Market Volatility Makes Convertible Bonds Attractive for Both Investors and Corporations

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One thing that can be said of the COVID-19 pandemic is that it has created a whole lot of volatility in asset prices. One asset class that is seeing an increase in interest from both investors and corporations due to this volatility is convertible bonds.

New issuance of convertible bonds has surged recently, and is on pace to eclipse all of 2019 issuance by the halfway mark of 2020. What are the reasons corporations are looking to this market to raise capital? One certainly is the aforementioned uptick in volatility. Convertible bonds are essentially a regular corporate bond with an embedded call option. Option pricing is dependent on volatility and with the recent uptick, has allowed companies to “monetize” their equity volatility in return for lower coupons and thus lower funding cost. The plethora of new paper in the convertible market is coming cheap for investors too, with convertible bond model discounts of 4% to 5% readily available. Not only does this give investors a very attractive entry point to get involved in the asset class, it has also caused cheapening in the secondary market for convertibles.

To put the opportunity in context, let's look at a couple recent new convertible issues we see as excellent opportunities.

Teledoc (TDOC) is the preeminent telemedicine provider in the United States. They have seen their business expand at an accelerated rate due to the COVID-19 crisis and looked to the convertible market to raise capital to capitalize on this demand. The company was able raise $850 million via convertible issuance with a modest coupon of only 1.25%. Investors in the paper, which is a 7-year note, own the optionality to convert to equity at a price only 35% higher over the full term. In other words, if the stock rises by more than 35% over the next seven years, the value of the option will be worth more than the original amount invested. If this doesn't happen, then they receive par back at maturity.

Lyft is another recent new issue to the convertible market. The ride-hailing service has definitely felt the negative business impacts from the COVID-19 pandemic. The company, needing capital to fortify its business, tapped the convertible market with a $650mm issue. Here too, a low coupon of 1.5% benefits the company, while investors own an option that is only 30% out of the money with five years to maturity. Just like TDOC, there is a lot of upside potential over the next several years, with the downside of getting paid back at maturity.

Overall, the opportunity in convertibles has expanded across the board. The diversity of sector exposure from companies issuing paper in today's market has also increased, so we are seeing potential for the asset class to perform well for years to come. In an environment when future returns are uncertain, a convertible bond structure gives investors an opportunity to profit if stock prices rise, but provides protection if they fall. With many equity markets having rallied substantially over the past several weeks, prudent investors might look to convertible bonds as a way to capture upside while minimizing risk and targeting risk-adjusted returns.

Convertible arbitrage and strategies in convertibles can provide traditional fixed income investors a liquid alternative that can offer low correlation and reduced volatility to enhance returns and improve diversification in a low rate environment. We have been managing our market neutral strategy since 2011 with an experience team focused on combining short duration convertible bonds with a levered convertible arbitrage strategy to take advantage of attractive credits, mispriced volatility and potential pricing catalysts.

As of Dec. 31, 2019, the team managed $1.4B across both absolute return and global convertible bond mandates.

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