Convertible Bonds: Historic opportunity or illiquid quagmire?

By Danielle Levy | 13:00:00 | 02 February 2009

At the outset of 2008 some 70% of convertible bonds were owned by hedge fund arbitrageurs seeking to exploit short-term valuation anomalies.

When the crash came and these hedge funds became forced sellers it sent the asset class into freefall, a reality which will scare many potential income-seekers who are now drawn to attractive yields.

But according to figures from Aviva Investors, by the start of this year the proportion of the market held by hedge funds had shrunk to 40%, with some 60% now held outright by more fundamental investors.

It has left an opportunity which Rathbone Brothers' David Coombs has been keen to exploit. He begun buying in during September, gaining access in the form of the RWC Global Convertibles and Aviva Global Convertibles funds.

These funds are exploiting short-dated convertibles yielding north of 2.5% in companies such as Bank of America.

The attraction for many is that while convertibles are at their current prices, yielding more than high-yield debt, some 60% of the market is made up of instruments issued by investment grade companies.

Brewin Dolphin head of fixed income research, Peter Smart, agrees and said he is seeing some incredible anomalies in the market. 'Convertibles make a high yield credit story. They tend to be short-duration and senior ranked paper, which is exceptionally important right now,' he said.

But for others the sharp sell-off seen last year speaks to the fact that convertibles are still an illiquid asset class.

It is for this reason that Michael Lally, an investment director at Thesis Asset Management, prefers to buy corporate bonds and equities separately. He also says specific preference shares, excluding those issued by banks, could offer a viable alternative to CBs.

Andrew Rambsottom, an investment director at Tilney Private Wealth Management, said: 'Convertibles tend to rank just before equity in the issuers' capital structure. With most convertibles well out of the money, the issues are effectively bonds, and we prefer debt with better covenants.'

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Registered in England no: 3828440.