Rising interest rates and convertible bonds

A key corollary to the extraordinary monetary and fiscal support provided in the wake of the COVID-19 pandemic has been renewed concern about interest rates. In particular, monetary aggregates expanded at unprecedented rates (US M2 grew by 19.6% of GDP in the 12 months to February) and, in contrast to the QE programs after the global financial crisis, most of the nascent stimulus money has made its way to the real economy, as evidenced by the fact that private sector demand deposits grew by over 10% of GDP during the past year. Consequently, as economic activity begins to normalize, there are concerns that these monetary surpluses could result in inflationary spikes, especially if they encounter supply-side bottlenecks, such as the ongoing global semiconductor shortage. In turn, such spikes could require the Federal Reserve to increase interest rates to achieve their primary objective of maintaining price stability.

So far in 2021, bond markets have begun to tentatively price these risks in. The US 10-year bond yield has increased 73bps to 1.61%. While still low by nominal standards, this is already back to pre-COVID-19 levels and far above the low of 51bps set in April 2020. Moreover, this rise has been driven largely by increases in inflation expectations as US 5- and 10-year inflation break-evens have risen 66bps and 40bps, respectively. With both inflation and real 10-year rates remaining at historically low levels, this suggests much more room for interest rates to rise should the inflation genie escape the bottle, even if only temporarily.

This has obvious implications for asset pricing – both through first order (interest rate) and second order (credit spread widening and asset allocation shifts) effects – and thus any fixed income manager must address these risks.

Consequently, we thought it worthwhile to provide an update on how we are addressing the potential for higher inflation and interest rates within the Polar Capital Global Convertible Bond Fund. Below, we address how interest rates affect convertible bonds in general and how we have sought to position our portfolio to effectively mitigate these risks within the Fund in particular. We believe this should give investors sound insight into how we are seeking to protect their capital without sacrificing upside return opportunities despite the potential for either volatility or even increases in interest rates.

Rising rates and convertibles: first order effects

Though convertibles are a fixed income asset insofar as they have the capital protection characteristics of a straight bond – guaranteed coupons and capital return at maturity – their hybrid characteristics mean they have markedly lower duration. As a result, convertibles have only a fraction of the interest rate sensitivity (rho) as a similar maturity straight bond would.

The reason for this is quite intuitive – if a convertible trades deeply in the money (ie has a high delta) it is unlikely to be redeemed at maturity but rather is more likely to convert. As such, its risk characteristics will be more equity-like than bond-like, implying it has a lower duration. Conversely, if a convertible is out of the money (low delta), it is more bond-like and will have a duration that more closely approximates that of a straight bond. Thus, a convertible's rho (interest rate sensitivity) is inversely correlated with its delta.

In short, because convertibles have both equity and bond-related exposures, they have only a portion of the risk applicable to either asset class itself. This is seen clearly in the chart below which highlights that convertibles currently have a duration of approximately half that of high yield bonds and less than one third of investment grade bonds.

David Keetley
Fund Manager
David joined Polar Capital in October 2010 to establish the global convertible team and is co-manager of the Global Convertible Strategy and the Global Absolute Return Strategy.

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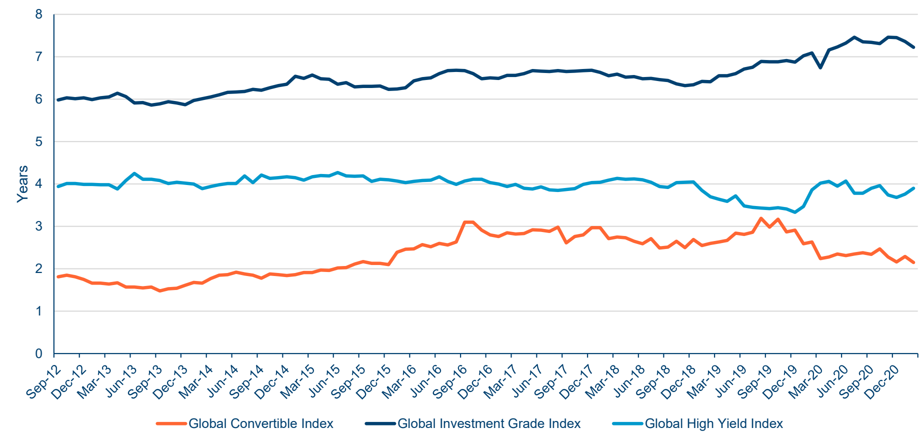
Stephen joined Polar Capital in October 2010 and is co-manager of the Global Convertible Strategy and the Global Absolute Return Strategy.

Awards & ratings

Effective Duration of Fixed Income Asset Classes



Source: Polar Capital, using BAML Indices (VG00 – Global 300 Convertible Index, HW00 – Global High Yield Index, G0BC – Global Investment Grade Index)

Rising rates and convertibles: second order effects

While the above suggests the ways in which convertibles' unique characteristics make things simpler for managers, there are ways in which these make things more complicated as well. In particular, managers must contend with three other considerations which are also affected by interest rates:

"Interest rate cycles affect allocation within equity sectors, resulting in a preference for low-duration earnings streams (Value) over longer-duration ones (Growth)"

- **Credit spreads**
- **Equity market volatility**
- **Relative equity performance of various sectors**

First, credit spreads tend to widen as interest rates rise. The rationale for this is a function both of risk (higher interest rates makes funding less affordable, implying companies will have more difficultly repaying bonds, thus necessitating greater discounting) and asset flows (higher risk-free rates crowd out funds for corporate bonds due to reduced investor need to move 'down the curve').

Just as with straight bonds, widening spreads are a headwind for convertibles' valuations. Thankfully, this is offset to some degree by the fact that volatility also tends to rise with interest rates. Though this does not usually offset all the credit-related exposure, it can often offset a material amount, leaving convertible managers with a relatively more controlled exposure to manage.

Finally, interest rate cycles affect allocation within equity sectors, resulting in a preference for low-duration earnings streams (Value) over longer-duration ones (Growth). As noted above, convertibles have meaningful exposure to equity markets, meaning managers must carefully consider the sectoral weighting in their portfolios as interest rates begin to shift. This is a particularly important question in the current cycle given the numerous Growth companies within the IT space that have issued convertibles in recent years.

Actions taken within the Fund to manage these risks

The Fund has multiple tools available to us to manage these risks. Foremost among these are the ability to hedge interest rates and credit spreads directly. While we do not hedge at the position level, we can and do at the portfolio level:

- **Hedge interest rate exposures:** Although the Fund's duration is low for the reasons noted above, it is non-zero. Thus, as interest rates remain low and represent an asymmetric risk against investors, the Fund has chosen to sell futures on US Treasuries to offset this eventuality. This is a low-risk way to protect capital as it simply hedges the Fund from movements in interest rates. Should rates fall, while our hedges will lose money, our long convertible bond positions would gain a commensurate amount. Thus, partially hedging rates at these levels and in the face of potentially meaningful gap risk seems a prudent move.
- **Hedge portfolio credit risk:** We remain comfortable with all our credit exposures. The target rating of the portfolio remains investment grade (BBB-) and each individual company within the portfolio has been subjected to a formal credit review, after which we have concluded the credit of the portfolio is unlikely to be materially impaired under normal market conditions. However, in the shorter term, the same dynamics which may result in interest rate increases may also result in widening credit spreads. Moreover, with spreads remaining tight despite increased equity-market volatility, it seems an opportune time to consider additional measures to protect capital. Towards this end, the Fund has bought protection on the CDX North American High Yield Index to reduce our overall risk to widening credit spreads.

"We believe that further convertible out-performance can be achieved by rebalancing the portfolio's equity and sector exposures to those companies, sectors and geographies that will benefit from a rising rate environment."

Finally, although the Fund maintains a relatively diversified sectoral profile, we have undertaken a comprehensive review of all sectoral exposures. In general, it is not clear to us that interest rate rises will necessarily have a negative impact on equities in the short term. Indeed, equities have historically tended to perform best when bond yields are low, yet rising in expectations of improved economic performance – precisely the current situation. Conversely, however, periods of significant increases in interest rates in excess of inflation, resulting in increases in real interest rates, have historically provided some of the largest headwinds to equity valuations.

These contradictory cases indicate the need for convertible managers to understand the nuances driving interest rates before making a determination as to the correct way to manage and exploit them. We believe that the most likely medium term outcome is for a moderately reflationary economic expansion as the World recovers the productivity lost due to the Covid-19 disruptions, leading to an increase in both interest rates and corporate earnings. This would be consistent with a rotation towards Cyclical and Value stocks as the improved pricing environment benefits most those companies whose operations are most sensitive to the macro backdrop or where high operating leverage gives them the greatest incremental earnings power.

Despite this generally sanguine outlook, we are also mindful of the potential for meaningful inflation overshoots and the risk they cause for unexpected interest rate hikes. Such a scenario would be a headwind for equity exposures in general but due to the significant implied increase in long term real rates, this would be especially pernicious for longer-duration assets. As with our base case assumption, this implies an outperformance of Value over Growth.

Thus, we believe that the best risk-adjusted opportunities currently exist in Cyclical and Value sectors such as Industrials, Materials, Construction, Financials, and Natural Resources. In addition, we believe the above also implies an optimal preference for Developed over Emerging Markets. In addition, we believe Europe may see a period of outperformance given its higher concentration in Industrial, Cyclical, and Value companies.

We have already made moderate changes in our portfolio to reflect these views while remaining on the lookout for additional ways to increase such exposures where attractive risk/reward exists.

Conclusion

As we pointed out in **Fixed Income Investing in a Rising Rate Environment**, Convertibles generally outperform other fixed income asset classes during periods of rising rates. This is due to their lower duration than other fixed income asset classes and due to their positive correlation to rising equity volatility. Consequently, in the interest of prudence we have reduced some of our interest rate and credit spread exposures via portfolio hedges. However, in addition we believe that further convertible out-performance can be achieved by rebalancing the portfolio's equity and sector exposures to those companies, sectors and geographies that will benefit from a rising rate environment. As a result, we believe the Fund is well positioned to generate good risk-adjusted returns for our investors while continuing to achieve our three objectives of income, capital protection and capital growth despite the more challenging macro backdrop.

Polar Capital Global Convertible Team

8 April 2021

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