



## Drop the top

– Richard Stutley, CFA

A lot has changed and at the same time many aspects of our lives and work go on much as before. We met last week for our regular round of asset allocation meetings just like we always do, only this time via video link rather than all sat around the desk. One area that looks interesting to us currently is convertible bonds, which in many cases are trading cheap relative to their component parts: the straight bond and the equity option. While convertible cars, or drop-tops, tend to dominate the drawdown phase of most people's lives, convertible bonds have something to offer in the earlier accumulation phase.

It was a convertible bond issue that reopened Italy's debt markets last week, following a hiatus caused by the coronavirus and the rising cost of borrowing. Convertible bonds come with an array of different features but in their simplest form they are just like any other bonds, paying coupons at regular intervals followed by the principal at maturity. They can also be converted into a predetermined number of shares in the issuer and the value of this option goes up as the company's share price rises. Should the share price disappoint, the holder of the convertible still owns a bond with a claim on the business. Convertible bonds pay lower coupons than similar, non-convertible or straight bonds, and the amount of yield given up reflects the value of the conversion option.

The MSCI World index has rallied 26% since the 23rd of March. This may continue – we certainly hope it does – but it is by no means a one-way bet. While focus gradually shifts towards how countries exit from the lockdowns, it remains to be seen who is ready to go back to work and play: certainly not people in the higher-risk age brackets, until such time as a vaccine is developed. The uncertainty over how long it will take for activity to rebound makes convertible bonds appealing to

us. As share prices go up, convertibles quickly start to look like equity. As share prices come down, convertibles start to look more like debt. In theory then, convertible bonds have a higher participation rate in equity upside than equity downside and they are attractive when that asymmetry is undervalued.

A convertible bond consists of a corporate bond and an equity option. We continue to like the valuations on credit, although spreads have tightened from their wiles following the Federal Reserve's intervention in the market, and the embedded equity option is not expensive by historical standards, despite the high uncertainty over the outlook for global growth. We like the component parts therefore, and we are happy to see the convertible bonds themselves trading cheap relative to these components. Today many convertibles are trading close to their straight counterparts, implying little to no value in the conversion option.

Convertible bonds are favoured by fast growing companies looking to reduce their annual interest bill by giving away some of their future growth. The current crisis is accelerating trends in online ways of working and consuming, and many issuers in the convertible bond universe cater to those areas. While the extent of this shift in behaviour should not be overstated, we are happy to find ourselves in alignment with it when adding to our convertibles positions.

Convertible bonds have been part of our portfolios for many years. Today they offer many attractive features in our view. They should not be viewed as a panacea, however, and form only part of a diversified blend of different asset classes, which is designed to smooth the investment journey for investors.

## The Marketplace

- The global number of coronavirus cases surpassed 2 million last week
- China printed a 6.8% first quarter fall in their year-on-year GDP growth
- Brent crude fell 10.8%, ending the week at \$28.1 a barrel
- Gold fell 0.8% ending the week at \$1682.8 an ounce

## Market Focus

### US

- The broad US equities index gained 3.1% over the past week, with the technology heavy alternative index outperforming by a wide margin at 6.1%.
- Overseas demand for US corporate debt increased over the week, with the US investment grade index returning 2.3% and its high yield counterpart gaining 2.6%.
- US initial jobless claims printed at 5.2 million, lower than the previous two weeks, but it takes the total to over 20m claims since lockdowns began.
- The US pulled its funding to the World Health Organisation with President Trump criticising its ‘covering up’ of the coronavirus outbreak.

### Europe

- The current state of lockdowns is mixed in Europe as some countries extend their lockdowns, outlining plans to reopen when statistics improve, and others start to slowly relax lockdown measures by opening smaller shops.

- Eurogroup finance ministers agreed on a €500bn package to support businesses, workers and sovereigns throughout the crisis. French President Macron warned that the eurozone could collapse if the constituents failed to agree upon a recovery fund.
- The International Monetary Fund (IMF) forecasted that the eurozone economy will shrink by 7.5% in 2020 before a partial recovery to grow 4.7% in 2021.
- The only EU country to be on lockdown for all of March, Italy, reported a service sector PMI figure of 17.4. As a reminder, 50 is the level which separates expansion from contraction

### UK

- The lockdown in the UK was extended by another three weeks to the 7th May.
- UK equities declined 0.9% over the past week. UK gilts also ended the week in the red by 10 basis points.
- The UK and the EU will hold their second round of Brexit negotiations this week, with the original meeting scheduled for mid-March but postponed due to the ongoing crisis. The UK also announced that regardless of the lockdowns it will refuse an extension to the transition period to leave the EU.

### Asia/Rest of The World

- The IMF predicts that the global downturn will be the most severe since the Great Depression in the 1930s.
- An OPEC+ meeting led to the agreement to cut global oil production by 9.7 million barrels per day in May and June. This was done in an attempt to increase prices. However, oil prices fell to over 20 year lows overnight as fears surrounding the commodity’s storage capacity rose.

Asset Class/Region	Currency	Currency returns			
		Week ending 17 April 2020	Month to date	YTD 2020	12 months
<b>Developed Market Equities</b>					
United States	USD	3.1%	11.3%	-10.7%	0.5%
United Kingdom	GBP	-0.9%	1.4%	-22.9%	-20.2%
Continental Europe	EUR	0.7%	4.3%	-17.6%	-9.9%
Japan	JPY	0.9%	2.8%	-15.1%	-9.2%
Asia Pacific (ex Japan)	USD	2.8%	7.4%	-14.8%	-11.8%
Australia	AUD	1.9%	8.1%	-16.9%	-8.6%
Global	USD	2.3%	8.9%	-14.0%	-4.9%
<b>Emerging markets equities</b>					
Emerging Europe	USD	-5.3%	6.0%	-32.7%	-21.1%
Emerging Asia	USD	3.0%	6.7%	-12.6%	-9.5%
Emerging Latin America	USD	-2.4%	4.8%	-43.0%	-38.1%
BRICs	USD	1.4%	5.7%	-16.4%	-12.4%
China	USD	2.6%	5.1%	-5.6%	-5.1%
MENA countries	USD	-3.7%	2.4%	-23.0%	-25.6%
South Africa	USD	-3.6%	5.1%	-37.3%	-40.4%
India	USD	0.8%	6.1%	-28.9%	-27.6%
Global emerging markets	USD	1.5%	6.3%	-18.8%	-15.6%
<b>Bonds</b>					
US Treasuries	USD	0.4%	0.3%	9.3%	15.7%
US Treasuries (inflation protected)	USD	-0.9%	1.9%	3.9%	10.0%
US Corporate (investment grade)	USD	2.3%	5.0%	1.2%	10.4%
US High Yield	USD	2.6%	5.9%	-7.6%	-2.6%
UK Gilts	GBP	-0.1%	1.9%	9.0%	15.6%
UK Corporate (investment grade)	GBP	0.9%	5.0%	-0.6%	6.2%
Euro Government Bonds	EUR	0.2%	-0.3%	0.0%	4.7%
Euro Corporate (investment grade)	EUR	1.1%	2.3%	-4.0%	-1.3%
Euro High Yield	EUR	1.7%	5.7%	-10.0%	-6.2%
Japanese Government	JPY	-0.3%	-0.3%	-0.8%	0.3%
Australian Government	AUD	0.4%	-0.3%	3.9%	9.1%
Global Government Bonds	USD	0.3%	0.1%	3.2%	8.4%
Global Bonds	USD	0.4%	0.8%	1.1%	6.3%
Global Convertible Bonds	USD	2.0%	3.9%	-5.7%	-1.3%
Emerging Market Bonds	USD	0.3%	1.3%	-7.5%	-1.4%

Asset Class/Region	Currency	Currency returns			
		Week ending 17 April 2020	Month to date	YTD 2020	12 months
<b>Property</b>					
US Property Securities	USD	-4.6%	6.9%	-22.2%	-14.3%
Australian Property Securities	AUD	0.6%	14.8%	-25.2%	-23.3%
Asia Property Securities	USD	0.8%	3.6%	-18.9%	-17.2%
Global Property Securities	USD	-2.4%	5.4%	-23.5%	-16.2%
<b>Currencies</b>					
Euro	USD	-0.7%	-0.9%	-3.2%	-3.8%
UK Pound Sterling	USD	0.1%	0.8%	-5.8%	-4.1%
Japanese Yen	USD	0.7%	0.2%	0.9%	4.1%
Australian Dollar	USD	0.0%	4.1%	-9.6%	-11.3%
South African Rand	USD	-4.5%	-5.6%	-25.9%	-25.8%
Swiss Franc	USD	-0.3%	-0.2%	-0.1%	4.5%
Chinese Yuan	USD	-0.5%	0.1%	-1.6%	-5.5%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-3.8%	2.2%	-30.6%	-30.0%
Agricultural Commodities	USD	-2.1%	-2.5%	-14.9%	-13.1%
Oil	USD	-10.8%	23.5%	-57.5%	-60.8%
Gold	USD	-0.8%	5.3%	10.5%	32.2%
Hedge funds	USD	1.50%	2.10%	-5.00%	0.40%

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