MFM
MIRANTE FUND MANAGEMENT

Convertible bonds:

an ideal asset class to enter the next economic cycle

Comment as of March 31, 2020

- ✓ In a challenging environment, convertible bonds once again demonstrated their resilience.
- ✓ Today, they offer expected returns that are much higher than conventional bonds.
- ✓ A defensive strategy reduces risk in a non-linear way.
- ✓ The next economic cycle offers a promising macroeconomic context for convertible bonds.
- ✓ Convertible bonds increase diversification and risk-adjusted returns in any asset allocation strategy.

A crisis of unprecedented speed

The spread of the pandemic has transformed the daily lives of a significant part of the world's population. Step by step, Asia, Europe and the United States have developed a comprehensive policy response to contain this health crisis. Containment has been imposed to varying degrees in all regions to protect health systems from overload. With economic activity suddenly halted worldwide, the impact on financial markets was felt almost immediately. In the United States, over three million people filed for unemployment insurance during the week of March 21. These figures confirm the economists' fears, with many predicting a historic contraction for the global economy that may be an order of magnitude higher than any previous recession.

Despite loud announcements by policymakers and central bankers, financial asset values continued to fall sharply in markets, driven by panic and lack of liquidity. It now appears that the semi-coordinated response of central bankers has helped to stabilize the financial system. The speed of the fall in equity prices and the increase in credit spreads was out of all proportion to previous corrections. The correlation between the different asset classes converged very quickly, driven by the need of some investors to generate liquidity.

Defensive convertible strategies Demonstrate their resilience

In this challenging environment, convertible bonds have once again demonstrated their resilience. Indeed, since the beginning of the year, our defensive convertible bond strategy has declined by 7.8% (outperforming its investment-grade benchmark), while global equity markets (MSCI World All Country EUR) have fallen by 19.6%. Equity market volatility was almost five times ours, at 25.5, compared to 5.6 for the Fund.

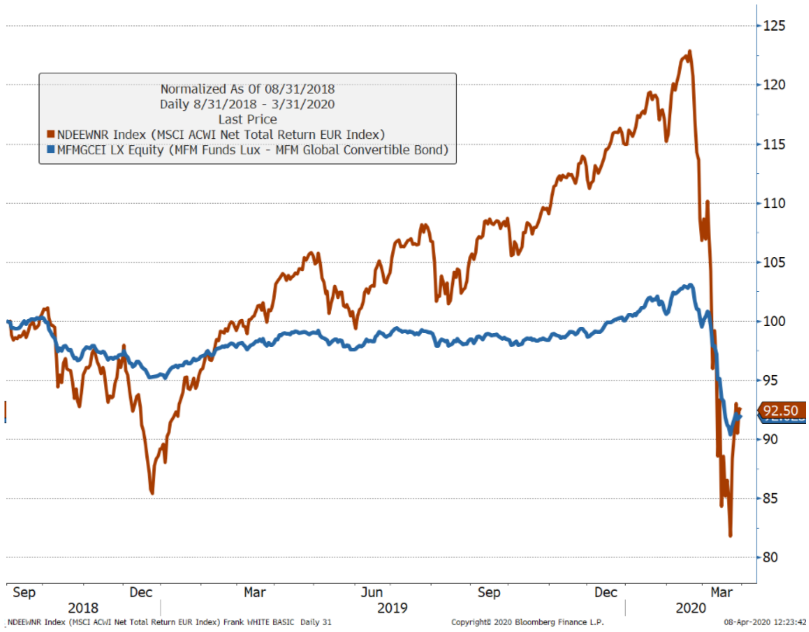


Figure 1 – Performance MSCI World All Country & MFM Global Convertible Bond from the 1st of September

In fact, if we look closely at the performance of MFM's convertible funds during periods of market stress, by stretching the period to August 31, 2018, therefore also capturing the Q4 2018 market drop (see graph above), our two convertible strategies still outperform equities. The excellent performance of our funds confirms the usefulness of such investments, which are better able to absorb unpredictable market shocks.

Once again, convertible bonds demonstrate their ability to reduce risk in a non-linear manner despite active exposure to equities. This characteristic is generated by the convex nature of these instruments, particularly when the "bond floor" holds up firmly, since the loss on the equity component of the instrument is strongly mitigated. As a result, convertible bonds remain an ideal asset class during and after the crisis, as they enable investors to participate in the anticipated rebound in equities by actively minimizing volatility and, therefore, the drawdowns inherent to these nervous periods.

Over the current year, one of the main benchmarks for convertible bonds (Global Focus Refinitv index, ex UBS Thomson Reuters) delivered a performance of -8.01%. The two main factors contributing to the negative return since the start of the crisis have been the equity component (the value of the conversion option) and the cheapness component (the difference between the market price and the theoretical price of the convertible bond). During this crisis, the impact on the cheapness came mainly from convertible bonds with high credit quality. This means the convertible bonds « universe » is now attractive in terms of valuation. Investors can take advantage of higher yields and benefit from any rebound in the equity market. This situation can be compared to 2008. More specifically, some convertible bonds of high credit quality, with near-zero sensitivity to equities and with short-term maturities, have recently traded below their bond floor level (the equivalent of the value of an ordinary bond from the same issuer with an identical maturity and coupon), offering yields far superior to regular bonds, as well as equity optionality.

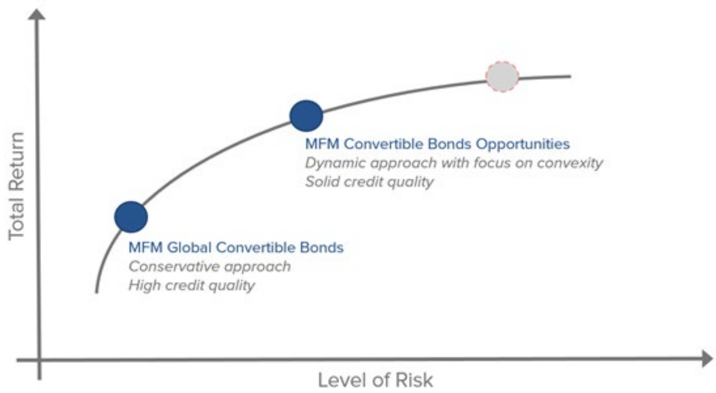
All these findings argue for an overweighting of convertible bonds in any asset allocation, especially during the period of economic instability that we will experience once we emerge from the health crisis.

Our convertible strategies

MFM Mirante Fund Management is a convertible bond specialist who has received several awards for the quality of its management since 2003. Today MFM offers two investment approaches:

MFM Global Convertible Bonds :

A defensive strategy focusing on credit quality to ensure the robustness of the bond floor when necessary. This strategy focuses on the credit quality of issuers. This quality, particularly in the event of a sharp widening of credit spreads, generates resilient bond floors, while sharply reducing sensitivity to equities, which are inherently more volatile.



By way of illustration, in March, at the heart of the crisis, the equity exposure of this strategy was mechanically pushed close to zero.

MFM Convertible Bonds Opportunities:

A more dynamic strategy seeking to benefit from all the characteristics of the convertible universe in order to optimize its convexity and consequently its Sharpe ratio. The strategy is a dynamic core-satellites approach. The core has a buy and hold bias. It focuses on liquidity as well as diversification across both regions and sectors. The core main objective is to mitigate idiosyncratic risks. The performance is enhanced through satellite boosters while defensive satellites prime target is to minimize drawdowns. The satellites' target is to generate alpha exploiting, both tactically and opportunistically convertible bonds specific situations.

Performance of our strategies.

The performance of the MFM Global Convertible Bond Fund (Class EUR, I) for the current year through March 31 was -7.82% compared to -8.01% for its investment grade benchmark.

In relative terms, our underweight position in European Industrials helped us, as did our underweight position in Asia-Ex names in the Communications Services sector. In absolute terms, Europe was the weakest region, followed by the US. Real estate was the weakest sector, followed by Industrials, and Technology. However, the Technology sector in the Asia-Ex region benefited from a strong rebound at the end of March. In this defensive strategy, we prepared ourselves by prudently managing our risk exposure and increasing our cash position opportunistically to take advantage of opportunities in this challenging environment.

The performance of MFM Convertible Bonds Opportunities (Class EUR, I) was -8.14% compared to -9.02% for its benchmark.

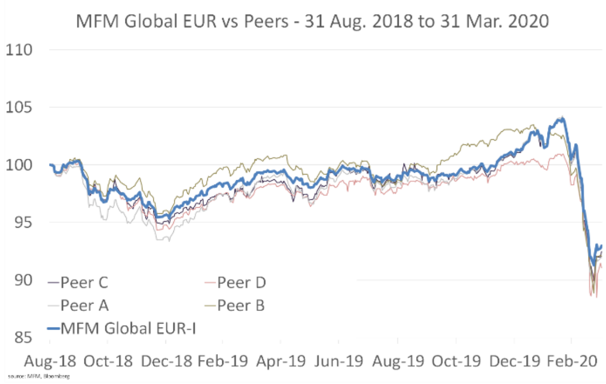
In relative terms, we benefited from our underweight position in European bonds in the Consumer and Industrials sectors. Also, our underweights in Energy, Health Care, and Communication Services in the US were positive relative contributors. In absolute terms, the US Technology and Communications Services sectors were the principal detractors, while the Consumer Discretionary sector was the main positive contributor. In terms of strategy and portfolio construction, core portfolios acted as a shock absorber, while our satellite strategies allowed us to take some profits at the beginning of the crisis while diminishing our risk budgets.

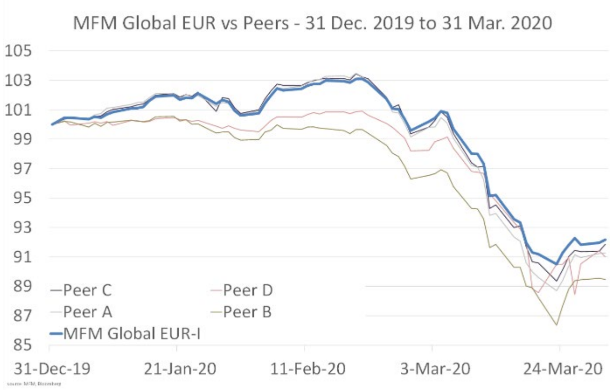
Performance compared to our peers.

As a specialist in convertible bond investments, we had to demonstrate the robustness of our investment strategies in this extremely challenging environment. Here is an illustration of the behavior of our strategies compared to that of our principal international competitors. Both strategies rank among the best of their respective peer groups.

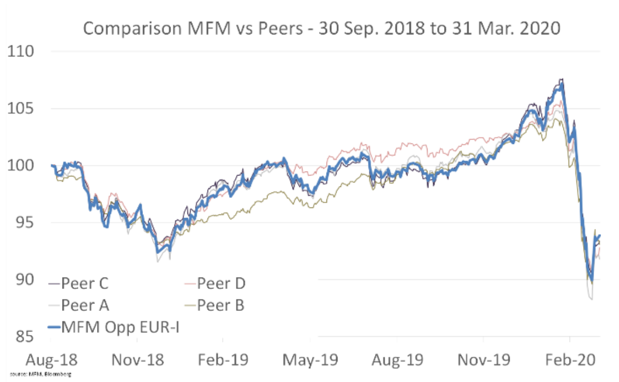
We present the performances over two periods: (i) December 31, 2019 to March 31, 2020 and (ii) August 31, 2018 to March 31, 2020.

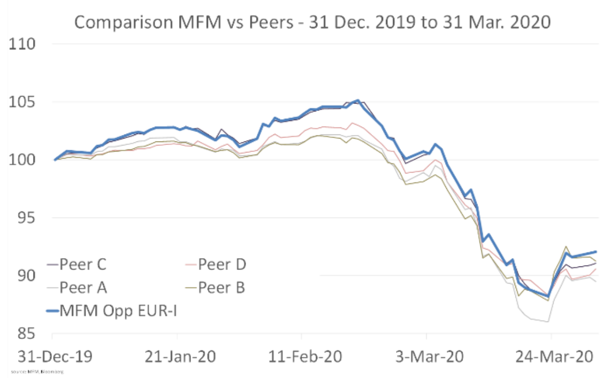
Performance of MFM Global Convertibles Bonds Fund





Performance of MFM Convertible Bonds Opportunities Fund





Entering a New Business Cycle Type

Phase one: The short-term outlook depends on the resolution of the health crisis. The peak of the epidemic has not yet been reached in most parts of the world. The situation remains critical in the United States with a spectacular number of new cases. The leveling of the number of new cases in China demonstrates that drastic containment measures can work. This example suggests that the situation should be brought under control at some point, either through significant improvements in treatment or through effective containment measures. In terms of investment, the progression of the virus will remain the main driver of financial market tension in the first phase. Until the peak of the epidemic is reached, particularly in the United States, volatility will probably remain very high. The rebound in the relative performance of Chinese equities began when the outbreak began to be contained in China a few weeks ago. Hopefully, the induced economic slowdown will not last beyond the first two quarters of this year. This scenario is optimistic; it assumes an effective health response to control the coronavirus. The situation will be extremely different if the social and economic lock-down continues, accentuating fears of an acute depression. This is not our base case scenario. Analysts and investors have largely welcomed signs of economic recovery in the initial epicenter of the virus - China - and predict a similar response in the second half of the year in the US and Europe. In addition to its duration, the other gauge of the depth of the induced economic crisis will be the extent of unemployment. In financial markets, the end of this phase should coincide with normalization of correlations and a fall in volatility.

- ✓ Convertible bonds participate in the upside when markets rebound, but preserve capital when markets are down. This effect is even more pronounced when the underlying credit and equity show significant volatility.
- ✓ Convertible bonds offer an appealing alternative to a typical rebalancing strategy, for example selling defensive assets such as sovereign bonds to take advantage of attractive entry prices on equities. Indeed, if you do not want to significantly increase portfolio risk by switching directly from sovereign bonds to equities, you should consider reallocating part of your fixed-income allocation into a convertible strategy. These offer volatility similar to bonds but with substantial participation in the rise of equities.

The second phase will be the path between the exit from the pandemic to end of the induced economic crisis. In this period, investors will need to digest the massive recovery plans. It is not straightforward to predict whether the amounts announced by central bankers and the extensive government stimulus packages will be enough. However, with governments and central bankers ready to "do whatever it takes", even if recent numbers are deemed insufficient, the risk of a prolonged depression has diminished. Currently, the extent of the economic damage is still unknown, and a V-shaped rebound in stocks seems unlikely. Nevertheless, the stimulus measures should facilitate a rebound in the real economy and thus induce a rise in equity markets.

- ✓ In times of uncertainty, convertible bonds can be an ideal asset class. They offer an alternative that eliminates the need for binary allocations to either bonds or equities. Also, the high level of volatility in this phase has a positive mechanical impact on convertible bonds, as the included option offers more value as the range of possible outcomes increases.
- ✓ Convertible bonds offer an effective way to gain exposure to volatility with high expected return potential without taking leverage.

The third phase will be the one that heralds the start of a new economic cycle. It is, of course, too early to anticipate it, but we can try to sketch its main lines. If the previous cycle was monetary, with global interventionism from central banks, the next should be fiscal. Indeed, the future economic cycle will be supported by governments. Tax cuts and increased public spending, both announced and to come, will set the pace for the real economy. Financial markets should benefit from the strengthening of economic activity, particularly the assets exposed directly to this growth. At the same time, the critical risk of the next cycle will undoubtedly be related to a rise, controlled or not, in inflation, which would push up interest rates by impacting assets exposed to duration. Another, more political risk will be linked to the fact that expansionary fiscal stimuli have historically been painful to reverse without generating substantial shocks.

- ✓ In a low interest rate environment, conventional bonds present an adverse asymmetric risk with insufficient returns and high duration risk. In contrast, convertible bonds offer low duration risk with active participation in growth in the event of a moderate rise in interest rates. Indeed, in a scenario of a modest increase in interest rates, equities have historically produced positive returns like convertible bonds.
- ✓ Convertible bonds add diversification, almost mandatory in a fiscal economic cycle, and attractive risk-adjusted returns to any asset allocation strategy.

Conclusion

We are delighted that convertible bonds have been able to offer investors a reliable product to navigate through the first quarter of 2020, which has proven challenging for all types of investors. Moreover, we are also convinced that the next economic cycle should benefit convertible bonds. Historically, convertible bonds have produced their best returns after painful periods, such as the one we are currently experiencing. Indeed, valuation differences are generally transitory, as the cheapness of convertible bonds necessarily converges towards its real value.

By combining an asset class offering attractive valuations with a promising macroeconomic context for convertible bonds, the time is appropriate to incorporate this asset class in every diversified asset allocation strategy.

Want to learn more?
We are available during this period of containment,
contact us !

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About MFM Mirante Fund Management and MFM Group

MFM Mirante Fund Management has been a recognised specialist in asset management since 2003 and has received several awards for the quality of its management. Two Lipper prizes were awarded both in 2009 and 2013 in the "convertible bonds" asset class:

- The Lipper prize in 2009 was awarded on the basis of combined performance between 2006 and 2008, one of the most difficult periods for the financial markets.
- The second Lipper prize was won in 2013 for the company’s capacity to generate a constant performance in variable market environments.

MFM actively manages twelve strategies covering the main assets classes. (convertible bonds, long-short credit and equity, sustainable fixed-income, multi-assets strategies, global long-only in fixed-income, equity, real estate and alternative).
We are ideally based in the center of Lausanne and Zürich.
Today, the MFM Group has more than 25 employees who strive to preserve the DNA of a company established 16 years ago.
Our complete range of services is aimed at both institutional and private clients.

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