But despite arguing that pricing of convertibles may be anomalous, Mr Hope does not expect the situation to change.

"Will shareholders wise up? Probably not. You are not going to stand up and say you should have got eight more volatility points. A public convertible will be at a 30 per cent premium to the market price. How can you object?"

"Selling volatility for a company is something of a no-brainer. Your stock has a volatility, so use it."

According to Mr Hope, Jefferies is something of an "accidental" fund manager. Back in the early 1990s the bank was involved in convertibles research and dealing on the behalf of clients. This morphed into asset management when a client, the Canton of Zurich, asked Jefferies to design a

benchmark for the asset class, then, in 1995, gave it a mandate.

Mr Hope, head of convertibles research at the time, stresses the operation's continuity. The Canton of Zurich remains an investor and "it's the same [investment] team as in the mid-1990s", split between London and Switzerland.

One criticism of convertibles is that they tend to perform weakly in periods of low stock market volatility, when the value of out-of-the-money options tends to decline. In the relatively benign period from 2003 to 2007, when the FTSE All World Developed Markets index delivered annualised total returns of 33.5, 15.5, 10.2, 21.2 and 10 per cent respectively, convertibles underperformed every year, with gains of 21.2, 8.0, 0.2, 16.0 and 9.8 per cent.

Mr Hope accepts the thesis, but argues convertibles more than earn their corn when market turbulence picks up.

"If you have a sustained period of low volatility they won't outperform, but when you have periods of high volatility they will," he says.

"When markets are very easy, people say 'this is not where we want to be'. But when things go wrong, you have got a component of your strategy that you can depend upon to deliver."

Indeed, convertibles outperformed equities during the equity bear market of 2000-2002 and have resumed this role since the onset of the global financial crisis.

In 2002 the outperformance was 21.3 percentage points; in 2008 it was 12.5 points (although convertibles still lost 27.8 per cent).

Mr Hope also ascribes some of the underperformance of convertibles between 2003 and 2007 to the emergence of specialist hedge funds levered as much as five times. This wave of investment may have upset the delicate supply and demand balance in the sector, reducing returns.

"In 2004 and 2005 there was too much hedge fund money and not enough issuance to meet it," Mr Hope says.

He believes the dedicated convertibles hedge funds have now largely disappeared, although relative value and multi-strategy funds remain active in the asset class.

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