Convertible Bond Arbitrage 2009 and Beyond

Convertible arbitrage has been one of the best performing hedge fund strategies year to date in 2009, up 17.9% while the HFRI general index has gained 4%. Recall, however, that convertible bond arbitrage was one of the worst performing strategies in 2008 losing 33% while the HFRI general index lost 19%.

The losses came from a confluence of general risk aversion, deleveraging by banks and institutions, hedge fund redemptions and failures from over-levered portfolios, and a collapse in the funding mechanism. So acute was the risk aversion that convertibles were sold down regardless of issuer fundamentals or credit quality. Such sell-offs naturally create opportunities for the astute investor as idiosyncratic risk is mispriced by a market on the one hand, and systemic risk is overpriced by the market on the other, in the midst of market panic.

It is natural therefore that once the acute and broad based risk aversion had reached its zenith, convertible bonds would represent exceptional value and rebound. The last 4 months have seen this occur in a reversion of the systemic risk trade. Convertible bonds have rallied across the board with demand coming from fundamental credit investors, hedge funds, corporates and issuers buying back their own bonds. Notably absent or at best much diminished was demand from bank prop desks.

For corporates, convertible bonds are an attractive means of funding. Issuers will balk at equity issuance at what many consider distressed equity valuations. Financials and Banks will continue to raise equity capital of course but for regulatory purposes. Corporates will find equity an expensive route to funding. Realized and implied volatility levels are such that convertible represent cheaper funding through selling equity at a premium and paying reduced rates of interest. US and European issuers have issued over 6 billion USD respectively year to Apriljabre. For issuers with the wherewithal, retiring existing debt trading at acutely distressed levels and refinancing with new issues is efficient balance sheet management. Convertible buybacks in the US alone amounted to some 7 billion USD in April alone and a total of 30 billion USD since 2H 2008.

For hedge funds, no longer do they face the volume of redemptions they faced in 4Q 2008 and the first couple of months of 2009. Greater predictability of their equity base has allowed them to restore their risk exposure. Moreover, while the financing mechanism hasn’t been fully restored, prime brokers are beginning to offer term financing for diversified portfolios of US and International convertibles.

The absence of bank prop trading in convertibles is an interesting theme. Bank prop demand was a major force in the convertible market pre crisis. Capital constraints have removed this important participant with interesting consequences. By reason of their size in the market, bank prop trading was a major competitor in the convertible market. The cost of funding for prop desks also put them at a relative advantage and also resulted in excess demand distorting issuance and pricing in the primary market.

One of the main concerns of investors has been liquidity in the convertible market. Liquidity is a fickle quantity. And yet, convertible markets have recovered a good deal of their liquidity since 2008. Liquidity is arguably better than in years such as 2005 when the hedge fund industry represented the large majority of demand for convertibles, for liquidity is more than demand or supply but a balance of both, and a diversity of participants on either side. Anecdotal evidence collected from my conversations with several convertible arbitrageurs suggests that most of their portfolios have become liquid to the point that even a large fund could liquidate their portfolios in a matter of days, if not a single day.

Convertible arbitrage also benefits from a diversity of applicable trading styles. While the distressed valuations at the end of 2008 suggested a glaring risk aversion reversal trade, the current market is replete with less-directional opportunities. These arise from the diversity of pricing and valuation across the convertible space, as well as a revival in primary issuance. The credit elements of convertible arbitrage were highlighted in 2008 and will continue to be interesting. Directional expressions of fundamental views on companies can be very efficiently captured using convertibles as well. A fundamental view on a company need not be restricted to first order (levels) but can extend to views about the cheapness of the volatility of the company. Capital structure trades can also be expressed with convertibles for example in theoretical replications with bounded jump to default values for a range of recoveries. The bottom line is that while somewhat complex, convertibles now represent good absolute value, good relative value, and value as a tool for expressing more esoteric arbitrage situations.