MAY 2022

CONVERTIBLE BOND ARBITRAGE
SEEKING OUT UNCORRELATED RETURNS

CONVERTIBLE BOND ARBITRAGE STRATEGIES OFFER ACCESS TO RETURNS WITH POTENTIAL FOR LOW CORRELATION WITH MAINSTREAM ASSET CLASSES. IN THIS PAPER WE EXPLAIN CONVERTIBLE BONDS, HOW AN ARBITRAGE STRATEGY SEEKS TO GENERATE RETURNS, AND INTRODUCE INSIGHT'S APPROACH.

- Convertible bonds are not a mainstream asset class, meaning skilled and experienced teams may be able to source returns that are uncorrelated with other markets.
- Convertible bond arbitrage strategies typically hold an issuer's convertible bonds alongside hedges in the equity, with returns generated by changes in the relative price difference between them.
- Investors typically access such strategies to gain access to returns with low equity beta and low correlations to wider markets. Insight's strategy has exhibited both characteristics.

CONVERTIBLES: A NICHE MARKET OFFERING ALPHA OPPORTUNITIES

Convertibles are typically viewed as niche and complex. However, the market has grown substantially in recent years, and now stands at over $650bn in size[1]. This expanded investment universe is presenting new opportunities for investors with the relevant skillset and experience to generate alpha.

A convertible bond is a fixed-income debt security that typically pays coupon payments (usually lower than the straight bond) but can be converted into a pre-specified number of equity shares. It therefore acts like a regular bond with an embedded call option on the company stock. Conversion makes sense when the underlying stock price rises past the point where the value of shares that can be redeemed is greater than the fixed income value. In practice, however, this typically does not occur before maturity as the convertible retains 'time value' in line with an option on the equity. In convertible arbitrage strategies, bonds tend to be actively traded and are not exchanged for equity or held to final maturity.

HOW CONVERTIBLE ARBITRAGE WORKS

A convertible arbitrage strategy aims to generate returns by holding a long position in a convertible bond alongside a short position (hedge) in the underlying equity.

As the pricing of the bond and underlying equity change, the relationship between the two can be expected to shift, leading to the potential for skilled investors to generate a return.

- **When an issuer's equity price is below the convertible conversion price**, the convertible will typically behave like a bond instrument as the market focuses on the issuer's creditworthiness. In-depth credit analysis of factors such as the balance sheet and cashflow profile of the issuer are key.

  If the 'bond floor' – the price of a comparable 'straight' bond by the same issuer – is considered sound, the convertible bond's price will hold up even as the underlying equity price falls, because investors are confident they will receive the coupons and principal offered.

- **As the equity price of a company increases towards and beyond the conversion price**, the convertible bond price becomes increasingly sensitive to moves in the underlying equity, to the point when the convertible bond price experiences similar volatility and value to the underlying stock.

[1] Source: Source: BofA Global Research, ICE Data Indices. Data as of 31 January 2022.

INSIGHT'S CONVERTIBLE ARBITRAGE STRATEGY

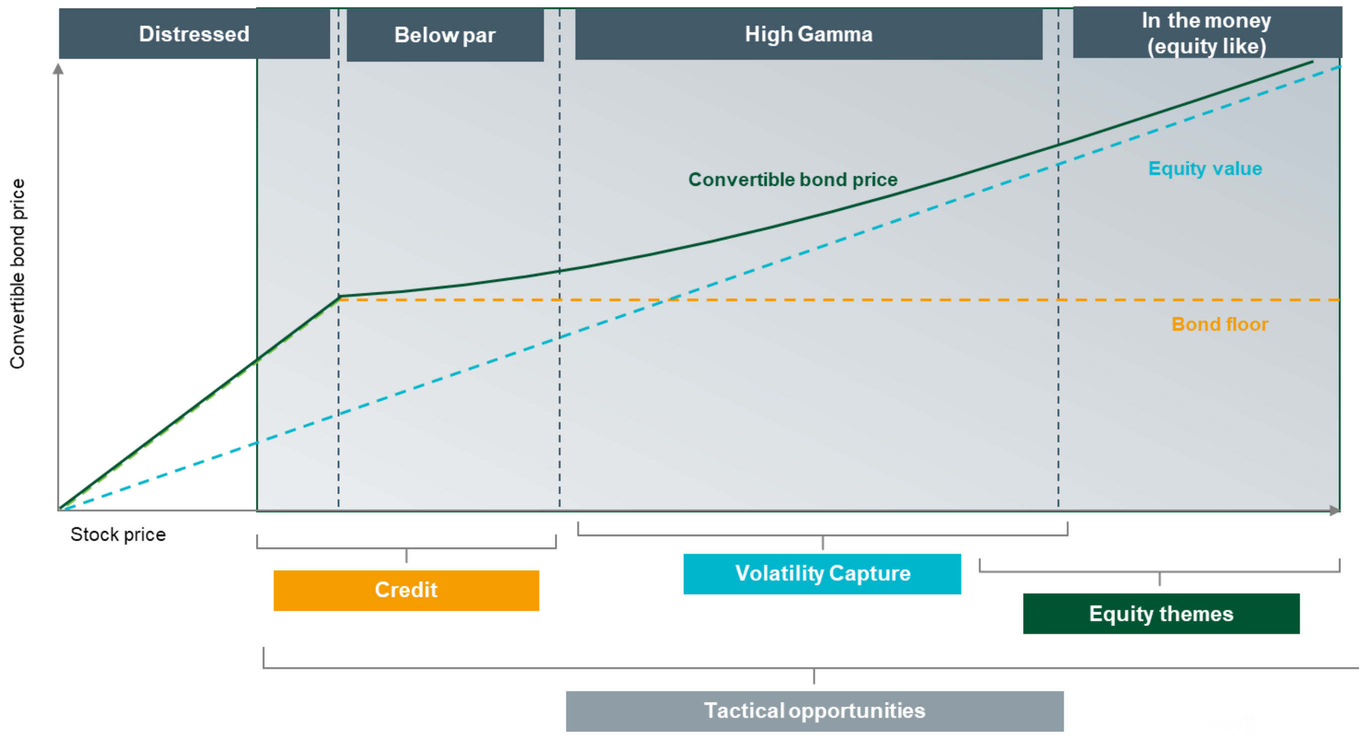
Insight's convertible arbitrage strategy aims to deliver positive returns while offering low correlation with mainstream assets and emphasising capital protection.

How does the strategy achieve this?

In our view, there are four key components of convertible bond returns: movements in equities, volatility, credit and rates. Our strategy aims to generate returns from market inefficiencies in the pricing of these components in three areas (see Figure 1):

- **Volatility capture:** Our strategy aims to generate the largest component of its returns from positions focused on this area, which are typically fully hedged. We aim to generate returns from the change in dynamics between price moves in the convertible bond and the underlying equity, which lead to a change in optimal hedging ratios.
- **Equity themes:** These positions aim to generate returns from equity upside (which we expect to lead to positive convertible bond performance) in specific sectors of the market.
- **Tactical opportunities:** These positions aim to profit from expected volatility spikes, new issuance, or other events.

Figure 1: The influences on convertible bond pricing – and how Insight's arbitrage strategy seeks to generate returns



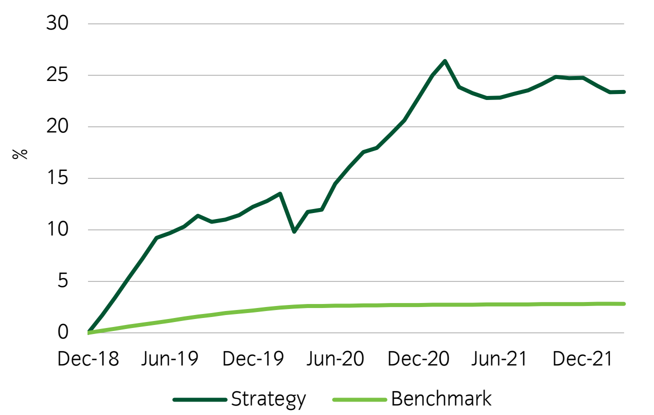
PERFORMANCE WITH LOW CORRELATION AND BETA TO MAINSTREAM ASSETS

Insight's strategy is managed by experienced portfolio managers who have navigated multiple economic cycles, and spikes in volatility, for over 20 years[2]. They draw on Insight's wider resources including credit research and specialist equity input.

We believe the performance and risk statistics for our strategy demonstrate how it has the potential to serve as an effective portfolio diversifier at a time when investors are reviewing correlations between asset classes (see Figure 2 and Table 1).

Since inception, the strategy's realised beta and correlation to global equities has been low, at 0.06 and 0.35 respectively. Relative to global bonds, the strategy's beta and correlation have also been low, with both at -0.03.

Figure 2: Cumulative returns of Insight's strategy (since inception)[3]



[2] Including tenure at predecessor company, which ended in 2018.
[3] Source: Insight, as at 31 March 2022. Please see performance disclosures at the back of this document.

Table 1: Risk statistics of Insight's strategy (since inception)[4]

Volatility (pa)	3.43%
Maximum drawdown	-4.66%
Realised beta to global equities	0.06
Correlation to global equities	0.35
Realised beta to global bonds	-0.03
Correlation to global bonds	-0.03
Positive months	79.49%

KEY HIGHLIGHTS FOR INVESTORS: MONETISING VOLATILITY AND EXPOSURE ADJUSTMENTS

We believe the strategy's ability to **monetise volatility** and **manage overall exposures** are notable given current conditions.

Monetising volatility

Equity indices have been volatile so far in 2022. We continue to expect violent equity rotation among underlying index constituents and individual companies, given uncertain earnings, supply-chain issues, wage-induced inflation, stimulus withdrawal and central bank hikes – as well as geopolitical uncertainty.

To illustrate how a convertible arbitrage strategy can take advantage of share-price volatility, we offer a historical example (see Figure 3), focusing on a volatile episode for Sika, an investment grade Swiss manufacturer of construction materials.

- **Phase 1: Equity price moves sharply lower**

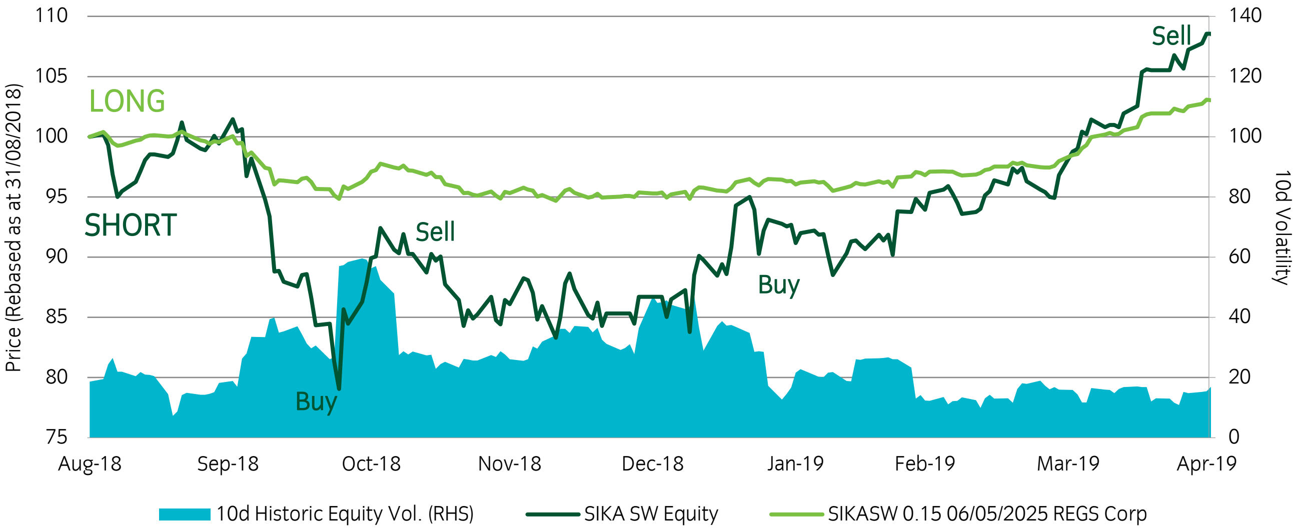
  In late 2018, the Sika convertible bond and equity prices declined, and the equity price substantially underperformed the convertible. A short equity position would have generated a gain, more than offsetting a loss on a long in the convertible bond. When the equity price stabilised, our convertible bond strategy could then use the gains to buy equity.

- **Phase 2: Equity price remains volatile, but recovers**

  From early 2019 onwards, the equity price recovered, but remained volatile. Over time, equity bought could be sold at a profit as the price recovered; and through the appropriate and timely application of equity hedges, further returns could be generated.

The core principle remains that the convertible will generally move less dramatically than the equity as it is supported on the downside by the 'bond floor', while increasingly benefiting from upside participation as the equity price rises.

Figure 3: Volatility capture example[5]



[4] Source: Insight, as at 31 March 2022. All risk statistics are calculated using daily data points. For beta and correlation calculations we have used the rolling 5-day average of the daily returns of both the portfolio and the indices in order to smooth out the volatility related to securities being priced at different times in the portfolio and the indices. Global equities: MSCI World 100% Hedged to USD (net total return index USD). Global bonds: JP Morgan Govt. Bond Hedged USD.

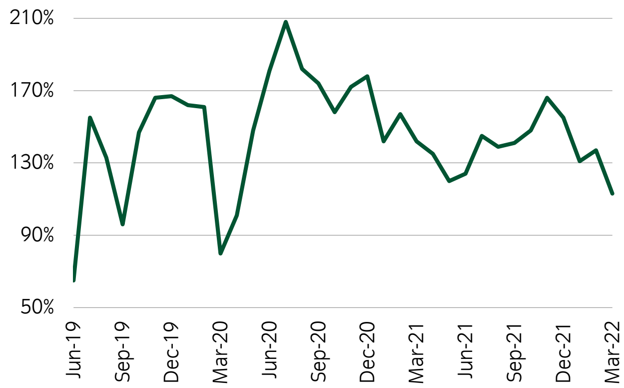
[5] Source: Insight and Bloomberg as at 30 September 2021. For illustrative purposes only. This information is not intended to be a recommendation to take any particular investment action and is subject to change. No assumptions should be made that the securities identified and discussed above were or will be profitable.

Flexibility to manage overall exposure

In addition to managing exposures to specific issuers, Insight's strategy may actively manage overall exposure to the markets. This adds another source of potential returns.

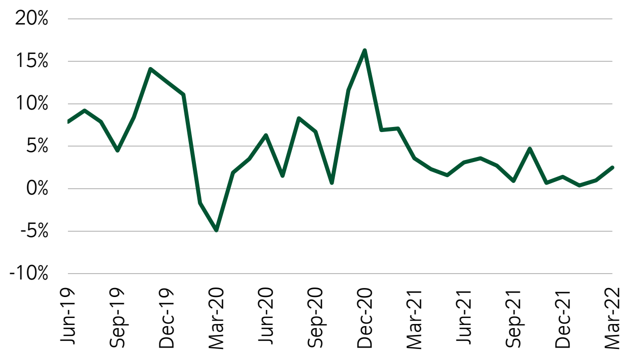
For example, the strategy's gross exposure has changed materially during the most challenging periods of the COVID-19 crisis (see Figure 4). In addition, through the active management of equity hedges for convertible bond exposures, and through additional portfolio hedges, the managers are able to refine and manage the net equity exposure of the portfolio. This is managed within clear guidelines (maximum 30%, including new issues) to ensure low beta to equity markets and capital protection in difficult periods. For example, the strategy was net short in the midst of the COVID-19 related selloff in March 2020 (see Figure 5).

Figure 4: Gross leverage (long MV % NAV)



Source: Insight, 31 March 2022.

Figure 5: Net equity exposure (% NAV)



Source: Insight, 31 March 2022. Net delta adjusted exposure of convertibles incorporating hedge and portfolio overlays.

WHY NOW FOR CONVERTIBLE ARBITRAGE?

We believe a convertible arbitrage strategy can play a meaningful role in investor portfolios today for several reasons.

1. **Improve diversification:** After years of strong performance in equities and fixed income markets, investors are increasingly looking to diversify into less correlated strategies. Convertible arbitrage strategies typically exhibit low beta and low correlations to other asset classes.
2. **Access new opportunities:** Convertible bond issuance has risen in recent years, with 2020 a record year, and 2021 the fifth-highest global issuance on record. Issuance is high across the US, Europe and Asia. Opportunities for convertible arbitrage strategies to potentially generate returns have therefore grown significantly. We note that rising-rate environments have historically been favourable for convertible issuance as convertibles pay a slightly lower coupon than conventional corporate bonds.
3. **Offset and benefit from the impact of volatility:** In recent months, supply-chain and labour constraints, a surge in aggregate demand to pre-pandemic levels, and unprecedented constraints in energy markets, have led to widespread inflationary pressure – putting pressure in turn on central banks to raise rates. We expect this to lead to volatility in fixed income and equity markets. Convertible arbitrage strategies can actively benefit from such episodes as they aim to exploit the relative changes in pricing of a convertible bond and its underlying equity.

Looking ahead, we expect a supportive backdrop for our convertible arbitrage approach in 2022. We maintain balanced convertible positioning with name-specific exposures; the largest exposures remain skewed toward better-rated issuers and we maintain a significant interest rate hedge. We expect our balanced portfolio, combined with increased individual stock volatility, to perform well in the current environment.

IMPORTANT INFORMATION

TEN-YEAR PERFORMANCE RECORD TO 31 MARCH 2022

	Calendar year returns									
	2021	2020	2019	2018	2017	2016	2015	2014	2013	2012
Insight's absolute return global convertible strategy	1.60%	9.40%	12.24%	-	-	-	-	-	-	-
Benchmark	0.09%	0.51%	2.18%	-	-	-	-	-	-	-
	12-month rolling returns									
	2021-2022	2020-2021	2019-2020	2018-2019	2017-2018	2016-2017	2015-2016	2014-2015	2013-2014	2012-2013
Insight's absolute return global convertible strategy	-0.38%	12.79%	4.24%	-	-	-	-	-	-	-
Benchmark	0.08%	0.19%	1.92%	-	-	-	-	-	-	-

Please refer to the following risk disclosures. Effective 1 November 2021, the benchmark changed from 1-month USD LIBOR to the Secured Overnight Financing Rate (SOFR) (90-day compounded). All benchmark past performance prior to this date was calculated 1-month USD LIBOR. Returns are shown in USD on a net basis (with a 0.75% annual management charge and performance related fee applied). From strategy inception on 1 January 2019 to 3 June 2019, performance relates to a model portfolio. From 3 June 2019 to date performance relates to a representative portfolio. Insight's simulated portfolios are managed in the same way as a real portfolio using portfolio management and trading systems on which trades are traded and settled in order to replicate live market conditions and possible outcomes and to produce an asset value. Model results have certain inherent limitations. Unlike an actual performance record, model results do not represent actual trading/returns and may not reflect the impact that material economic/market factors might have. Clients' actual results may be materially different than the model results presented. The return may increase or decrease as a result of currency fluctuations.

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and certain charges, such as currency conversion charges may depend on the individual situation of each investor and are subject to change in future.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

ASSOCIATED INVESTMENT RISKS

Convertible Securities

- Objective/Performance Risk: There is no guarantee that the strategy will achieve its objectives.
- Derivatives Risk: Derivatives are highly sensitive to changes in the value of the asset from which their value is derived. A small movement in the value of the underlying asset can cause a large movement in the value of the derivative. This can increase the sizes of losses and gains, causing the value of your investment to fluctuate. When using derivatives, the strategy can lose significantly more than the amount it has invested in derivatives.
- Changes in Interest Rates & Inflation Risk: Investments in bonds/money market securities are affected by interest rates and inflation trends which may negatively affect the value of the strategy.
- Credit Ratings and Unrated Securities Risk: Bonds with a low credit rating or unrated bonds have a greater risk of default. These investments may negatively affect the value of the strategy.
- Credit Risk: The issuer of a security held by the strategy may not pay income or repay capital to the strategy when due.
- Emerging Markets Risk: Emerging Markets have additional risks due to less-developed market practices.
- Counterparty Risk: The insolvency of any institutions providing services such as custody of assets or acting as a counterparty to derivatives or other contractual arrangements, may expose the strategy to financial loss

FIND OUT MORE

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