

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

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Current market uncertainties offer a very attractive entry point for convertible bonds which carry an appealing optionality. In more general terms the asset class offers above average equity-like returns, downside protection and limited volatility. It is characterised by an 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. Numerous studies show that the asset class has outperformed equities or other more traditional strategies over the long-term with lower volatility (source: *Exane as of end of August 2016*).

In fact, as of late the asset classes' valuations were supported by beginning of the year outflows following a risk-off mode and a decline of underlying equities. From a valuation point of view, convertible bond implied volatilities lost on average more than 5% YTD and even 10% since mid-November and just started to rebound after having reached multi years' lows.

In addition, primary market has been very dynamic in the past years, contributing to further diversify and expand the convertible bond universe.

For all the above mentioned reasons at Generali Investments, we believe that **convertible bonds** are an investment solution perfectly adapted to this new environment and new challenges. We also believe that, besides the traditional convertible bond strategies, introducing a flexible **absolute** return approach makes a lot of sense.

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. Convertible bonds are an "all-in-one" instrument, combining various alpha drivers such as: equities, bonds, credit, implied volatility, special situations (ratchet/prospectus clause) and benefiting from different market cycles. The portfolio manager's role is to enhance and even optimise these characteristics via an active and discretionary management.

We also 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 specific parameter of the instrument.

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.

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 (with examples like Alcatel/Nokia or Gagfah/Deutsche Annington, *Stocks are mentioned only as a guide. Such examples ought not to be interpreted as investment advices*).

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. 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, our GIS Absolute Return Convertible Bond fund aims at generating alpha through both outright «credit» or «equity» exposure offered by our convertible bonds' long positions 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 may 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*).

However, we would like to stress the importance of having an in-house credit research which thoroughly analyses both rated and unrated issues. At Generali Investments, our portfolio managers are backed by an 18-strong in-house credit research team, 13-strong macro research team and a dedicated equity research team.

Having a strong bond floor is an important prerequisite in order to be able to fully exploit the embedded option of a convertible bond. Therefore, the outcome of our methodology is portfolios with a high credit quality (with currently over 70% of our portfolio invested in investment grade names).

Lastly, it is important to highlight that another advantage of such instrument is its cost relating to Solvency Capital Requirements (hereinafter, SCR), within the Solvency II regulatory framework. Indeed, thanks to their convexity, convertible bonds bear a lower regulatory cost versus equities, while offering similar returns. The SCR ratio improves in the context of a risk controlled absolute return strategy therefore offering, in our opinion, a very appealing investment solution.

In conclusion, an absolute return investment approach applied to convertible bonds fund allows 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 a more attractive investment.

COMPANY PROFILE

Generali Investments (GI) is the main asset management arm of Generali Group, one of the largest and most respected insurance companies in the world with 185 years of providing a solid, stable and highly professional service. With AUM over € 450 billion GI is one of the leading European asset managers recognised for delivering consistent results through proven risk-based investment solutions. Active internationally with a strong European presence, GI operates out of 3 main hubs: Germany, Italy & France, with a team of over 400 customer-focused experts with deep knowledge of local markets and asset classes. (Data as at 30.06.2016, source Generali Investments Europe S.p.A. Società di gestione del risparmio).

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GIS Absolute Return Convertible Bond presents a risk of loss of capital.

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