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Consider Convertible Arbitrage

To Balance Performance, Risk

Hedge funds have attracted a lot of investment in a struggling market, and funds that hedge convertible securities can be especially attractive.

By Andrew Pernambuco

Generating consistent, risk-averse returns on corporate assets has been tough in recent years. Battered by roiling equity markets and lackluster fixed-income vehicles, financial executives may be feeling like they've been tossed from one wave to another, finally fleeing toward the safety of shallow waters — only to discover no safe haven from stormy markets.

The search for investment alternatives has led increasing numbers toward hedge funds, private partnerships with the attractive promise of consistent if unspectacular returns, diversification and lower overall portfolio risk. Unfettered by regulations that govern other types of funds, hedge fund managers are ostensibly able to employ greater leverage within their portfolios by utilizing strategies unavailable to mutual fund managers. Obstacles that once deterred hedge funds from institutional portfolios — such as asset allocation vagaries, holdings transparency and benchmarking issues — have been largely eliminated. In fact, institutional investors hold more than one-third of the assets in hedge funds, up from just 5 percent a decade ago.

Big Variety

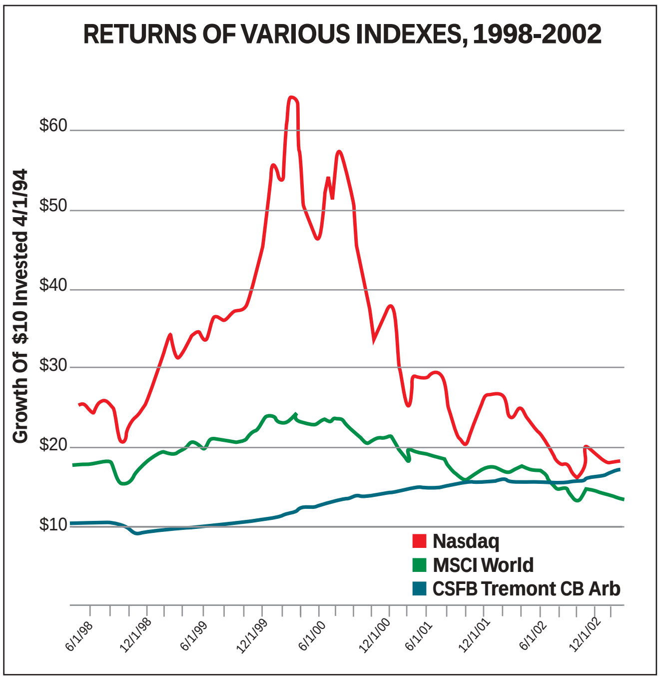
Hedge funds are now almost mainstream. A recent Gollin/Harris Ludgate survey noted that 64 percent of European institutions surveyed currently invest, or were intending to invest, in hedge funds.

The hedge fund universe has more than 5,000 funds with diverse investment mandates, ranging from simple long equities to esoteric derivatives to global macro strategies. Some, such as dedicated short bias and long/short equity, are accompanied by relatively high volatility; others — such as convertible arbitrage, merger arbitrage and event-driven products — tend to be lower. In addition, individual funds within each strategy represent widely diverse risk elements.

Among the various low-volatility strategies, convertible arbitrage has been among the most consistent. Convertible arbitrage funds have absolute-return characteristics. Investment risk is analogous to a U.S. Treasury fixed-income strategy, with returns comparable to a conservative equity strategy.

Absolute return refers to performance uncorrelated to underlying markets above zero. While these returns are not correlated with the broader markets, the funds can have interim mark-to-market down months, and there is no assurance they will outperform the markets at all times. The distinction is that true absolute-return funds offer performance independent of the markets.

According to the CSFB/Tremont Arbitrage Index, the five-year average annual return for convertible arbitrage from 1998-2002 was +10.60 percent, with a five-year total compounded return of 65.46 percent. Just as important, annualized volatility (a critical risk management measurement) for convertible arbitrage for the five-year period was just 5.49 percent, roughly one-fifth the volatility of the Russell 2000, which was at 24.03 percent. The Russell averaged a disappointing -2.60 percent annualized return for the same period.



Not surprisingly, more than $4 billion flowed into convertible arbitrage funds during 2002, representing about an eighth of all hedge fund inflows. According to the *Financial Times*, "the last time convertible arbitrage experienced this kind of surge in inflows was in the last quarter of 1997 and the first half of 1998 — the very top of the market."

Convertible Bond Flexibility

Given the low volatility and respectable performance, convertible arbitrage appears to be a worthy contender for corporate asset portfolios — provided that financial executives scrutinize convertible arbitrage funds for managers with experience evaluating credit and a multi-layered strategy. The performance and attendant popularity of hedge funds has spurred a host of new players, with the number of convertible arb managers doubling in the past 24 months. Many are inexperienced in credit analysis, and only a few have a thorough understanding of the full range of convertible strategies and nuances.

These funds hedge convertible securities — corporate fixed-income instruments with an equity component. Convertible bonds came into play as an efficient means for companies to access the capital markets. Typically, companies raise money in the capital markets by issuing stock (equity), through a secondary public offering or high-yield debt. Large companies tend to issue more straight debt because of their long history of having easier access to the capital markets.

Alternately, they may issue a convertible bond, a fixed-income instrument with an embedded equity option. This option may be exercised at any time, converting the bond into equity. These bonds typically carry significantly lower interest rates than high-yield debt, making them a more attractive financing alternative.

Straight bonds contain covenants, or restrictions on the lender of capital. In effect, the company is borrowing money from investors at interest rates typically somewhat higher than that of a convertible bond. The prohibitive cost of borrowing in straight, high-yield debt can be a catalyst that depresses the value of a company's equity. A company may choose instead to issue a secondary offering of stock, usually through an investment bank, but there is a downside — the markets may quickly pick up that information and begin shorting the stock so as to buy it as cheaply as possible.

So while the company may have intended to issue the secondary stock at $20 per share, it may be forced to issue it at $15 in response to the market bidding it down. In this environment, it is simply too expensive and inefficient for companies to do secondary stock offerings.

In contrast, the equity embedded in a convertible bond is issued at a premium to the prevailing market price, ensuring that the bond sale proceeds will add to the issuer's bottom line. It is also clear that the lower interest rate payment is a boon to the issuing company when compared to other options.

Not Without Investor Risks

One of the most attractive features to investors is that convertible securities and their debt obligations hold a senior position to common stock. Besides their value as fixed-income securities, they may be converted into a fixed number of shares of the issuing company, giving them a conversion value equal to the market value of the shares obtainable by bond conversion.

Convertible bond investors assume an inherent credit risk in that there is no absolute certainty the issuer will still be in business when the bond matures, which makes informed credit analysis vital in selecting convertible issues. Since most convertible bonds are not otherwise rated, an arbitrary credit rating that quantifies the amount of credit risk must be established, and the risk then hedged in some way in order to enhance the probability that the coupons will be paid and the security will mature.

One of the two primary drivers of the convertible arbitrage market is volatility, where managers attempt to capture the price differences between implied and historical volatility. Volatility arbitrageurs rely on the constant movement of the underlying equity to provide opportunities for reducing or intensifying their hedges. The direction of the underlying equity is of minor concern because as long as the stock is moving, it means the arbitrageur can consistently pick up excess capital by buying the stock when it dips and selling it as it reaches its highs.

This is a comparatively simple procedure, because given the appropriate pricing and computer models, virtually anyone can identify when to buy and when to sell. In recent years, convertible arbitrageurs may have seemed like sages because their returns have been so much better than the broader markets. Volatility arbitrageurs, who make up as much as 80 percent of the convertible arbitrage universe, have been prolific primarily because there has been so much market volatility.

But that situation reversed itself during the first three quarters of 2002, due to a precipitous decline in volatility brought on by several events, including the widening of the speculative grade credit spreads and the worsening of the global economy

As economic and political events began to play out, the likelihood of an armed conflict in the Middle East increased and the markets reacted erratically, producing renewed volatility. The last quarter of 2002 saw a significant rebound in the returns of volatility arbitrageurs. As a result, the strategy as a whole returned more than 7 percent, according to the HFR Convertible Arbitrage index. This interim down period caused many volatility arbitrageurs to look elsewhere to capture excess capital. Enter the "credit arbitrage game."

The Credit Default Time Bomb

With the rash of defaults partly brought on by corporate malfeasance came a considered focus on evaluating the creditworthiness of every company that had issued debt. It was no longer taken for granted that because an issue had a credit rating slapped on it by a credit rating agency, that the issue was creditworthy. Many volatility arbitrageurs began to look at credit from a different perspective. Since they were new to the game, instead of actually looking at what it took to understand what issuing companies did as a business (a business model, taking apart the balance sheet, the competition, revenue streams, et al.) many arbitrageurs decided to skip this entire process and proceeded to mitigate their risks by buying credit default swaps.

Credit default swaps purport to completely obviate the risk in an underlying issue by swapping out the issue's credit to a buyer (usually a bank) willing to take the credit risk because it had a better handle on the underlying companies due to its long-standing relationships with them. A number of factors come into play with a convertible bond — volatility, currency, equity movement, interest rates and credit — so focusing simply on the default probability doesn't provide the big picture. In addition, a bank can write (sell) credit protection for any number of buyers, and can conceivably write the same protection for more than the actual size of the issue. This use of bank leverage can be a potential pocket of worry that market participants should monitor closely.

There is no substitute for good old-fashioned credit work where an analyst digs deep into an issuer's financial statements. Likewise, there is no substitute for getting to know the issuer's management, either by arranging a face-to-face meeting or by getting on their quarterly conference call or by talking to other analysts who cover them.

When the spreads between S&P investment-grade bonds (rated AAA) and speculative or high-yield bonds blew out in October 2002 to an all-time high of over 1,500 basis points, few Johnny-come-lately credit arbitrageurs were able to take advantage of this anomaly to boost their positions in this high-yielding paper. The main reason was that their reliance on credit default swaps to mitigate their risk did not anticipate that spreads could widen so dramatically without an actual default. For one thing, many managers lacked experience in evaluating credit. They threw a lot of money into credit plays regardless of whether the issuing companies were default risks or not.

Portfolio Risk Reduction?

So on one hand, convertible arbitrage holds the promise of reduced portfolio risk, diversity and consistent returns. On the other, convertible fund managers who take inappropriate risks by utilizing credit swaps and other derivatives jeopardize this strategy's risk management attributes.

There are a number of databases and benchmarking services that can provide a comprehensive overview of long-term performance by fund managers. In evaluating performance, financial executives should key to 12-month rolling volatility. Managers with huge monthly gains are likely to be the same people with comparable monthly losses. Be wary of a manager who is up 7 percent in a single month: Convertible arbitrage should deliver consistency and minimal monthly variance.

Convertible arbitrage is a complex, multi-layered strategy, and while volatility and credit are important aspects of the convertible universe, many other strategies — including equity-related, fixed-income, in-the-money and out-of-the-money options, distressed securities and others — are significant contributors to steady, risk-averse performance. Top fund managers are not limited to volatility or credit plays; they offer a diverse approach that requires more expertise, research and analysis, but provides a payoff of consistent, conservative long-term performance with measured risk.

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