01/2015

Script - Convertible Bonds Webcast

Convertible bonds: Offensive yet defensive

Convertible bonds are securities issued by a publicly traded company that grants the investor the right to exchange the bonds for shares of the company within a fixed time period. In principle, convertible bonds combine the characteristics of stocks and bonds.

Why should yield-seeking investors care about convertible bonds? The answer is simple. In a low-interest environment, convertible bonds behave like bonds and provide attractive coupons. We should not forget that there is no guarantee stock investors will be paid dividend. A company may not declare dividend if it has run into difficulties. On the contrary, holders of convertible bonds can enjoy a steady stream of coupon income. In addition, convertible bonds are subject to lower downside risks but may participate in most of the upside of stocks.

For example, in January 2010, company A issued 5-year convertible bonds with a coupon rate of 3% p.a. and an exercise price of USD5. Investors may exercise their right to convert the bonds into shares before January 2015. Assuming the share price of company A rises to USD6, holders of the convertible bonds may purchase the shares through conversion at a lower price and make a profit. If, however, the share price of company A falls to USD4, which is lower than the exercise price, the holder may continue to hold onto the bonds and receive coupon income.

Benefits of convertible bonds

With both stock- and bond- like attributes, convertible bonds offer flexibility to investors to cope with the ever changing investment environment.

When the stock market is doing well: a portfolio of convertible bonds can be more aggressive and attempt to achieve returns comparable to stocks. When the stock market is doing poorly: holders of convertible bonds may let the portfolio behave more like traditional bonds.

Similar to the US high yield market, the size of the US convertible bonds market is also the largest in the world.[1] The US market also offers the most choices, with nearly equal number of issuers of investment grade, non-investment grade and unrated bonds.

In the convertible bonds market, the share of unrated issuers has grown[2]. This is because many of these companies have fairly sound balance sheets, that is low or without debt or uncomplicated capital structures. And therefore, they do not intend to pay Moody's or Standard and Poor's to rate their securities.

Convertible bonds provide potential returns comparable to equities but with lower volatility, which offers protection against downside risks during declining markets. The combination of offensive and defensive natures makes convertible bonds a compelling choice during times of uncertainty. The key is to convert at the right time.

Historically, convertible bonds have exhibited a high correlation to equities, meaning its price movements are quite similar to the stock market. In contrast, the correlation between convertible bonds and US Treasuries is only low, meaning their prices rarely move in tandem with each other.

Historically, convertible bonds exhibit asymmetric risk/reward profile, meaning they participate more in the upside than in the downside of the underlying stock. Since 1988, convertible bonds have delivered equity-like returns with lower downside volatility.

Risks of convertible bonds

Convertible bonds are subject to risks associated with both stocks and bonds. These bonds can fluctuate in value when the price of the underlying stock changes. If interest rates rise, values of convertible bonds decline.

It is worth noting that the convertible bonds market is relatively complicated as it is difficult for retail investors to access it on their own. A more practicable way of investing in convertible bonds is to entrust the task to a professional management team.

In general, a fund management team analyses different aspects of the investment, such as:

- Financial condition
- Valuation
- Credit rating
- Bond spread

[1] Source: Bank of America Merrill Lynch as of 06 November 2014
[2] Ibid

Holdings are adjusted as market conditions change, by selling the bonds or converting them into shares.

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