

BSAMC

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RISING POTENTIAL OF CONVERTIBLE BONDS



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1. Executive Summary:

High interest rates have increased borrowing costs for everybody and that includes companies looking to raise or refinance debt. That generates a renewed appetite for an overlooked asset class called convertible bonds. Convertible bonds are what we call a hybrid instrument combining the features of a traditional corporate debt and common equity. Like corporate bonds, it guarantees income via interest of the initial investment but the reason they're called convertible is because they offer investors the option to convert that bond to common stock when a company's share price hits a certain threshold. From the issuer's side the convertible bonds have lower interest expense during the high interest rate periods. Convertibles are relatively less attractive with lower interest rates and accommodating capital markets for traditional alternatives. That's why it lost market share from traditional corporate bonds over the last 15 years. However, considering the current outlook, the issuance of convertibles started to rise not for only the companies who can't directly access the debt market because of their ratings, but also even for the companies with higher credit ratings. Through the report the common attributes of the convertibles and the risk-reward opportunities have been analyzed. Looking ahead we believe the convertibles market is poised for growth, and we will likely see more convertible issuances given a higher industry environment, tighter capital markets and a wall of maturities that is debt coming due in the next 2 to 3 years. Convertibles are a particularly suitable instrument in this context as they offer defensive income enhanced alternative to investing in the underlying common stock.

2. Introduction to Convertibles:

Defining Fixed Income:

Fixed-income instruments, also known as fixed-income securities or debt securities are financial instruments, issued by various entities that provide interest payments and return the initial investment amount upon maturity. There are many different types of fixed-income instruments, such as bonds, treasury securities, municipal bonds, convertible bonds, and many others. These investment options can be popular due to their reputation for being low risk, appealing to both individual and institutional investors alike.

Understanding how fixed-income instruments work is indispensable for anyone considering investing in such instruments, thus it is worthwhile for us to take a look at it as well.

As a first step, an entity (usually a government or corporation) issues a fixed-income instrument, with specific terms regarding it. There are 4 important measures we learn about a fixed income instrument upon issuance. The first is the price of the bond which is the face value that the investor has to pay for the issuer to acquire a bond. The second thing is the interest rate that the issuer will pay by the maturity date of the loan. The maturity date refers to a specified time when the issuer returns the principal amount on top of the interest rate. Credit quality is also important as these instruments exhibit varying degrees of risk. Generally speaking, the higher the credit quality, the lower the probability that the issuer will default on the debt security.

Once a fixed instrument is issued investors can purchase them, essentially lending money to the issuers. The transaction between the investor and the issuer will terminate upon the maturity date when the issuer returns the interest and the principal.¹

Issuers release fixed-income instruments such as bonds to get access to capital. They believe in their ability to achieve a higher ROI with the money borrowed than the interest rate of the fixed-income instrument making it a worthwhile decision for entities to issue them. Investors will choose to buy fixed-income instruments as they represent a relatively low-risk investment with fixed-interest payments at regular intervals.

General macro trends and intuition behind fixed income instruments:

Even though fixed-income instruments can always be an attractive investment opportunity there are some specific cases when they are particularly in high demand.

As fixed-income instruments represent a relatively low-risk investment strategy, they become more commonly traded during economic downturns.² While stocks that represent an alternative investment strategy to fixed-income instruments, are highly volatile and usually lose value during a recession the same cannot be said about income securities. As a result of the predetermined interest rate the instalments received by investors will remain the same, regardless of the company's performance. Of course, if the economic downturn is severe enough it is plausible that the issuer defaults on the loan,

¹ Chen, J. (2023, May 2). Guide to Fixed Income. Retrieved from Investopedia website:

<https://www.investopedia.com/terms/f/fixedincome.asp#:~:text=Fixed%20income%20broadly%20refers%20to>

² Groves, J. (2023, September 9). Fixed Income Investing: What You Need To Know. Retrieved from Forbes Advisor UK website:

<https://www.forbes.com/uk/advisor/investing/fixed-income/#:~:text=Market%20conditions%3A%20demand%20for%20defensive>

resulting in a loss for the investor. That being said fixed-income instruments are still a relatively safe investment strategy in a recession, making them a popular choice when the economy is struggling.

High interest rates also make fixed-income instruments more attractive. We usually see high interest rates alongside high inflation rates as raising the interest rate can be a tool to slow down the economy by making borrowing more expensive and thus reducing inflation. In these situations, investors can also expect to see higher interest rates on debt securities leading to a higher ROI.

Our current experiences also support the above statements. At the time when this report is written (Q4,2023) we are experiencing high inflation (in the US it is currently 3.7%, but just a few months ago it was around 5%)³ and thus staggeringly high interest rates as well (US Federal Reserve interest rate is at a 19 year high at 5.5%)⁴. Reports have also shown that investors have been favoring fixed-income instruments in 2023 and they are gaining more popularity as the interest rate increases.⁵

Convertible bonds, numeric example and intuition behind them:

This report will focus on a specific type of fixed-income instrument, namely convertible bonds. A convertible bond is a fixed-income corporate debt security that yields interest payments but can be converted into a predetermined number of common stock or equity shares. The conversion from the bond to stock can be done at certain times during the bond's life and is usually at the discretion of the bondholder.⁶

Consider the following example to better understand convertible bonds. Suppose that Company X issues a convertible bond, with a face value of 1000 USD, an interest rate of 7%, and a maturity of 5 years. The bond also allows investors to convert the bond into 10 company shares; this is called the convertible ratio. Note that this stock option is what makes a convertible bond different from other type of bonds. In this example we are assuming that Company X values their stock at 100 USD at the moment since they would be willing to sell 10 shares for 1000 USD if the investor converts their bonds into stocks.

If the investor holds the bond until maturity, 70 USD of interest (0.07×1000) will be returned to them on top of the face value of 1000 USD putting them at a total of 1070 USD (unless Company X defaults on the bond). The investor can receive this money regardless of how the company's stocks are performing. On the other hand, if Company X's stock value increases by 20% the investor might consider converting their bond into stocks. They would do so since after the 20% increase the stock will be traded at 120 USD and upon conversion the investor will have 1200 USD worth of stock ($120 \text{ USD} \times 10$), which is more than the 1070 USD they would have received if they held the bond until maturity.

As we can see from our example above as well, while in the case of bonds the investor is indifferent about the performance of the company if the same individual holds a convertible bond, it is in their favor for the company to perform well, due to their stock options allowing them to convert their bond to stocks.

³ US Inflation Rate. (2023). Retrieved October 22, 2023, from ycharts.com website: https://ycharts.com/indicators/us_inflation_rate#:~:text=Basic%20Info

⁴ United States Fed Funds Rate. (2023). Retrieved from Trading Economics website: <https://tradingeconomics.com/united-states/interest-rate>

⁵ Kolostyak, S. (2023, March 2). Fixed Income Funds Remain Popular in 2023. Retrieved from Morningstar UK website: <https://www.morningstar.co.uk/uk/news/232303/fixed-income-funds-remain-popular-in-2023.aspx>

⁶ Chen, J. (2020, October 6). How Convertible Bonds Benefit Investors and Companies. Retrieved from Investopedia website: <https://www.investopedia.com/terms/c/convertiblebond.asp>

3. Different Investment Strategies Regarding Fixed Income and Convertible Bonds:

What is intuitively known within the fixed-income market is that interest rates and the fixed-income market's products' prices are negatively correlated. Hypothetically, in an event where interest rates rise, the prices of these securities will decrease. In other words, most fixed-income securities pay a fixed interest rate, which becomes more appealing when interest rates decrease, leading to increased demand and a rise in the bond's price. Conversely, the rise of the interest rates will make investors less enthusiastic, which will result in a decline in the prices.

Considering there are many distinct fixed-income securities and intricacies for the sake of the paper, this section provides general and intuitive investment strategies and, subsequently, more specifically, convertible bonds.

As already mentioned, the basic strategy of fixed-income markets is utilizing the understanding of the inverse relationship between interest rates and bonds. To better display the strategy, the term "Yield To Maturity" must be considered (YTM). YTM represents the return generated by a fixed-income investment. It is computed under the assumption that the investor holds the bond until maturity. The bond's yield is determined by a combination of its buying price and the annual interest (or coupon) payments it disburses. To grasp the connection between bond prices, interest rates, and YTM, it's most instructive to examine an illustrative case.

Suppose an investor purchases a bond with a coupon rate of 5% at t_0 . Then, assume a decline in interest rates over the year, and at t_1 , a similar bond is issued with a 4% coupon rate. The investor's previously purchased bond has now become more attractive due to its higher coupon payment compared to the one issued in the current year. Since the 5.0% coupon bond yields more interest than the prevailing market rate, the price of your bond will be appreciated.

Price of Bond	Coupon Rate	Yield-to-Maturity
\$99 (trading at discount)	3.5%	4%
\$100 (trading at par)	4%	4%
\$101 (trading at premium)	4.5%	4%

Laddered Bond Portfolio Investing:

Another investment strategy would be the Laddered Bond Portfolio Investing. Emphasizing this investment method will allow the investor to mitigate risks through diversification. It consists of multiple fixed-income securities with varying maturity dates, which minimizes the risk through a diversified portfolio, and additionally, it enhances the portfolio's liquidity.

In other words, this method works by spreading risk in a manner resembling a ladder. When the short-term bonds mature during periods of unfavorable market conditions marked by increasing interest rates, the principal can be reinvested in the long-term bonds, which, in the end, the strategy helps reduce

exposure to risks associated with interest rates, reinvestment, credit, and liquidity. For example, by purchasing solely bonds with shorter maturities, the investor will have bonds that are relatively stable but offer lower returns. On the other hand, bonds with longer maturities are more susceptible to interest rate fluctuations, yet they provide higher yields in a typical yield curve scenario.

To illustrate the strategy, suppose an investor has \$150,000 to invest in municipal bonds and wants to create portfolio with maturities spaced one year apart:

Maturity (Year)	Price of Bond	Yield-To-Maturity	Face Value
1	\$30,000	2%	\$30,600
2	\$30,000	2.5%	\$30,750
3	\$30,000	3%	\$30,900
4	\$30,000	3.5%	\$31,050
5	\$30,000	4%	\$31,200

Based on their investment goals and interest rates, investors can reinvest the principal and interest from matured bonds into new bonds or modify their laddered portfolio. As can be seen from the numerical example, the laddered strategy distributes risk across multiple maturities and offers a consistent income while retaining some flexibility.

Barbell Investment Method:

One more approach would be the Barbell Investment Method. It is a portfolio management approach that combines two extremes: short-term, low-risk bonds (usually at the "safe" end of the barbell) and long-term, higher-risk bonds (usually at the "risky" end of the barbell). Eventually, the strategy aims for balancing safety and yield potential.

Presume an investor has a total investment of \$100,000, and the investor wants to implement the strategy:

Safe End of the Barbell (60%):

- \$60,000 in Short-Term U.S. Treasury Bonds (2-year term) with a yield of 1.5%: These bonds offer safety and liquidity, and due to their short-term nature enables the investor relatively shorter to access the principal.

Risky End of the Barbell (40%):

- \$40,000 in High-Yield Corporate Bonds (10-year term) with a yield of 5%: Because of their longer maturity and higher yield, these bonds have a higher degree of risk but also have a chance for higher returns.

Arbitrage Method:

Convertible bond arbitrage strategy emphasizes on enhancing income and reducing equity market risk while still providing potential returns through an asymmetric risk and reward profile.

Through this method, investor purchases a mispriced convertible bond and simultaneously sell a number of shares of the company. Using this technique, the investor can benefit from price volatility.

Convertible arbitrage strategies can help mitigate the potential impact of equity market volatility. Consider a convertible bond decline in value. Typically, the underlying common stock would also decline. This would benefit an investor who had shorted the stock, offsetting the decline in the convertible.

Convertible arbitrage can generate returns from many sources including:

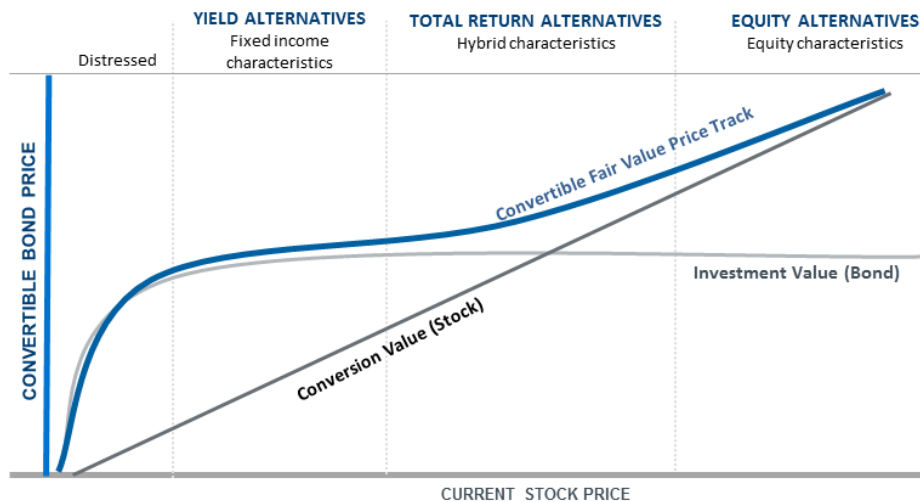
- Short interest credit: Potential income from rebate of the portion of interest charged by the lender to the short seller on short stock positions
- Capital appreciation from undervalued securities

Other than that, convertible bonds can be very rewarding through the volatile markets, especially through the arbitrage strategy. This concept can be better understood through “gamma trading”.

*Gamma Trading*⁷:

In a convertible arbitrage strategy, we are buying convertible bonds and selling short shares of the underlying stock as a hedge. If the stock rises, we will lose money on the shares we are short, but we will make money on the bonds we own as they appreciate.

To understand gamma trading, we must begin with the “delta”. Delta symbolizes the sensitivity to stock moves. The delta increases as the stock price advances and the bond becomes more equity-like, which means “higher delta”. Delta falls as the stock price declines and the convertible becomes more bond-like, which means a “lower delta”. The change in delta as stock price moves is what we refer to as gamma.



⁷ Hill, J., & O’Donohue, D. (2023, April 17). *Gamma trading: Why big market swings can be good news*. Calamos Investments. <https://www.calamos.com/blogs/voices/gamma-trading-why-big-market-swings-can-be-good-news/>

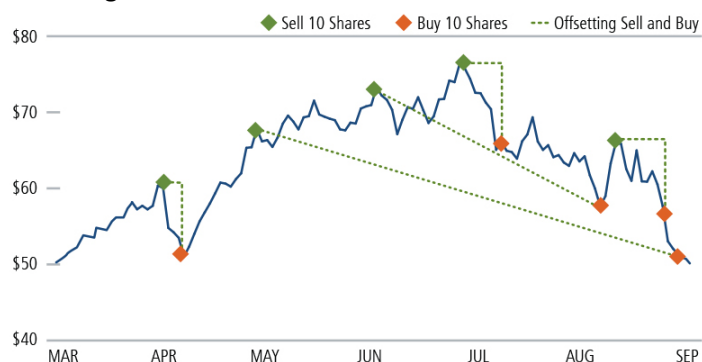
If you look at the convertible fair value price track, you can see that as the price of the underlying stock rises, the convertible value rises, and as the stock value falls, the convertible value falls as well.

In a convertible arbitrage strategy, if a stock rises, we will lose money on the shares we are short, but we will make money on the bonds we own as they will appreciate in value. If we think the stock is undervalued, we can short fewer shares (a bullish hedge). Or, if we think a stock is overvalued, we can short more shares (a bearish hedge). More frequently however, we implement what is called a delta neutral hedge. If we are on a delta neutral hedge, the money we make on the bond and the money we lose on the stock should be equal and offset. Unlike a bullish or bearish hedge where we are seeking to profit from the stock rising or falling, a delta neutral hedge seeks to profit simply from stock volatility.

As the stock moves, our delta changes (gamma) and we need to adjust our position if we wish to maintain a similar hedge. As the stock rises, our delta increases, which means we need to short additional shares to stay on a similar neutral hedge. Conversely, as the stock falls, our delta falls and we need to cover shares to remain on the neutral hedge. From a mechanical standpoint, we continually sell as a stock advances (sell high) and buy as a stock declines (buy low). The more volatility in the market, the more stocks rise and fall—which can give us more opportunities to sell high and buy low.

To give a hypothetical example, let's say we have a convertible bond that converts into 100 shares of ABC stock and has a 0.50 delta at the start.

In this case if our delta is 0.50, to be in the similar neutral hedge, we need to short 50 shares of ABC stock. If on Day 2 the stock rises, and the delta increases to 0.60 we would short another 10 shares of stock to remain neutral. Let's say on Day 3 or Day 4 the stock price declines back down to the original Day 1 level. We would then buy back the extra 10 shares we shorted. We would still be on a neutral hedge with the same bond and stock prices as on Day 1 but we now have real profits booked on shares we sold high and then bought low.⁸



This chart is an example of gamma trading over a longer period. The chart shows five sales and five purchases of ABC stocks. Together, the pattern of selling high and buying low forms. As the stock price moves, we buy or sell based on the change in delta (gamma). At the end of the period, the stock price is very similar to where it was at the start of the period, and theoretically, the convertible bond price and

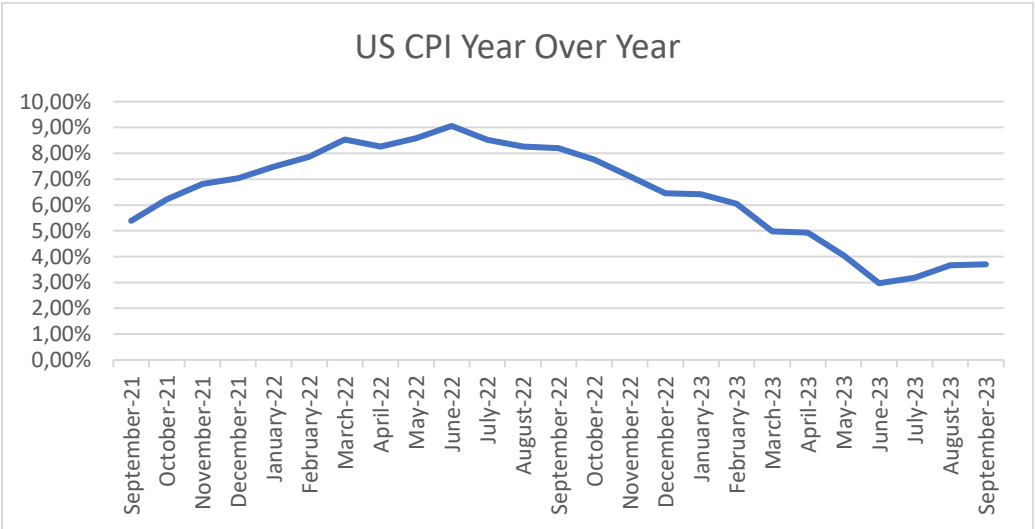
⁸ Hill, J., & O'Donohue, D. (2023, April 17). *Gamma trading: Why big market swings can be good news*. Calamos Investments. <https://www.calamos.com/blogs/voices/gamma-trading-why-big-market-swings-can-be-good-news/>

the delta would be fairly similar to their starting levels, as well. If we had simply held the position, we may have only minimal profits or losses. However, in this hypothetical example, we have locked in realized profits from the five sets of gamma trades.

Overall, while big market volatilities may not be comfortable for other investors, convertible bond arbitrage strategy can provide gamma trading opportunity and make profit.

4. Past Performance Analysis of Convertible Bonds:

In 2022, One of the most significant economic statement globally was that “The US Federal Reserve has triggered and economic climate change.” Therefore 2022 was a generally disappointing year for risk assets. Convertible bonds are not an exception regarding this, as both the equity market sell-off and fixed income headwinds (rising interest rates) worked against the asset class. We have seen one of the fastest interest rate hiking cycles in history, and for 2023, looking to the recent data, we see that in US particularly, the inflation is still going down for 2023 but in a smoother way. A reason is the disappear of base effects (like the jump in energy prices due to Ukraine-Russia war is rolling off) but also the Central Banks have moved to fine-tuning rates.



Source: U.S. BUREAU OF LABOR STATISTICS

Monetary policy remains tight, while the fiscal policy is mounting up the further debt. After lifting the debt ceiling, US Treasury launched more than USD750bn of bonds into the market.⁹ This is drawing liquidity from the market and puts upward pressure on the interest rate curve.

The reason why convertible bonds can be in rise again after years of silence, is this macro environment and this will be supported through the past performance analysis, how the convertibles proceed beside equity market and traditional bond market.

⁹ Convertible bonds - market update Q3 2023. Convertible Bonds - Market update Q3 2023. (n.d.). <https://www.schroders.com/en-ch/ch/professional/insights/convertible-bonds-market-update-q3-2023/>

First, looking at historical performance for convertible bonds, traditional bonds, and equities will be insightful to understand how these different instruments behaved in past, and how they reacted to certain events. The comparisons will be made with the instruments defined below:

iShares US Aggregate Bond ETF Fund:

iShares U.S. Aggregate Bond Index Fund seeks to provide investment results that correspond to the total return performance of fixed-income securities in the aggregate, as represented by the Bloomberg U.S. Aggregate Bond Index.

The Fund pursues its investment objective by seeking to match the total return performance of the Bloomberg U.S. Aggregate Index, which is composed of approximately 10,000 fixed-income securities. The fixed-income securities that comprise the Bloomberg U.S. Aggregate Index include U.S. Government securities and corporate bonds, as well as mortgage-backed securities, asset-backed securities and commercial mortgage-backed securities.¹⁰

The reason behind the choice of iShares US Aggregate Bond ETF is that it seeks to track the investment results of the Bloomberg U.S. Aggregate Bond Index. This index represents a wide array of fixed-income sectors, including government, corporate, mortgage-backed, and asset-backed securities as mentioned above. Analyzing iShares US Aggregate Bond ETF Fund can provide insights into the overall performance of the U.S. bond market.

iShares Convertible Bond ETF:

The iShares Convertible Bond ETF (the “Fund”) seeks to track the investment results of an index composed of U.S. dollar-denominated convertible securities, specifically cash pay bonds, with outstanding issue sizes greater than \$250 million.

The Underlying Index is a subset of the Bloomberg U.S. Convertibles: Cash Pay Bonds Index, which is one of the four classes of the Bloomberg U.S. Convertibles Index (the “Parent Index”)

The Underlying Index is market capitalization-weighted and consists of only cash pay convertible bonds. Cash pay convertible bonds allow the holder of the bond the option to convert into a pre-specified number of shares of the issuer’s common stock, but do not require conversion. The securities may be investment-grade, high yield (as determined by Bloomberg Index Services Limited).¹¹

iShares Convertible Bond ETF provides exposure to a broad range of convertible bonds. Analyzing its holdings can give you insights into the performance of this asset class which is one of the most important objectives of this report.

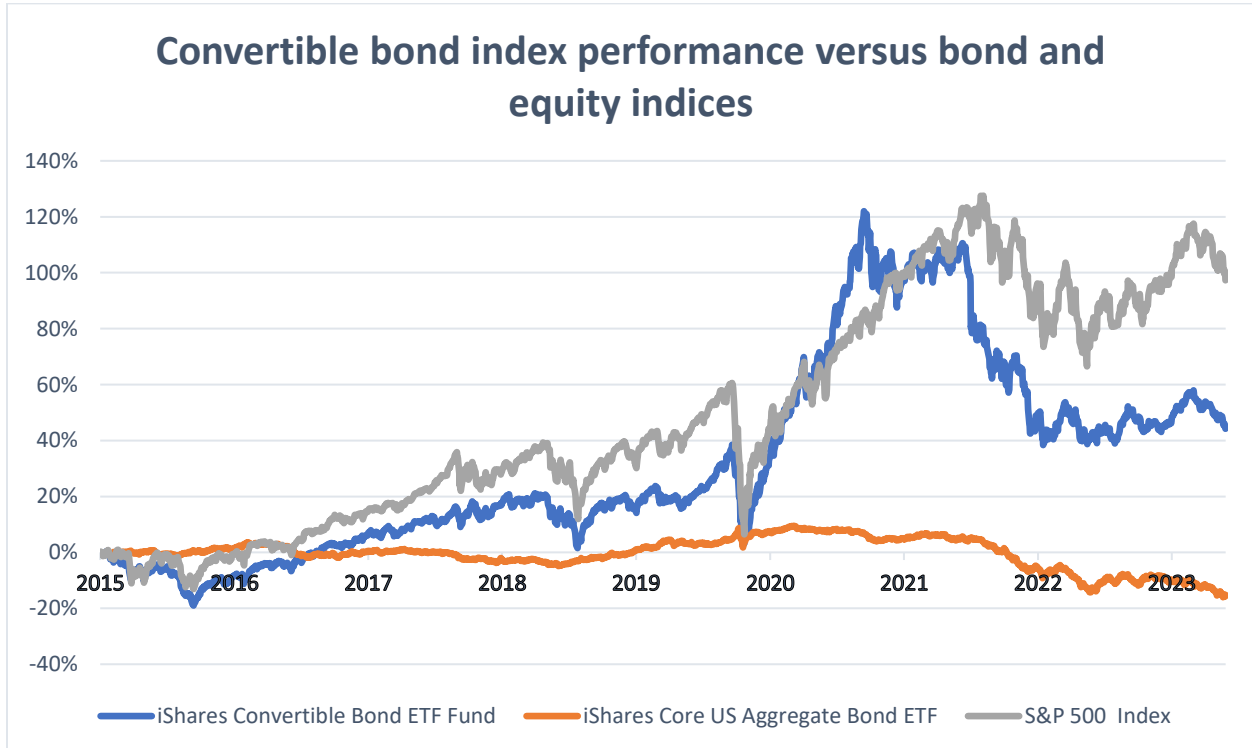
¹⁰ BlackRock, Inc. (n.d.). iShares Aggregate Bond Index, Summary Prospectus. <https://www.blackrock.com/us/individual/resources/regulatory-documents/stream-document?stream=reg&product=FF-WFBIX&shareClass=CLASS%2BA&documentId=1699858~1699855~1699854~1680870~1586906~1864419~1864374&iframeUrlOverride=%2Fus%2Findividual%2Fliterature%2Fsummary-prospectus%2Fsumpro-usaggbond-inv-us.pdf>

¹¹BlackRock, Inc. (n.d.-a). iShare Convertible Bond Summary Prospectus. <https://www.ishares.com/us/library/stream-document>

S&P 500 Index:

The S&P 500 is widely regarded as the best single gauge of U.S. large-cap equities. The index includes 500 leading companies spanning all sectors of the U.S. stock market. It covers approximately 80% of the U.S. equity market capitalization and over 50% of the global equity market.

S&P 500 is an index that is commonly used to understand the progression of the equity market and how the U.S. economy reacts to different economic situations. Comparing the index with the instruments mentioned above gives more reliable performance analysis.



Convertible bond index performance versus bond and equity indices

If one look at the chart over time, it can be said that the convertible bond market is imitating the movements of the equity market on a less rate of change between 2015 and 2019. The reason behind the less return on investment can be explained by the riskiness of the instrument. As said before, convertible bonds are considered under the class of fixed income instruments, which gives it a less risk level than equity market where also there is less return. As COVID lockdown starts in late 2019 in U.S., we see one of the bottom points of the chart for all the instruments.

After the bottom point in 2019, a divergence between convertible bonds and equity market can be seen, which clearly shows one of the most important strengths of Convertible Bonds, which is high performance under volatile conditions. It can be said that for most of the global markets, the re-opening after Covid lockdowns were highly volatile, (with government interventions and high liquidity), therefore, for a specific time, the CB market is outperforming the equity market, which is very rare under the different risk-return appetite of these two different classes of investment instruments.

iShares Conv.	Beta (β) Coefficient	Std. Err.	t	P> t	[95% conf. interval]	R-squared
iShares Agg. Bond.	0.885	0.0230848	38.33	0.000	.8396369 .9301793	0.8624
S&P 500	0.026	0.0002296	112.91	0.000	.0254695 .0263699	
Alpha Coefficient	-58.23744	2.561025	-22.74	0.000	-63.25983 53.21504	

Multiple Linear Regression model for Convertible Bonds

It is important to understand the relative price movements with a multiple regression analysis. First, we need to know what the model indicates. It would be better to explain each sub section of the model made using traditional bonds and equity market with convertible bonds.

Alpha Coefficient: It measures the difference between an investment's expected returns based on its beta and its actual returns. A positive alpha indicates the investment has performed better than its beta would predict. A negative alpha indicates an investment has underperformed, given the investment's beta.

Beta (β) Coefficient: It measures an investment's sensitivity to market movements. A beta greater than one indicates the investment is more volatile than the market. If beta is less than one, the investment is less risky than the market. Here we observe the following beta coefficients:

- **iShare Aggregate Bond:** The coefficient for iShare Aggregate Bond is 0.8849081. This means that, holding S&P 500 constant, a one-unit increase in iShare Aggregate Bond is associated with an increase of 0.885 units in iShares Convertible Bond.
- **S&P 500:** The coefficient for S&P 500 is 0.026. This means that, holding iShare Aggregate Bond constant, a one- unit increase in iShare Aggregate Bond is associated with an increase of 0.026 unit in iShares Convertible Bond.

Standard Error (Std. Err.): This is the standard deviation of the sampling distribution of the coefficient estimate. It measures the variability of the estimate. Smaller standard errors indicate more precise estimates.

t (t-statistics): The t-statistic measures how many standard deviations the coefficient estimate is away from zero. A higher absolute t-value suggests a more significant relationship.

p value (P>|t|): This is the probability that the coefficient is different from zero purely by chance. A low p-value (typically < 0.05) suggests the coefficient is statistically significant.

[95% conf. interval]: This represents the 95% confidence interval for the coefficient. It provides a range of values within which we can be 95% confident the true coefficient lies.

R-squared: The R-squared value of 0.8624 indicates that approximately 86.24% of the variance in iShares Convertibles is explained by the independent variables iShares Aggregate Bonds and S&P 500 in the model. This suggests a strong explanatory power of the regression model.

Now looking at the model, it can be significant to say that the changes in the convertibles in the past, has been in a linear relationship with both the equity market and the traditional bond market. While through

the model we can see a stronger relationship between convertibles and traditional bonds, it signals a good risk escape for the investors who might find equity market too risky and the bond market too flat.

5. Advantages and Constraints:

Convertible bonds possess unique characteristics that provide distinct advantages to investors. However, they also introduce certain constraints that may impact both investors and issuers, potentially affecting their appeal. In this section, we will analyze these aspects to gain a comprehensive understanding of this financial asset.

Advantages of Convertible Bonds:

Convertible bonds allow issuers access to capital at a lower cost compared to traditional fixed-income instruments, as investors are willing to accept lower yields in exchange for the conversion feature. In cases where conversion into equity is not economically advantageous, the issuer effectively issues a bond at a reduced rate without diluting existing shareholders.

From the convertible bondholder's point of view, they can benefit from the issuer's stock price appreciation if they choose to convert their bonds into common shares. This makes them indirectly exposed to the stock of the company, even if they do not own it, and can decide to convert it when they want to. In other words, this feature allows them to gain if the stock price rises, while does not imply a loss in case the stock price falls. Because of this, we can consider convertible bonds as diversification instruments, as they can expose a bond portfolio to the returns of the stock market, while at the same time containing the higher intrinsic risk of stocks.

Constraints of Convertible Bonds:

Nevertheless, there are also disadvantages of issuing convertible bonds. From the issuer's perspective, the conversion of convertible bonds into equity can lead to dilution of existing shareholders if the stock price rises significantly. This could be a concern for companies as it impacts the ownership structure.

Also, convertible bonds are inherently more complex than traditional bonds, requiring additional due diligence to understand the terms and conversion features. This complexity could dissuade some investors and, in turn, reduce the capital raised through these instruments.

Another negative aspect is the volatility risk; convertible bonds are sensitive to changes in the issuer's stock price, so if the stock price drops significantly, the conversion feature may become less valuable, and bondholders may not receive the expected equity upside. Finally, convertible bonds tend to yield lower returns than both stocks and traditional bonds, primarily due to their reduced yields. The presence of call provisions, which allows issuers to enforce bond conversion into stock, further influences investor choices, potentially leading them to explore alternative investment option

6. Conclusion and Investment Recommendations:

Now we have reached a macroeconomic environment where the leading central banks of this world in union combine the pause (or more probably, the end) of rate hikes with a higher for longer rate scenario, and potentially more rate hikes on the horizon.

We have already seen one of the fastest interest rate hiking cycles in history – and surprising to many analysts, the economy stayed strong, the labor market stayed resilient, and the US consumer kept spending.

We have underestimated the spending power of the US consumer. Now, it seems that the last money of the COVID-19 cheques has finally been spent and credit card limits have been reached.

The global high yield bond market has increased since the Great Financial Crisis while the convertibles market remained almost on the same capitalization. There is a lot of refinancing coming up – and it is coming up at significantly higher interest rate levels and with much tighter credit conditions.

The most dangerous day for any fixed income investment is the day of maturity. The risk of default jumps significantly when refinancing conditions are tight, when interest rate costs are considerably higher than before, when bank lending standards are tighter, when default rates are on the rise, and when less liquidity is around.

Like in 2009 when optionality was very attractive, and it is possible now we may see such attractive pricing levels in the future for convertible bonds, especially with less risk than other asset classes.

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