Generating returns and managing volatility:
the absolute return approach to convertible bonds

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The past months have been characterised by an unprecedented low rate environment. The continuous search for yield has pushed institutional investors out of their comfort zone, having to further diversify, to rethink their investment approach and risk budgets within a context of asset allocation optimisation. A further complexity surged with recent heightened volatility of risky assets.

At Generali Investments, we believe that Convertible Bonds are an investment solutions perfectly adapted to this new environment and new challenges. The securities feature an attractive convexity which seems extremely appealing in a context of market uncertainty and return of volatility, and yet low interest rates. We also believe that, besides the traditional convertible bond strategies, introducing a flexible absolute return approach makes a lot of sense.

Convertible bonds offer above average equity-like returns, downside protection and limited volatility. They are characterised by a very attractive asymmetry which offers correlation to equity markets in bullish market conditions and downside protection in falling equity markets, therefore benefitting from a self-adjusting, risk-adjusted return profile.

A convertible bond fund, thanks to its multi-asset class profile and embedded convexity, will therefore, to some degree, almost automatically adapt to the market changes and respond to some of the current challenges. The Portfolio Manager's role is to enhance and even optimise these characteristics via an active and discretionary management.

Numerous studies show that the asset class has outperformed equities or other more traditional strategies over the long-term with lower volatility.

At Generali Investments, we are convinced that convertible bonds will continue to benefit from unique and attractive ratchet clauses in a context of dynamic M&A activity. These clauses, originally intended to protect investors in the event of a takeover of the issuing company, are not fully priced-in until this occurs. Ratchet clauses can be in a way described as "a bonus upside" for investors, leading to gains sometimes greater for convertible bonds' holders than equity holders if the take-over occurs (the most recent examples being Alcatel/Nokia or Gagfah/Deutsche Annington).

Another advantage of such instrument is its cost relating to Solvency Capital Requirements, within the Solvency II regulatory framework. Indeed, thanks to their convexity, convertible bonds bear a lower regulatory cost versus equities, while offering similar returns, which, in our opinion, makes convertible bonds a very appealing investment solution.

For the above reasons, the asset class sees greater interest from institutional investors, leading to increasing inflows: demand will most likely remain strong as a result. In parallel, the primary market has so far proven to be very active, and we believe that the volume of new issues and the number of issuers will continue to rise. This activity has led to a better diversified sector and country distribution.

However, we remain conscious of the fact that net asset inflows and new issues do not necessarily match, therefore leading to potential valuation distortions. Periods of over-valuations such as the one witnessed in June 2014 (due to net inflows in the asset class and temporary shortage of primary issuances), have been followed by violent implied volatility sell-offs (as happened in Q4 2014), for the very opposite reasons.

At Generali Investments, we think that these cycles in convertible bond valuations create strong opportunities in terms of delta-hedged strategies, especially in association with an Absolute Return strategy as implemented in the Generali Investments Sicav (GIS) Absolute Return Convertible Bond fund. The central idea with this fund is to have the ability and the possibility to isolate and exploit volatility.

Convertible bonds are an "all-in-one" instrument, combining various alpha drivers such as: equities, bonds, credit, implied volatility, rachet/prospectus clause and benefiting from different market cycles. It is also important to note that these components do not always move together at the same time. Depending on the year and on the market cycle, some would generate alpha while others could underperform and undermine performance.

To optimise the different parameters, GIS Absolute Return Convertible Bond fund has the ability to hedge the unwanted parameters in order to focus on, isolate or emphasise the alpha drivers. Introducing an absolute return approach to a long only strategy allows investors to not only benefit from an outright investment in convertible bonds but also hedge unwanted risk (i.e. equity, credit, interest rates, volatility) and/or further isolate and exploit different strategies and sources of alpha.

At times, convertible bonds' performance is solely or mainly driven by one of the aforementioned alpha drivers, therefore making outright strategies dependent on one of them. For instance, in the past couple of years, the main driver of performance for convertible bonds has been the underlying equity markets. In our view, it makes a lot of sense to add a degree of flexibility and be able to mitigate and hedge - if and when needed - the equity exposure.

Therefore, GIS Absolute Return Convertible Bond fund aims at generating alpha through both outright « credit » or « equity » exposure offered by convertible bonds' long positions or and hedging strategies (to isolate different alpha sources) – whether it is a macro hedge, overlay or a micro hedge at the security level. Moreover, those techniques aim to improve the convexity of convertible portfolios and the downside protection offered.

Put simply, the concept is based on isolating and exploiting a desired parameter - for example isolating an attractive prospectus *("ratchet")* clause - while limiting or removing the *unwanted* underlying equity exposure.

Another technique that we use is to have a long exposure to convertible bonds' implied volatility, via a long delta-hedged strategy, when we believe that a security is undervalued. We can *however* manage and exploit a volatility pick-up within the context of an absolute return convertible bonds investment approach.

Many other strategies can be put in place, just by removing some dependency to one parameter *(usually equity)*. Below is a summary of all the different strategies that could be implemented via this approach:

	Exposure	Hedged/ Arbitrage	Overlay Macro
Credit	x	x	x
Interest Rates/FX	x		x
Equity	x	x	x
Volatility	x	x	
Prospectus	x	x	

We acknowledge the importance of fundamental analysis (credit and liquidity) which is why we have placed it at the very beginning of our investment process. At Generali Investments, our portfolio managers are backed by a 18-strong in-house credit research team, 13-strong macro research team and a dedicated equity research team.

In conclusion, an absolute return investment approach applied to convertible bonds fund allow us to add arbitrage techniques only used by some hedge funds, in a transparent, rigorous and risk-managed UCITS structure.

We believe that institutional investors should increase their allocation to convertible bonds tactically but, importantly, should also consider the asset class as a longer term investment solution. Finally, the ability to add more flexibility by adding proven arbitrage and overlay techniques, only makes the strategy more attractive investment.