



# **CQS Strategy Perspectives**

## **Convertible Market Outlook and Opportunities 2015**

February 2015



## About CQS

CQS is a credit-focused, multi-strategy asset manager. Founded in 1999, CQS is headquartered in London and has a presence in key global markets. Our approach centres on fundamental analysis to identify absolute and relative value globally across corporate capital structures and asset classes. This fundamental research is combined with active investment management to create value for our investors. Since launching our first strategy in March 2000, we now manage alternative, long-only and bespoke mandates for institutional investors globally. Our robust operations and risk management platform provides all client mandates with liquidity management and risk monitoring, enabling our investment professionals to be nimble and effective in all market environments. CQS is regulated by the FCA in the UK, the SFC in Hong Kong, ASIC in Australia and registered with the SEC in the US, with a presence in the Channel Islands, Cayman Islands and Luxembourg.

## Executive Summary

We see investment opportunities in convertibles arising from the following key themes in 2015:

- 1 **Dispersion in convertible valuations and in underlying credit and equity markets**
- 2 **An active new issuance calendar and net growth in the convertible market**
- 3 **Increasing equity market volatility**
- 4 **Increasing M&A activity**
- 5 **Opportunities in European Convertibles**

In this environment we believe that the arguments for adding convertible bonds to balanced portfolios are compelling.

In our view the risk-controlled equity exposure that convertibles offer is attractive, especially in Europe following the recent announcement of quantitative easing measures by the European Central Bank (ECB). We believe that interest in European convertibles, in which global convertible investors may be underweight, could increase after the ECB action.

As monetary policy conditions diverge globally, the short effective duration of convertibles and their demonstrated low / negative correlation with government bonds are attractive in an environment of potentially rising US interest rates.

We think that an active investment approach with a strong focus on fundamental research and on issuer and instrument quality will best capitalise on the opportunities we see arising in the market, while also helping to mitigate the rise in idiosyncratic risk which was evident in the closing months of 2014 and which we anticipate will continue.

## The Convertible Market in 2014

### Performance

The global convertible market delivered solid returns in 2014, continuing the asset class's track record of delivering sound risk-adjusted returns and a competitive Sharpe ratio compared to other assets over the long run.

As illustrated in Figure 1 below, the BoAML G300 Index of global convertibles delivered a currency-hedged return of 7.2% on the year. Given the relatively short duration of convertibles, they slightly underperformed the strong rate-driven moves in broad government bond and investment grade credit indices, while outperforming shorter-duration government bond indices. Convertibles outperformed high yield credit and delivered a respectable 73% of the performance of the MSCI World equity index. Reflecting underlying equity returns, convertible returns were materially stronger in the US, at 10.7%, than elsewhere, while European convertibles delivered disappointing returns of 1.5%. Investment grade convertible bonds outperformed high yield convertibles as the latter were negatively impacted by weakness in spreads in the second half of the year.

Figure 1: Global Cross-Asset Returns (Currency Hedged to USD)<sup>1</sup>

Global Cross Asset Returns	2014 (%)
Global Government Bonds	8.3
Global IG Index	7.7
Global HY Index	2.5
MSCI World Equity Index	9.8
Global Convertibles (G300)	7.2

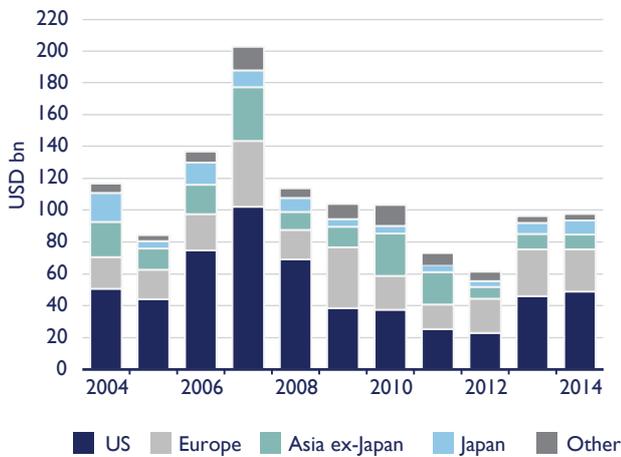
Global Convertibles Performance	2014 (%)
Global Convertibles (G300)	7.2
US	10.7
Japan	4.9
Europe	1.5
Asia ex-Japan	3.9

<sup>1</sup>Source: Bank of America Merrill Lynch, MSCI, Bloomberg, as at 31 December 2014. BoAML Global Government Index (W0G1), Global Corporate Index (G0BC), Global High Yield Index, (HW00), Global 300 Convertible Index (VG00), Global Convertibles –US and Canada Index (VR10), Global Convertibles: Japan Index (VR20), Global Convertibles – Europe Index (VR30), Global Convertibles –Asia/Pacific Index (VR40), all total return, currency hedged to USD, MSCI World Index (NDDLWI), total return, local currency.

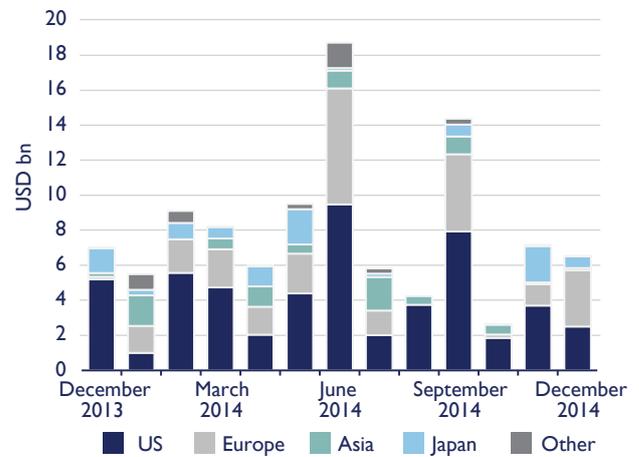
**New Issuance**

Figure 2: Convertible Issuance 2004-14<sup>2</sup>

**Annual Convertible Issuance 2004-2014**



**Monthly Convertible Issuance 2013-14**



<sup>2</sup>Source: UBS Convertibles Marketing / MACE to 31 December 2014.

As shown in Figure 2, new convertible issuance was healthy in 2014, with annualised issuance of \$97.8 billion globally. US and Japanese issuance was higher than in 2013. Asia-ex Japan issuance was essentially flat, while European issuance fell slightly year-on-year. Average deal size globally was higher, with the largest deals being the \$2.9 billion Fiat Chrysler and the \$1.9 billion Telefonica mandatory convertibles.<sup>3</sup>

Technology issuers comprised 25% of new issuance globally. Companies with ‘breakthrough’ and potentially disruptive investment plans accounted for a significant proportion of new convertible issues. Consumer discretionary, financials and health care were the other most active sectors. Recognised names including Citrix Systems, LinkedIn and Priceline issued convertible paper and Tesla Motors again returned to the market.<sup>4</sup>

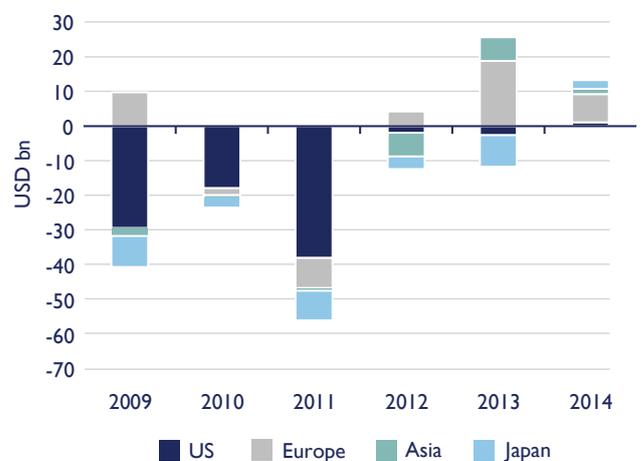
It was encouraging that a number of investment grade issuers came to the European convertible market including Unibail Rodamco (A), Industrivarden Exchangeable into ICA (A-) and ST Microelectronics (BBB-/Baa3).<sup>4</sup> Almost 50% of new European issuance by capitalisation was investment grade. UK issuers also returned to the convertible market, including Sainsbury, Playtech and Carillion.<sup>4</sup>

The Japanese convertible market (once the largest in the world) recorded the highest level of issuance for several years.

Underlying the need for a strong fundamental research capability in the convertible market, approximately three-quarters of new issues globally in 2014 were unrated.<sup>4</sup>

Figure 3 shows that the convertible market has now seen positive issuance net of redemptions for two years and it is pleasing to see the market returning to growth.

Figure 3: Net Issuance 2009 to 2014<sup>6</sup>



<sup>6</sup>Source: Bank of America Merrill Lynch, ‘Poised for a rebound’, Convertibles Research, 2 October 2014.

Source: <sup>3</sup>UBS Convertible Issuance Statistics, December 2014. <sup>4</sup>CQS analysis and UBS Convertible Issuance Statistics, as at December 2014. <sup>5</sup>Unibail Rodamco (Standard & Poor’s A), Industrivarden Exchangeable into ICA (Standard & Poor’s A-) and ST Microelectronics (Standard & Poor’s BBB-/ Moody’s Baa3).

**Fund Flows**

Fund flows into dedicated convertible funds, as measured by EPFR, were strong in H1 2014 before turning negative in the summer and becoming more balanced into year end, as shown in Figure 4. This pattern of flows was essentially similar to that evident in several other asset classes, including high yield and European equities.

**Valuations**

As shown in Figure 5, convertible valuations were firm in the first six months of 2014 as strong investor demand for the asset class buoyed the market. Valuations moderated in the second half of the year, especially in June and September, when demand for convertibles was met by strong supply from primary issuance, as can be seen in Figure 2. Convertibles also cheapened with other asset classes in the first half of October and again in the first half of December, but recovered from both of these corrections.

**Key Themes for Convertible Investment in 2015**

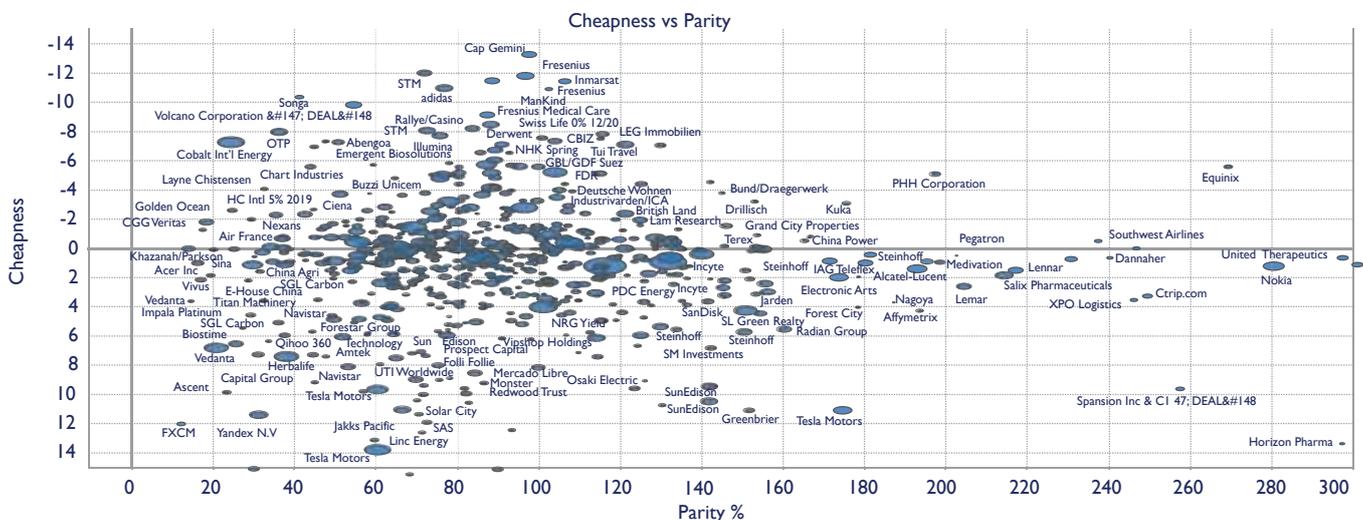
**Dispersion**

(a) In Convertible Valuations

We believe that the reduction in capital committed to convertible arbitrage strategies in recent years and the closure of bank proprietary desks have contributed to the dispersion of valuations within the convertible market, as shown in Figure 6 below.

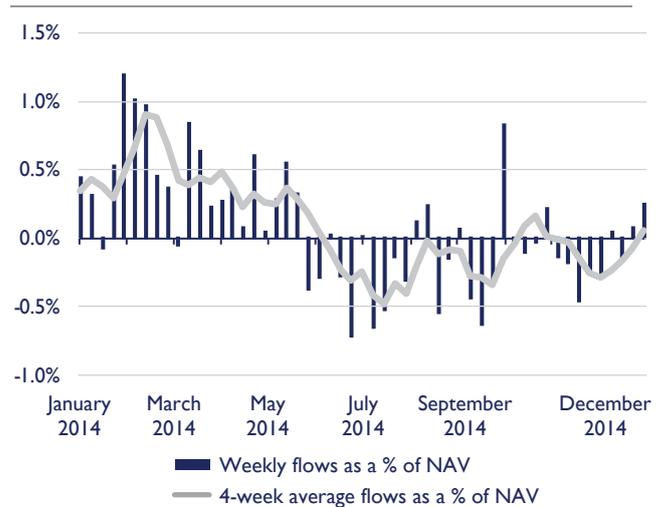
This dispersion of valuations continues to create opportunities for active portfolio management, in particular for benchmark-agnostic mandates.

Figure 6: Marked Valuation Dispersion<sup>9</sup>



<sup>9</sup>Source: CQS, Deutsche Bank and Bloomberg as at 6 February 2015. The chart represents what we believe to be the outstanding global convertible bond universe and relative cheapness to other bonds within the universe. We do not endorse these as valuations as CQS has not evaluated each security in the universe. The size of circles is indicative of market size relative to other bonds. No recommendation is made to buy or sell a bond. For illustrative purposes only.

Figure 4: Convertible Fund Flows<sup>7</sup>



<sup>7</sup>Source: Deutsche Bank and EPFR Global, 'Weekly Fund Flows', 30 January 2015.

Figure 5: Convertible Valuations<sup>8</sup>



<sup>8</sup>Source: Nomura, as at 23 January 2015. For illustrative purposes.

(b) In Credit and Equity Markets

After benign conditions in the first half of 2014, we began to see a material decompression in credit spreads from June onwards, as illustrated in Figure 7. We believe this tendency for increased dispersion may persist, driven in part by the end of quantitative easing in the US.

Greater dispersion between riskier and safer companies has also been evident in the equity market since July, as shown in Figure 8. We expect this greater level of dispersion in both credit and equity markets to create more opportunities for active portfolio management in convertibles.

**Active New Issuance Calendar and Net Growth in the Convertible Market**

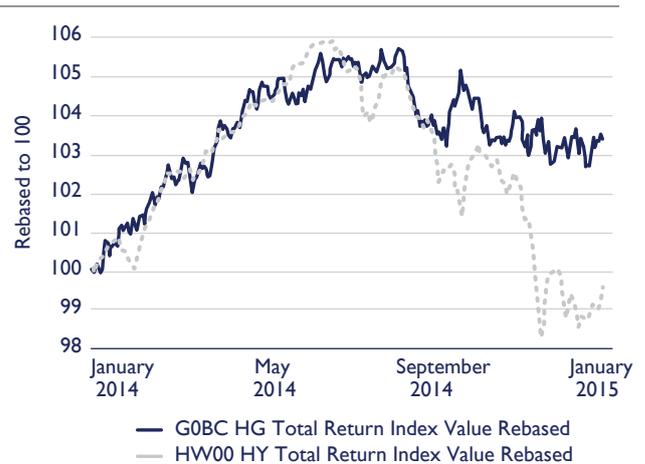
We believe that market conditions are favourable for a robust level of convertible issuance as companies continue to shift toward capital market financing from bank borrowing.

Any material increase in yields caused by rising US interest rates, widening credit spreads, or both, should enhance the relative attractiveness of convertibles to issuers. There is little doubt that the convertible market has lost significant potential issuance to the high yield market in recent years as absolute yields have been so low. As can be seen from Figure 9, it appears that this trend is beginning to reverse. If and when interest rates and credit spreads do rise we expect the convertible primary market to gain further momentum relative to high yield.

We expect that the higher prevailing level of equity prices will continue to encourage more issuance.

An environment of increasing corporate capital expenditures and investment opportunities should be supportive of the primary market in the coming year, as witnessed by the revival of convertible issuance in Japan in the second half of last year. We are encouraged by this improvement in Japanese issuance and believe that it demonstrates the potential for European issuance should European economies return to growth.

Figure 7: One Market, Two Outcomes: Wider High-Yield Spreads but Tighter High-Grade Spreads<sup>10</sup>



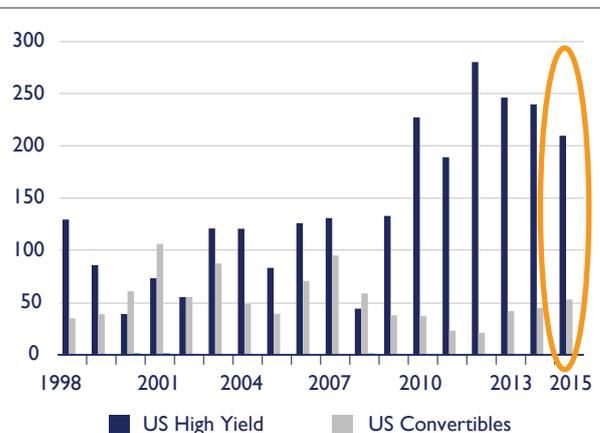
<sup>10</sup>Source: Bank of America Merrill Lynch and Bloomberg, as at 4 February 2015.

Figure 8: Dispersion is Back: Uncoupling in Stocks...<sup>11</sup>



<sup>11</sup>Source: Bloomberg as at 8 December 2014. Index rebased to 100 as at January 2014. MSXXHYDS Index: Morgan Stanley HY Debt Sensitivity Index.

Figure 9: US Convertibles vs. High Yield Issuance Including 2015 Forecast, \$1bn<sup>12</sup>



<sup>12</sup>Source: BofA Merrill Lynch Global Research, 'Global Convertible Year Ahead 2015', 8 December 2014.

An increase in M&A may provide further momentum. We have, for example, seen two recent UK convertible issuers motivated by acquisitions: Sainsbury issuing to refinance its purchase of the balance of Sainsbury Bank and Playtech issuing to fund potential future M&A.

Figure 10: Global Issuance Forecast and Realised, \$bn<sup>13</sup>

2015 Forecast	United States	Europe	Asia	Japan	Total
Issuance	53.4	23.5	11.5	6.8	95.1
Redemptions	25.5	13.8	8.8	2.2	50.3
Net	27.9	9.7	2.7	4.6	44.9

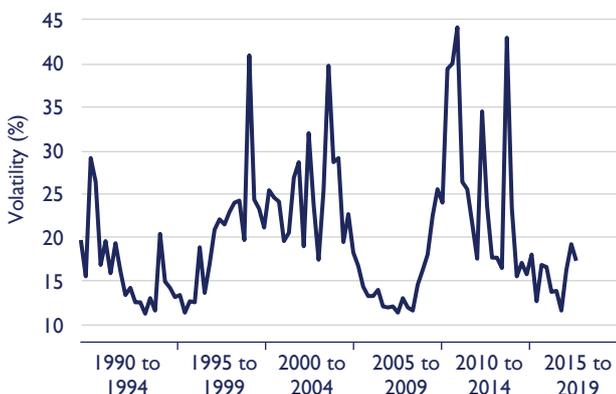
2014	United States	Europe	Asia	Japan	Total
Issuance	44.4	24.1	12.4	8.3	89.1
Redemptions	45.5	17.0	12.1	5.0	79.6
Net	(1.1)	7.1	0.2	3.3	9.5

<sup>13</sup>Source: BofA Merrill Lynch Global Research, 'Global Convertible Monthly', 8 January 2015.

Bank of America Merrill Lynch forecasts positive net issuance across all geographies in 2015, helped in part by a fall in expected redemptions of convertibles from \$80 billion in 2014 to \$50 billion in 2015 (see Figure 10).

This level of net issuance would increase the total size of the global convertible market by over 10% and we believe this expansion of the market, if realised, will be helpful for returns. In a robust issuance year such as we anticipate, new convertible issuance can be approximately 25% of the outstanding market, creating a proportionately much higher level of potential primary market opportunities than that typically available in other asset classes. We expect that strong primary issuance will also help to keep index valuations at reasonable

Figure 11: Equity Index Volatility<sup>14</sup>



<sup>14</sup>Source: VIX Index, Bloomberg as at 4 February 2015.

levels notwithstanding continuing inflows into the convertible asset class, and more generally will expand the convertible investment opportunity set.

### Increasing Equity Market Volatility

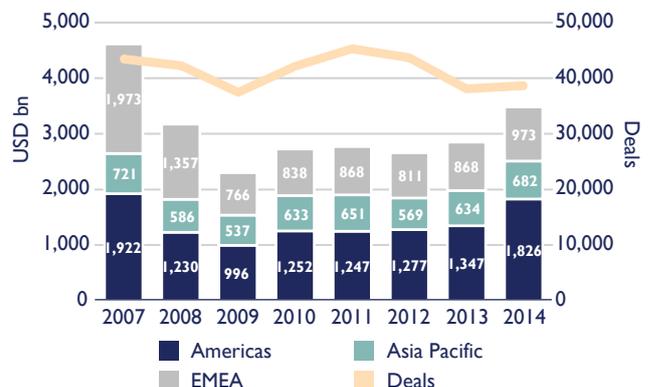
We believe that the factors that appear to have contributed to the increase in equity market volatility in the second half of 2014, such as heightened geopolitical risk, increased idiosyncratic corporate risk and concerns over Federal Reserve tightening and Eurozone deflation will continue to be important in 2015. October and December brought two of the largest spikes in equity market volatility since the Eurozone crisis in 2011. In our view therefore, the long volatility exposure afforded by convertible bonds is intrinsically attractive in the current environment.

### Increasing M&A Activity

As shown in Figure 12 below, in 2014 global M&A volume reached its highest level since 2007. Health care, Real Estate and Telecoms were the three most active sectors for global M&A, the first two of which are well represented in the global convertible market.

In Europe many convertible bonds have attractive conversion term adjustments in the event of a change in control of the company. The potential for strong returns from these 'ratchet' clauses was underlined in December last year when German real estate companies Deutsche Annington and Gagfah announced a merger. The adjustment clause in the Gagfah 1.5% 2019 convertible resulted in its value increasing by over 25% after the bid, materially more than the gain in the ordinary shares.

Figure 12: Global M&A Volume<sup>15</sup>



<sup>15</sup>Source: Dealogic M&A Review, Full Year 2014 Final Results, January 2015.

An increase in M&A may also generate opportunities through additional primary issuance. There were signs of this in 2014, when 14% of new US convertible deals were issued to finance M&A compared with 5% in 2013.

**Opportunities in European Convertibles**

Markets appear to be torn between assessing the likely effects of the recently announced programme of quantitative easing in Europe and the prospects for potential interest rate rises in the US and the UK. Despite this, there is evidence that within the convertible market investors are currently overweight the US and underweight Europe (see Figure 13).

Given the underperformance of European convertibles in 2014, we would not be surprised to see this relative positioning shift in Europe’s favour over the coming months, given the ECB’s quantitative easing programme and especially if the US Federal Reserve raises interest rates. Clearly any significant easing in Europe has the potential to stimulate convertible issuance and M&A in the region, as well as broader credit and equity markets.

**Risks**

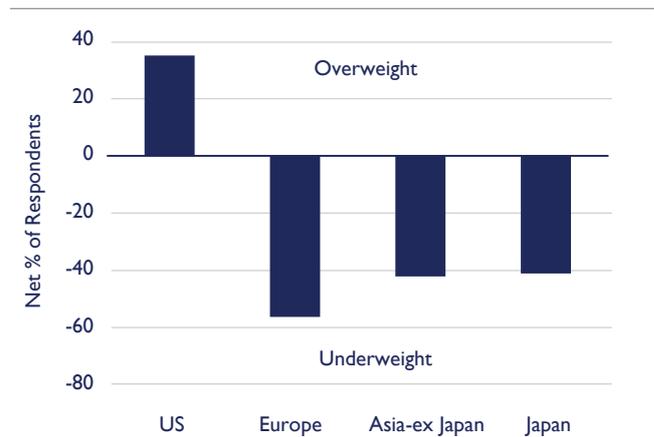
We believe key risks in 2015 include rising interest rates in the US and UK as well as higher idiosyncratic corporate risk.

We are optimistic that the low effective duration and the balanced equity sensitivity of the convertible market should make convertibles relatively resilient to higher interest rates. The effective duration of the global convertible market is approximately 2.1 years. This compares with the effective duration of high yield, as measured by the Bank of America Merrill Lynch Global High Yield Index, of 4.1 years and the effective duration of investment grade credit, as measured by the Bank of America Merrill Lynch Global Corporate Index of 6.5 years.

Furthermore, as we noted in our paper ‘A Case for Convertibles’ last year, over long periods convertibles have demonstrated low or negative correlation to government bonds.

Periods of rising interest rates have also displayed the relative resilience of convertibles as shown in Figures 14 and 15.

Figure 13: What is Your Convertibles Position by Region?<sup>16</sup>



<sup>16</sup>Source: BofA Merrill Lynch Convertibles Research, 6 November 2014.

Figure 14: Rising Interest Rates: 1 January 2003- 31 December 2006<sup>17</sup>

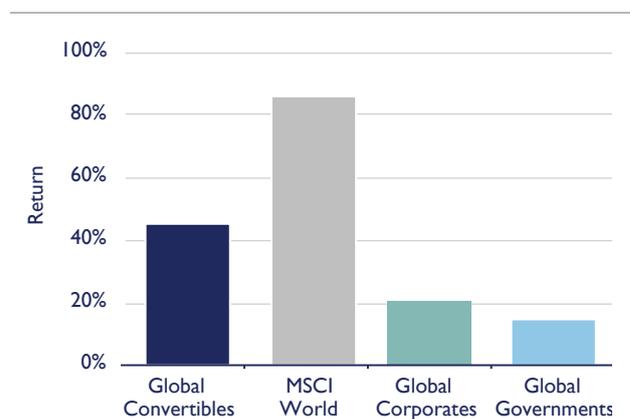
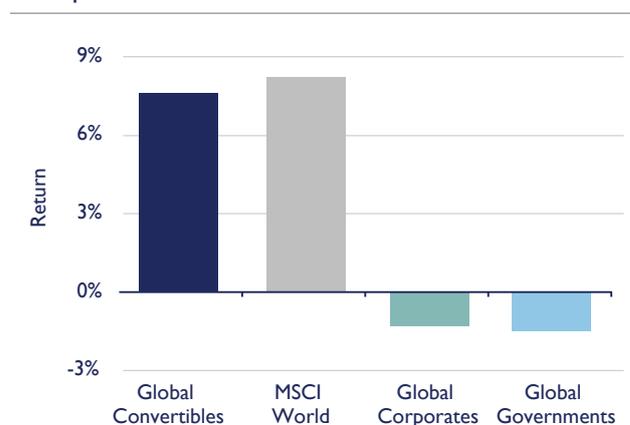


Figure 15: Taper Tantrum: 1 April 2013 to 31 September 2013<sup>17</sup>



<sup>17</sup>Source: CQS, Bloomberg, Merrill Lynch, and MSCI as at the date ranges indicated above. These include historic returns and past performance is not a reliable indicator of future results. The value of investments can go down as well as up. BoAML Global Convertible Master Index (VG00), BoAML Global Broad Market Corporate Index (G0BC), BoAML Global Government Bonds Index (W0G0) and MSCI World Index. All total return, USD Hedged indices.

We believe that we have entered a period of rising idiosyncratic risk as the economic cycle has extended and certain sector and name-specific risks have built up. An increase in credit events in individual names first became apparent in Europe with the Phones 4 U (not a convertible issuer) administration in September last year. In 2014, we witnessed adverse credit situations in the convertible market, names including Dendreon, GT Advanced Technologies, Centrus Energy, Kaisa Group, Espirito Santo Financial Group and American Reality Capital Properties.

In the final quarter of last year stress became evident in energy-related issuers in particular as a result of the sharp fall in the oil price since mid-year. The global convertible market's exposure to Energy is actually quite low. The sector accounts for approximately 6.3% of the US convertible market, 10% of the European market, 7% in Asia and zero in Japan. In the US, for example, the exposure is less than in the S&P 500 Index and in corporate credit indices, and materially less than in high yield.<sup>18</sup>

We believe that an emphasis on issuer and instrument quality and appropriate portfolio diversification will be especially important in these conditions.

## Outlook for Convertible Fund Flows and Supply / Demand

Interest among institutional investors indicates that the long-term strategic arguments for including convertible bonds within diversified portfolios are increasingly accepted.

We believe that the tactical attractions of convertible bonds in the current investment climate are becoming more appreciated, especially the relatively low duration and the long volatility exposure they afford.

We therefore expect good levels of institutional investor allocations to the convertible asset class to continue. In addition we note that conditions are appealing for convertible arbitrage investors which in turn should also be supportive of the overall market.

Given the favourable outlook for primary market supply which we discuss above, we expect the generally balanced supply / demand environment which has prevailed in the closing months of 2014 to continue. In these conditions the upward pressure on the valuations of convertible index and balanced profile names may be more moderate than in the first few months of 2014.

## Convertible Market Profile and Valuations

The global convertible market entered 2015 with a balanced profile between debt and equity, as illustrated by a global convertible market delta of 57% (see Figure 16 below.) This balanced profile of the market between credit and equity makes convertibles particularly attractive as a diversifying asset and also facilitates active portfolio positioning. We expect good issuance levels to help the market keep this balanced profile, even if equity prices rise further. As shown in Figure 5 (page 5), general convertible market valuations are reasonable at present and are measurably cheaper than the levels which prevailed through the first half of 2014. As discussed above, we are encouraged by the opportunities presented by the dispersion of valuations within the market.

Figure 16: Convertible Market Summary Statistics<sup>19</sup>

	Global	US	Europe	Asia ex-Japan	Japan
Market Value (bn)	314.2	196.7	84.2	19.2	12.2
Number of securities	819	525	173	64	57
YTM/P/CY %	3.3	3.5	3.1	4.2	0.2
Premium %	30.0	28.2	32.1	47.6	20.7
Delta %	57	64	48	30	57
Rich/(Cheapness) %	(0.7)	(1.1)	0.3	(0.8)	0.2
Rho %	(2.1)	(2.6)	(1.3)	(1.3)	(2.1)

<sup>19</sup>Source: Barclays CBI Insight, Convertible Market Summary Statistics as at 2 February 2015.

<sup>18</sup>Source: BoAML Global Convertible Year Ahead 2015, as at 8 December 2014.

## Conclusion

We are constructive on the prospects for returns in the convertible market in 2015

- Over long timeframes, convertibles have delivered equity-like returns with less volatility and with low / negative correlation to government bonds
- In our opinion the currently balanced profile of the convertible market and the short duration and long volatility exposure it affords are compelling in the present investment climate
- Following the moderation in convertible valuations in the second half of 2014 we view current valuation levels as generally attractive
- We expect an active primary market, the dispersion of convertible valuations and potentially increased M&A activity to create opportunities for additional returns in the coming months
- Our expectation of greater equity market volatility and idiosyncratic risk in credit markets leads us to believe that a strong focus on issuer and instrument quality and on appropriate diversification will be especially important in 2015. We believe that an emphasis on fundamental research will pay particular dividends in this environment

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MSCI World Index: A market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe, and the Asia/Pacific region. Indices are unmanaged, and, unless otherwise stated, the figures for the index shown include reinvestment of all dividends and capital gains distributions and do not reflect any fees or expenses. Investors cannot invest directly in an index. The Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The BofA Merrill Lynch Global High Yield Index tracks the performance of USD, CAD, GBP and EUR denominated below investment grade corporate debt publicly issued in the major domestic or eurobond markets. The BofA Merrill Lynch Global Corporate Index tracks the performance of investment grade corporate debt publicly issued in the major domestic and eurobond markets. BoAML Global Convertible Master Index (VG00) is a global convertible index composed of companies representative of the market structure of countries in North America, Europe and the Asia/Pacific region.

#### **AIFMD and Distribution in the European Economic Area:**

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