FAQs about the global convertible-bond market

1. Is the convertible-bond market big enough for institutional investors?

Yes – with a market capitalisation of around US$ 450 billion, the market provides investment and diversification opportunities for large-scale portfolios. (To put that into context, the market capitalisation of the DAX is slightly more than twice as high, while that of the MDAX is about US$ 315 billion.)

2. The market has the reputation of being relatively illiquid. Are there new issues on a regular basis?

Yes – new issues have been increasing steadily again since 2013 and they are improving tradability. The average volume issued in the past three years was US$ 90 billion, and new bonds totalling US$ 100 billion are forecast for 2015.

3. How many convertible bonds worldwide are currently tradable?

At present, around 450 bonds are tradable for an investor with global market access, such as Union Investment.

4. Is market pricing appropriate despite strong demand from investors?

Yes – there are essentially two indicators that are relevant in this case:
1. Implied volatility, which has been between 25 and 35 per cent p.a. for about the past three years and is now 30 per cent.
2. Implied credit spreads, which are currently still slightly higher than the credit spreads on conventional corporate bonds.

5. What does 'convexity' mean when applied to convertible bonds?

Convexity means that convertible bonds react in different degrees to changes in the underlying share price (equity sensitivity). When share prices rise, so does the equity sensitivity of convertible bonds, and vice versa. This is also what creates the bond's 'protective' role because the equity sensitivity of a convertible is generally very low after a significant fall in the underlying share price.

6. Now that the stock markets have rallied, does the market still offer convexity? What is the current level of equity sensitivity?

Yes – the market currently offers very good convexity. The resurgence in the number of new issues since 2013, in particular, is increasing the convexity of the market as a whole. Equity sensitivity (equity delta) is currently around 50 per cent.

7. There are numerous high-yield issuers in the convertibles market. Is it possible for a portfolio's average rating to be investment-grade?

Yes, that's actually the norm. Around 50 per cent of the global market in which we invest consists of investment-grade bonds.

8. Many convertible bonds are not rated by the rating agencies. Does Union Investment have an internal rating process for convertible bonds?

Yes, it has had one for more than ten years. At present, just under 50 per cent of convertible bonds are not rated by the rating agencies, but our specialists in the corporate-bond team compute an independent internal rating for all convertibles before they can be purchased by us.

9. What is the minimum volume and number of bonds for a dedicated convertible-bond portfolio?

A customised convertibles portfolio with a balanced risk profile is possible with minimum assets of about € 30 million diversified across at least 60 bonds.

10. In terms of trading, how liquid are convertible bonds compared with investment-grade corporate bonds?

The average liquidity of individual bonds is currently comparable with that of investment-grade corporate bonds. Convertible bonds with a high level of equity sensitivity (above 80 per cent) are usually much more liquid.

11. How is it possible for the 'bond yield' on convertible bonds to be negative?

A negative 'bond yield' indicates a rising equity market. If the option value of a convertible bond has risen, the calculated yield assumes that it is worth more than its par value – say 150 per cent – despite the fact that 100 per cent is repaid on the bond's maturity date (only the bond component, not the conversion right is included). Consequently, if the price of a convertible bond is well above 100 per cent because share prices have risen, it is usually meaningless to calculate the 'bond return' component because it is negative.

Union Investment

FAQs about the global convertible-bond market

12. How do convertibles differ from hybrid bonds?

Hybrid bonds offer a high coupon rate provided the share price does not fall below a defined level. If the share falls below the threshold value, hybrid bonds are automatically converted into equity. This means that, unlike convertible bonds, hybrid bonds specifically do not provide any protection against the impact of a stock market crash.

13. Hedge funds are very active in the convertibles market. What percentage of global trading is carried out by hedge funds?

Our current estimate for the proportion of trading attributable to hedge funds is approximately 50 per cent. The activities of hedge-fund managers are **advantageous** for classic investors because they increase trading liquidity.

14. Why should you invest globally?

A global strategy enables portfolios to be properly diversified and also generates greater upside potential. The rate of growth in the new issues market means that the available supply is constantly changing. Due to its size, we believe the US market alone currently provides sufficient potential to construct a broadly diversified regional portfolio.

15. Is it also possible to take sustainable and/or ethically responsible approaches to managing convertible bonds?

Yes – Union Investment manages a number of convertible-bond portfolios using sustainable approaches in the form of segregated funds, and has access to a team of sustainability specialists for this purpose in portfolio management. Even with sustainable convertible bonds, these specialists are still able to construct sufficiently diversified portfolios by means of detailed analysis. We also offer an institutional mutual fund that is managed in line with this approach.

16. What are 'synthetic convertible bonds'? How are they different from those created inhouse by the Union Investment team?

The term 'synthetic convertible bond' describes a convertible bond that has been issued or structured by an investment bank rather than an issuer. A call option and a bond are securitised in the form of paper that can usually only be traded by the issuing bank, so it may become very illiquid in certain circumstances.

For the convertible bonds created inhouse at Union Investment, liquid exchange-traded options and bonds are purchased separately and are viewed in the portfolio as virtual convertible bonds. Efficient inhouse replication enables significant advantages to be gained in trading and management.

17. Isn't it better to purchase an exchange-traded convertibles fund rather than having to bear the costs of an active client portfolio?

The average bid/offer spread on this type of exchange-traded fund is around 0.75 per cent (or even as much as 1 per cent), so the product is not as reasonably priced at it first appears. What's more, the average premium (the difference between the NAV and the mid price) is about 1 per cent, which means that investors are paying 1 per cent too much for the content. Overall, the effective cost for a passive fund of this type is about 0.5 per cent.

The passive nature of ETFs is often restricted by clauses promising optimisation and so they may well deviate from their indices.

Nor is currency risk hedged, as a result of which their effective asymmetry can be destroyed.

Union Investment