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GLOBAL CONVERTIBLE BONDS

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MINDING THE GAP

Throughout 2013 Citywire has held fund selector events across three continents, tapping sentiment country by country, month by month.

Coinciding with Ben Bernanke's forward guidance on tapering, we saw a noticeable uptick in interest in convertibles at our Montreux event in May.

By attempting to clarify the timing of a scaling back of bond purchasing, the outgoing Fed chairman was preparing investors for the end of free money. With a QE exit having never been attempted, it is no surprise investors flocked to the investment world's flexible friend.

In this supplement we shine a light on some of the fund industry's middle men and women, those with the skills to operate in two worlds; equity and fixed income, simultaneously.

We've highlighted the strategies they've employed as they shepherd investors onto the first rung of the post-QE ladder.

AMY WILLIAMS

Editor, Citywire Global

Driving all-round returns

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Driving all-round gains

With their potential to benefit from upsides in bond and equity markets, convertible bond fund managers have been able to minimise volatility and maximize returns. But investors need to keep a close eye on macro moves, as well as quality and pricing.

Rob Griffin reports



When stock market conditions are unpredictable it is understandable that investors will be drawn to asset classes that not only promise them exposure to the upside of equity markets but also provide an element of downside protection.

It is against this backdrop that convertibles have enjoyed resurgent popularity of late with the area seen as a dream ticket to the best of both worlds. It's not that simple, of course, but the qualities they offer can certainly be enticing.

As well as sharing characteristics with traditional fixed income products, such as a maturity date, credit rating and fixed coupon payment, convertibles also include an option to convert the bond into stock of the underlying company.

Such attributes provide an attractive risk/reward potential that makes convertibles a strong proposition for a wide variety of investors, says Bryn Jones, head of fixed income at Rathbone Investment Management.

'For bond investors it means they've been able to get some exposure to the equity uplift we have seen of late,' he says. 'You've then had equity investors buying convertibles because they are trying to protect themselves after this massive rise in the markets.'

The view ahead

So where are managers of convertible funds focusing their efforts?

As far as the economic backdrop is concerned, Miles Geldard, manager of the Jupiter JGF Global Convertibles fund, expects to see monetary policy start to normalise very gradually with tapering occurring and quantitative easing being reduced.

'We don't see any chance of higher official interest rates but do anticipate QE being significantly reduced, perhaps sooner than some people do,' he says. 'As long as we don't have a situation where interest rates rise very sharply, we think it's a relatively benign environment for equities and convertibles can do well.'

The economic issues, he says, are not necessarily to be feared. 'Tapering should effectively be a good sign because it means the extraordinary interventions of the period during and post the financial crisis can be withdrawn as the financial system can stand on its own two feet again,' he says.

Like many of his peers Geldard agrees there's a need to be 'selective and tactically cautious' on the valuations of convertibles as a result of them having risen in value from a technical perspective, but he believes the equity type exposure they provide can be beneficial.

Geldard still has exposure to Japan and is slightly more positive on Asia ex-Japan than others in the area, but expresses a desire for some larger, higher quality companies to start issuing convertibles, which would provide a significant boost to the entire market.

'As long as we don't have a situation where interest rates rise very sharply, we think it's a relatively benign environment for equities and convertibles can do well'

Miles Geldard,
Jupiter



'Generally things are getting better and the US economy continues to move along at a steady pace,' he says. 'Unemployment is still too high in many parts of the world and you can have disruptive political consequences so you can't say everything is brilliant.'

Arguably the most potentially devastating effect would be a major disruption in the Middle East as this could catch a lot of people off guard, especially as the US has become used to the oil price coming down in recent months.

However, the overall view is positive. 'In places like Germany, the UK and the US it's getting better,' he says. 'China is looking OK and although parts of Europe are still quite weak, they are not verging on the systemic crisis that we experienced previously, so hopefully we'll have a more normal environment.'

Is the price right?

The fact that issuance around the world has been high in recently doesn't come as much of a surprise to Dawn Kendall, a senior bond strategist at Investec Wealth & Investment.

Having been heavily involved in the convertible universe for a number of years she was optimistic at the turn of the year that the asset class would provide strong returns but the reality has, so far at least, failed to live up to expectations.

'We've had a lot of issuance within convertibles for the first time in years, which is great and it would be the perfect environment for them,' she says. 'There's low volatility in equity markets and a good macro environment, with reasonably strong fundamentals.'

The problem, however, lies with individual convertibles. 'The pricing on the new issues isn't attractive at the moment, particularly in Europe,' she says.

'It doesn't do the convertible market any favours when expensive deals are brought to the table.'

It has made the investment house more cautious about the types of exposure it buys. 'As we don't generally go for direct convertibles the trick for us is finding fund managers that understand the technicals in

SPONSORED STATEMENT

Process and selection drive returns

Global convertibles strategies need flexibility and a strong investment team, says Stefan Meyer of Fisch Asset Management

The Fisch CB Hybrid International fund launched in 2003 to offer convertible bond investors an opportunistic investment strategy in investment grade, high yield and non-rated issues. The fund typically holds between 80 and 100 issues, with around 100 in the current portfolio line-up.

The active management helps the fund to achieve its primary goal: to outperform benchmark and peers in weak markets and match them when markets rise. The degree of active management is mirrored by its active share of 66%, although that ratio has risen to above 70% at times this year.

'We have no restriction on the credit side'

The institutional Fisch CB Hybrid International Swiss franc share class rose 14.2% this year to the end of October, beating its benchmark by 2.5%. Such returns are built on comprehensive monitoring of credit quality and underlying stocks. The investment universe of the CB Hybrid International fund is the UBS Global Focus index, chosen for its transparency and clearly defined selection procedure.

'The benchmark includes investment grade, high yield and non-rated issues. In our opportunistic convertible bond strategies

we have no restriction on the credit side, allowing us to focus on our conviction and specialist knowledge,' says Meyer.

Around 43% of the fund's exposure is to high yield, significantly higher than Fisch's more defensive convertible bond strategy. The opportunistic product also has a higher current spread of around 230 basis points, 80 points wider than the average for the defensive portfolio.

The investment process is made up of four core elements, starting with a top-down macro view of the market cycle. Economic inputs include liquidity flows, money supply, yield curve and special situations. The monthly macro process establishes the basic parameters for developing the fund's strategy, concentrating on delta, duration, region, sector timing, credit quality and volatility sensitivity.

Securities analysis and portfolio construction are the two elements that drive overall performance. The global convertible bond universe is made up of around 1,000 securities, with issues from America, Europe, Japan, Asia and other regions analysed in daily meetings. With a substantial team of eight managers, the Fisch team has sufficient resource to dedicate individual members to specific regions for a fully comprehensive view.

The macro factors also feed into this process, as do momentum indicators, credit analysis and a view on the asymmetrical



Stefan Meyer
Portfolio Manager
Fisch CB Hybrid International

price behaviour (known as delta and gamma) of each issue.

'The team has a detailed insight into each region and each sector, covering all convertibles and their underlying equities,' says Meyer.

Credit analysis is a core element that distinguishes the convertible bond strategies from its competitors. Fisch Asset Management has a majority stake in Independent Credit View (I-CV), the only independent credit research boutique in Switzerland which is exclusively paid for its

FISCH. ASSET MANAGEMENT

services by investors. Its 11 analysts have no conflicts of interest. They also provide input to the final strands of running and maintaining the fund: risk management and an automated alert system that indicates when a convertible is moving in or out of the area of convexity.

‘Comprehensive manpower and specialisation give us the edge. We also have additional input from our fixed income team at Fisch who work on straight investment grade, high yield and emerging market bonds,’ says Meyer.

The combination has delivered on its promises. Meyer says convertible bond selection has been the biggest contributor to recent outperformance, an indication that the team does not rely on beta to drive up the fund’s value.

The portfolio currently holds a substantial weighting to Japan. The local equity market has rallied on the back of government policy and actions by the Bank of Japan that have driven liquidity into the market.

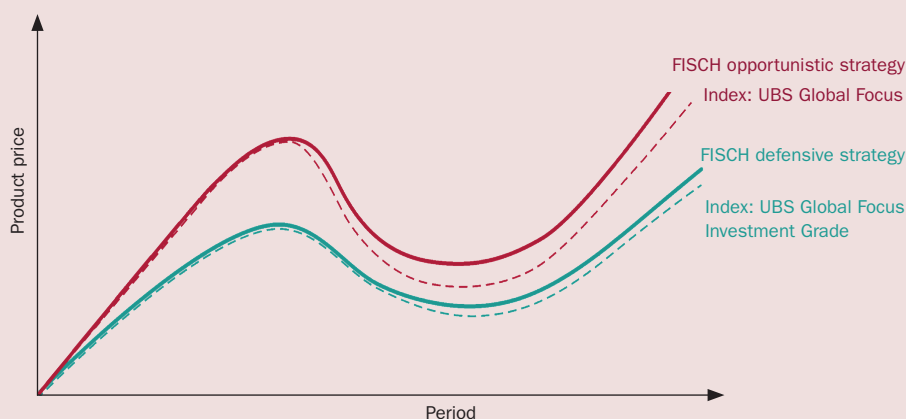
‘We expect the global economy to pick up, so cyclical Japan will outperform further. Even so, flows into investment grade Japanese convertibles are stable which provides a margin of safety if all our expectations of a global upturn are not met,’ says Meyer.

North America and Europe are underweight compared to the benchmark. The slight underweight to the US is being complemented by the use of short index futures on the S&P 500 and NASDAQ to fine tune risk and to keep transaction costs low.

Whilst still underweight, the fund’s exposure to Europe is rising as Asia and America are parred back. Asian REITS enjoyed a successful run in 2012 but that faltered late in the year, leading to the team’s decision to cut back and switch into Europe and the cloud computing-led rally in US investment technology convertibles.

Although European exposure has risen and prices rallied, the team is careful to consider each issue and issuer in depth rather than rely on market beta. I-CV’s analysis of Alcatel-Lucent, a big issuer,

DESIRED BEHAVIOUR OF THE TWO FISCH CB STRATEGIES



Source: Fisch Asset Management

highlighted the turnaround story’s weak financial profile, high leverage and negative cash flow. With a CCC+ rating from Standard and Poor’s, any margin of safety is small. The team opted not to take the company’s paper, despite subsequent strong short-term rises in value, preferring to seek issues with a stronger bond floor instead.

Credit analysis of Nokia provided a stronger investment case. The Fisch portfolio management team bought into its convertible bond on strong coverage and quality. A subsequent turnaround in Nokia’s stock value led to massive profits.

‘Comprehensive manpower and specialisation give us the edge’

Consumer discretionary is a strong theme at present. Two thirds of issuers across the portfolio have beaten their earnings estimates, prompting the team to stick with their overweight exposure for the time being.

Financials remain underweight. US interest rates are bottoming out, indicating a

future rise that will hit the sector’s dominant domestic property issuers and those in emerging markets and Asia. Traditional financials are to be avoided too.

‘We avoid all asset- and mortgage-backed related convertibles. If Quantitative Easing tapering starts, investors could be in for some unpleasant surprises,’ warns Meyer.

He and his colleagues are adopting a relatively conservative stance for the time being. The Fisch opportunistic strategy currently has an equity sensitivity of 38%, some 7% below the benchmark.

‘We have become more defensive in recent weeks. We have decreased the equity exposure to protect against downside risk,’ says Meyer.

Even though the team is cautious, it is still willing to take measured positions in conviction issuers. Biotech is a good example, making up around 5% of the portfolio.

Biotech convertibles issues have extremely high price potential but realising those future gains depends heavily on their research output. The associated risks demand diversification within the sector and size limitations on each single position to limit any downside. Well selected issues from this growth sector provide important portfolio diversification and non-cyclical returns.

terms of how expensive the market is becoming,' she adds.

Jon Gumpel, who manages the IFSL Brooks Macdonald Defensive Capital fund, agrees that it's become increasingly important to be choosy when it comes to convertibles and pay close attention to the financial health of the individual issuers.

'One of the problems – and a reason why we are a bit cautious about full-on convertible funds – is a lot of the companies that are raising money in the convertibles market are in a couple of specific sectors, small, or less than the highest calibre,' he says.

The result is that although issuance has increased, the convertibles available can be rather a mixed bag. 'They are not necessarily companies in which you'd want to buy the ordinary shares,' he says. 'We like to dip in and out, picking those we like.'

That said, Gumpel says exposure to convertibles in his portfolio has risen from 5% to around 30% over the past two-and-a-half years, with a particular focus on names that are capable of delivering asymmetric returns.

'The risk-reward characteristics of convertibles have come to the fore and in the current environment they offer attractive defensive equity options,' he says. 'You hope to get bond characteristics on the downside and equity characteristics on the upside.'

For example, one that has worked very well for him in recent months has been Nokia. 'We bought it because the convertible was attractively priced and we didn't think the company was as bad as the market felt it was,' he says. 'It then announced the sale of a part of its business to Microsoft (for €5.4 billion) and the share price soared.'

Such strong returns on a position held for a relatively short space of time is, of course, the ideal scenario, but involvement in convertibles is not an automatic route to returns. 'The problem is that at different times convertibles can get quite expensive and if this is the case it's not really giving you much protection or much upside,' he says. 'Therefore when parts of the sector

get too expensive we'll go elsewhere or look at synthetic convertibles.'

Navigating volatility

Anja Eijking, manager of the F&C Global Convertible Bond fund, isn't surprised that investors have been turning their attention towards convertibles – especially when they provide income as well as the opportunity to participate in the equity growth potential.

'By identifying and exploiting convertibles that offer good growth potential whilst, at the same time, providing downside protection, actively managed global convertible portfolios will generate a higher risk-adjusted return compared to bonds and equities,' she says.

Convertibles continue to provide equity market exposure with a reduced risk profile, she suggests, while the medium-term economic outlook appears to be good with China expected to grow around 7.5% in 2014 and the US by 3.5%. The weak recovery is already under way in Europe with growth of up to 1.5% expected next year.

'Medium-term acceleration of economic growth combined with monetary policy should be supportive for equity markets with not too strong movements in bond yields,' she says. 'However, markets continue to be vulnerable to shocks.'

This is particularly in regard to the impact of austerity and the level and duration of QE

measures. 'Hence focus in the portfolio is on risk control to shield the portfolio from severe market corrections while continuing to participate in further equity market potential,' she says.

Issuance hotspots

The increasing appetite for convertibles has been a good way for corporates to raise capital, although Rathbones' Jones says there's been little in the way of issuance in the UK over the last 15 years, with most taking place in Europe, the US and Japan.

'Companies in the UK don't like to dilute their shareholders,' he says. 'If you were a chief executive then why would you issue a convertible if you thought your stock price was going to rise 10%, because this would dilute existing shareholders.'

Elsewhere, however, it's been a different story. There has been US\$31.4 billion (€23 billion) worth of EMEA convertibles issued so far this year, according to Dealogic data to 25 November 2013 – up from US\$19.6 billion over the same period in 2012 and US\$11.7 billion the year before.

This year has also seen the launch of funds focused on convertibles. For example, back in the summer JP Morgan announced the successful launch of JPMorgan Global Convertibles Income fund with the company having raised £136 million.

Jones believes convertibles will continue to be popular but doesn't expect to see a massive spike in demand.

'It's not going to make up a huge part of clients' portfolios and I would say an allocation of between 5% and 10% makes sense,' he says.

'If equity markets start to collapse then people might seek some defence in convertibles and although there will always be demand for them they will never be a core part of people's portfolios.'

A lot will also depend on the financial attractiveness of any new issues, points out Investec's Kendall. 'The hybrid structure fits very nicely within asset allocation which is why a lot of people are thinking they can take a bond exposure and have a little equity kicker – and that is great as long as it's priced properly.' ●

'Actively managed global convertible portfolios will generate a higher risk-adjusted return compared to bonds and equities'

Anja Eijking
F&C

A short duration solution for yield and liquidity in Emerging Market Debt

UBP's short duration High Yield strategy with a liquidity safety net counters Emerging Market volatility

Late last year, investors' concerns turned to the eventual ending of QE. As the Fed was looking to exit QE3, interest rates looked certain to rise. That brought added risk for all fixed income investors.

'Investors came to us looking for a decent yield without exposure to Treasury risk. We concluded that a new strategy needed to emphasise High Yield and short duration for lower correlation to US interest rate risk, but most existing strategies were fairly long duration,' says Denis Girault.

He and his EM fixed income team knew there is sufficient choice and diversification in the Emerging Market spectrum for a short duration strategy that maintains a low correlation with interest rate risk, delivers yield and avoids default risks. The result is the UBAM - EM High Yield Short Duration Corporate Bond fund, launched in February this year, initially open only to qualified investors. A UCITS-compliant version open to all investors is available since 19th August.

'The portfolio aims for an average duration of around two years, against average market duration of four years. Around 70% of the tradable Emerging Market High Yield universe is short term by nature, giving us and investors plenty of investment choice,' says Girault.

The Emerging Market High Yield market value amounts to around \$270 billion, comparable to Europe's High Yield market. It is highly diversified, from banks to food producers, and telecommunications companies such as Vimpelcom from Russia.

Denis Girault and his team put high emphasis on managing re-financing risk. Given the structurally short maturity of the issues in the portfolio, we only select issuers with low re-financing risk and we rigorously apply a stop-loss policy by strictly selling issues that fall below a pre-set level, says Girault.

The UBAM - EM High Yield Short Duration Corporate Bond fund also has an additional safety feature. Girault and his team built a liquidity cushion using credit default swap indices (CDX) to ensure daily liquidity in times of extreme stress for the Luxembourg-domiciled SICAV fund.

'The portfolio aims for an average duration of around two years'

'The CDX position enables us to be long credit markets. The remaining cash of the CDX position is invested in high quality securities providing an efficient liquidity buffer in periods of extreme market stress. This position amounts to around 20% of the portfolio. CDX are standardised indices with small spreads, easy to trade and the market behaves predictably,' says Girault.

Emerging market CDX is relatively illiquid. So the team uses the wider and deeper US and European CDX markets via multiple counter-parties.

The fund's broad diversification across countries and sectors also acts as a cushion. The UBP fund currently invests in 36



Denis Girault
Head of EM Fixed Income

countries, across a range of sectors and high quality non-investment grade companies.

The institutional response has been positive. The fund has already gathered assets of almost US\$90 million. Investors use the fund in both their High Yield and Emerging Market buckets.

The fund also proved its worth in recent market turbulence when QE tapering concerns resurfaced in June and July.

Girault thinks there are two reasons why EM markets were hit. Firstly, concerns about Fed tapering and US rate rises have hit the less sticky, opportunistic carry trade. Flighty investors were quick to pull out of fixed income assets, including EM bonds.

Secondly, the IMF revised its economic outlook around the same time. EM growth expectations were cut more severely than the outlook for their developed world peers.

'The combination of negative news gained a bigger weight that it would normally do in other circumstances,' says Girault.

From the SIF's launch in February to August the fund rose 0.24% gross of fees. In comparison, emerging high yield corporate bonds fell between 3-4% overall. The fund saw no redemptions as markets turned down, says Girault.

'Corporate balance sheets are healthier than many sovereigns, although the difference is less extreme than in Europe. Lessons have been learnt from the Asian financial crisis. Corporate bonds - and short duration - are a strategic choice, investors are less inclined to sell,' he says.

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Delivering on convertibles in all investment conditions

The Edmond de Rothschild Europe Convertibles fund has proven its worth in the last twenty years - and in the ups and downs of last few years too

The Edmond de Rothschild Europe Convertibles fund is the oldest of a range of four convertible funds. Newer strategies include Global and Emerging Convertibles, as well as a defensive strategy.

Since inception, Edmond de Rothschild Europe Convertibles has delivered annualised returns of 6.72% (1), ahead of the Exane Euro Convertibles benchmark. Over the last five years to the end of October, that annualised figure has been 9.73% (1), reflecting the ability of convertible bonds and the active management team to capture equity upside as risk sentiment has improved. The addition of hedging strategies in 2012 has also added additional protection through the use of index put options.

‘Convertible Bonds tend to have a relatively short duration compared with other corporate bonds, making them far less interest rate-sensitive’

Fund manager Laurent Le Grin thinks Convertible Bonds offer investors good reason to invest whatever the investment conditions. They tend to have a relatively short duration compared with other corporate bonds, making them far less interest rate-sensitive.

At a time when interest rates are rising, those features work well for investors. Returns are more equity-like, with lower downside risk. Yet running a convertible strategy requires multiple

skills. Active managers need strong equity and credit skills to assess each issue and issuer, and proven technical analytic abilities.

‘A convertible bond is a bond so you need to understand credit, of course. But it is also provides an option to become a shareholder in the issuing company, so you need to understand the upside - or downside - potential of the equity portion too. Combining the two needs experience and a stable team. Three of our four convertibles managers have worked together for over ten years,’ says Laurent Le Grin.

Because of the changing balance between the two bond and equity components, convertible strategies also work well throughout the cycle. Well-chosen convertibles provided good yields for bondholders from 2008 to 2012. But now that equity markets are rallying, convertibles are well placed to deliver upside potential as their equity sensitivity rises.

Le Grin thinks convertibles are also a good equity exposure diversifier. Over the mid- to long-term, they can deliver similar levels of performance with half the volatility attached to pure equities. He also says that some institutional investors allocate significant portions of the equity buckets to the Edmond de Rothschild Europe Convertibles fund, as much as 5% to 10%.

The Edmond de Rothschild Europe Convertibles fund is a big player in a relatively small asset class. Established in 1993, it recently passed the €1.2 billion mark in assets. Even so, the asset class remains a niche that requires special expertise.

‘It is worth remembering that the convertibles universe is only around \$360



Laurent Le Grin
Fund manager

billion in size. European issuers make up around \$105 billion of that total. In comparison, Apple has an equity market cap of around \$470 billion and Google is around \$345 billion,’ says Le Grin.

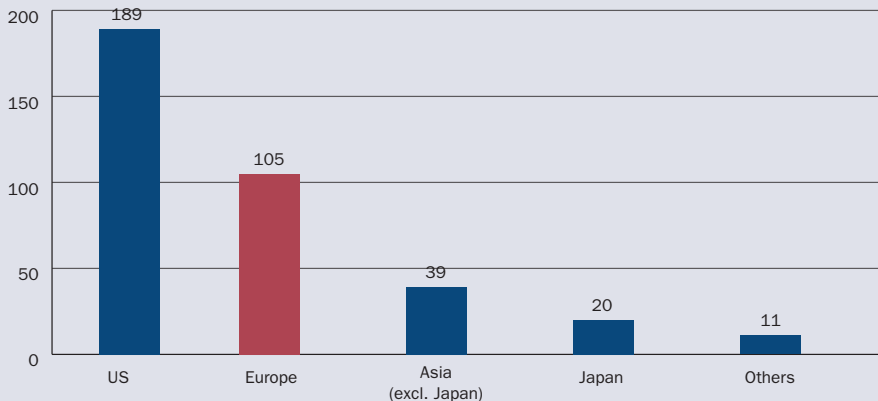
At first glance, the European convertibles market looks particularly titled towards financial issuers. That does not necessarily mean that investors must rely on the performance of the region’s banks to generate the bulk of their returns. Half of all ‘financials’ are real estate companies, which add an interesting technical issue for investors.

Real estate companies follow a specific mark-to-market approach to accounting for their assets and liabilities. As such, the dilution impact is neutralised with the marked-to-market accounting policy. The dilution impact is accrued in P&L during the life of the instrument. As they reach the point of maturity, real estate firms tend to pay back 100% of the value of the bond in cash. They then make up



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SIZE OF THE CONVERTIBLE BOND MARKET BY REGION (IN BILLION \$)



Source: Edmond de Rothschild Asset Management, Deutsche Bank. Data as of end of August 2013.

the difference between the redemption value and the equity value with new shares, meaning less dilution of the equity pool. This is the net share settlement methodology compared to the plain-vanilla methodology in which there is no accrual of dilution effect but the payoff is either 100% in cash, or parity in equity boosting dilution impact.

Other sectors can follow the same approach, or they may simply issue new shares for the whole value of the bond and the increase in equity prices. Greater levels of dilution are not necessarily a bad thing.

'This year has proved strong for new issuances and there are plenty more to come'

'We always ask the chief financial officer how they intend to account for their convertible bond issues in order to know if the company is ready to be diluted and that

could give us a positive view on the equity stock,' says Le Grin.

The European Convertible Bond market has a wide mix of investment grade, high yield and non-rated issues. The Edmond de Rothschild Europe Convertibles portfolio has a self-imposed maximum limit of 30% high yield in the portfolio as Le Grin and his colleagues want a quality bias for maximum downside protection.

The remaining 70% is investment grade, or non-rated with investment grade like. Non-rated issues currently account for just under 35% of the portfolio.

'We undertake our own credit analysis for every issue. Non-rated issues offer good potential, as long as we are certain the issuer can cover the bond coupons,' says Le Grin.

The portfolio comprises 40 to 50 positions, each screened under Edmond de Rothschild Asset Management's proprietary process. The amount of credit, equity and technical analysis varies greatly between issuers and issues, depending on the complexity of each corporate. Le Grin says primary issues are

interesting, but must be thoroughly analysed.

'We are cautious about primary issues. We prefer to miss one if we cannot get a good view on the firm. It is better to take our time and have conviction in the issues we like, so we will not always participate, especially when primary issues look expensive,' he says.

This year has proved strong for new issuances and there are plenty more to come. Le Grin says a total of \$ 30 billion has already been issued this year, against a total of \$ 25 billion for the whole of 2012.

'We are positive on the outlook for the European equity market. We expect a wave of new convertible bond issues to appear as CFOs look to monetise the rise in their equity prices. The mix of reissues and new participants will be good for diversification,' he says.

(1) Past performances are not reliable indicators of future performances. Data as of end of October 2013 for the A Unit of the fund.

COMPANY PROFILE

The Edmond de Rothschild Group is an independent, family-owned group that specialises in private banking and asset management. Founded in 1953, the Group has been chaired since 1997 by the founder's son, Baron Benjamin de Rothschild. The Group has more than EUR 130bn under management, employs 2,900 people and has 30 offices throughout the world. Driven by innovation and the quest for long-term performance, Edmond de Rothschild Asset Management is a leading player in European asset management, offering products and services that create high value added. Its expertise allies performance and risk control and covers numerous asset classes and geographical zones.

* Written on November 13, 2013. Non-binding document. This document is for information only. The fund main risks are: capital loss risk, risk from holding convertible bonds, interest rate risk, credit risk, equity risk, currency risk, risk linked to the use of financial contracts, discretionary management risk.

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The search is on

Convertible bond fund managers must consider a wide range of factors to track down the best investments for various market conditions.

Rob Griffin talks to some of the leading names to find out where the latest hunting grounds are

It is fair to say the last five years have been tough for fund managers tasked with the job of steering their portfolios through a darkly troubled period with numerous economic, political, regulatory and company-specific issues coming to the fore.

For those involved in the increasingly competitive world of convertibles it has been particularly challenging because each of their investment decisions relies on a thorough knowledge of many asset classes.

This point isn't lost on Shawn Mato, one of the managers of the Aviva Investors Global Convertibles fund, ranked sixth out of 43 managers in the Global Convertible Bond sector over five years (see table p16). Mato acknowledges the inherent difficulties in choosing assets that will be affected by both equity and credit sensitivity.

'As a convertible investor you are typically a jack of all trades and have to be mindful of all the different characteristics within

equities, credit, and interest rates,' he says. 'You need to look at these scenarios and understand what's going on in each security that you own.'

However, the key factor in determining performance will always be bottom-up security selection, he insists. 'This is what's really driven our returns,' he says. 'It usually accounts for 80-85% of them with 15-20% coming from top-down calls.'

Narrowing the selection

As the fund is focused on the balanced area of convertibles – defined by Mato as being in the delta range of 25%-75% – the huge number of potential holdings are whittled down by removing those that are very bond-like or overly sensitive to equities.

'On the equity analysis side we look at fundamentals such as price-to-earnings, what the company is growing at, what's driving that growth, and whether the top line

is improving,' he explains. 'We try to get an understanding of the metrics for individual companies.'

Over the past year the fund has benefitted from exposure to health care – especially in the US – as well as being overweight Japan, a stance that was prompted by the belief that individual company fundamentals were starting to look more attractive.

Japan in vogue

Japan has also been a good hunting ground for Beat Thoma of BayernInvest Convertible Bonds Fonds, who is ranked ninth out of 60 managers over three years. Thoma says the overweight position is based on the fact there are both top-down and bottom-up opportunities in the country.

'We are finding quite a lot of interesting Japanese bonds,' he says. 'The other big advantage is that Japanese companies are mostly investment grade which makes them

more stable than high yield. This is a positive by-product of the Japanese overweight.'

Diversification has also been a crucial element behind the fund's performance. 'We don't take huge macro or top-down bets but instead prefer a lot of small bets on single positions,' he says. 'The advantage of this is you have a diversified outperformance and aren't dependent on single bets.'

Credit quality is another vital cog in the process. 'It's really important to not only manage the equity sensitivity but also the credit quality of your portfolio,' he says. 'This is why we have a large team of 12 credit analysts.'

Overall, Thoma believes the best returns are generated when the top-down and bottom-up elements are working in your favour. 'If a specific region is strong and you pick the strongest bonds within that region you will have an advantage,' he says.

Sector favourites

For Hubert d'Ansembourg, manager of TreeTop Convertible International, there have been a number of lucrative sectors in which to invest. Citywire + rated D'Ansembourg, and ranked joint-first in the five-year table, says two of the best sectors in recent years have been the car industry and the electronic payments world.

Strong returns have been generated from investments within motor manufacturers, particularly Hyundai, while electronic payments is favoured because of the increasing use of the internet and the associated demand for customer solutions.

'A third sector we like is convenience stores, particularly in the US,' he says. 'This is a very fragmented sector but we like Alimentation Couche-Tard as it's a big firm, the growth has been spectacular, and it has opportunities to add to its portfolio.'

Within the favoured consumer electronics arena he highlights Samsung, while another area of interest is flexible business centres run by names such as Regus.

'It's the world leader and has a good,

Top Global Convertible Bond fund managers by Manager Ratio over three years

Manager name	Total return (%)	Manager ratio	Contributing funds	Citywire rating
Stefan Meyer	28.67	0.31	FISCH CB Hybrid International CHF HB	citywire A
Alessandro Esposito	26.85	0.21	BlueBay Global Convertible Bond I USD, BlueBay Global Inv Grade Conv Bond I EUR (AIDiv)	citywire A
Michael Reed	26.85	0.21	BlueBay Global Convertible Bond I USD, BlueBay Global Inv Grade Conv Bond I EUR (AIDiv)	citywire A
Jacques Berghmans	20.50	0.12	TreeTop Convertible International A EUR, TreeTop Scolea SICAV International	citywire +
Hubert d'Ansembourg	20.50	0.12	TreeTop Convertible International A EUR, TreeTop Scolea SICAV International	citywire +
Peter Eggenberger	14.19	-0.03	LLB Wandelanleihen (EUR) P	
Alexander Müller	19.06	-0.09	CONVERTIBLE GLOBAL DIVERSIFIED UI	
Stefan Winkler	18.26	-0.13	Apollo Euro Convertible Bond Fund T	
Beat Thoma	19.55	-0.17	BayernInvest Convertible Bonds Fonds InstAL, Schroder ISF Global Conv Bond A Acc	
Rupert Mathews	17.49	-0.17	Salar A1 USD Acc	

CITYWIRE MANAGER RATIO: Manager Ratio reflects how much 'added value' in terms of outperformance against the benchmark the fund manager delivers for each unit of risk assumed, where risk is defined as not mirroring the index's return. It ties together the fund manager's personal career history with the Information Ratio of the underlying funds

systematic strategy,' he says. 'More and more people are working in a flexible way and find it's very interesting to use this kind of business centre.'

According to d'Ansembourg, the philosophy of the fund is based around three key elements: conviction, global nature, and flexibility. 'We have a limited

number of positions, a maximum of 30,' he says. 'We also never put more than 50% in a big region because we think there are always opportunities globally.'

Reading the market

Mike Reed, senior portfolio manager of the BlueBay Global Convertible Bond fund, who is ranked second over three years and has a Citywire A rating, agrees that getting the calls right has been an essential element in his performance over the past three years – especially when it comes to regional exposure.

'We have generated strong returns from our exposures to Asia and the US,' he says. 'We have also profited from an overweight to higher-yielding credits and had a strong call on the eurozone crisis dating back to 2010.'

The team attributes its success in Europe to correctly analysing the ebb and flow of the political and economic situation, saying this philosophy has enabled the fund to generate significant returns for clients.

'Having identified in early 2010 that the situation in the periphery would deteriorate

'It's really important to not only manage the equity sensitivity but also the credit quality of your portfolio.'

Beat Thoma, BayernInvest Convertible Bonds Fonds

SPONSORED STATEMENT

Convertible bonds. To convexity....and beyond!

Convertible bonds can provide investors with the upside potential of equities with lower price volatility and protection in a rising interest rate environment

By Mike Reed, Partner & Senior Portfolio Manager, BlueBay Asset Management LLP

Year to date, convertible bonds have provided investors with robust returns, despite rising interest rates dampening returns on other fixed income instruments. With the global economy normalising and the US Federal Reserve's (Fed) quantitative easing (QE) programme widely expected to end next year, we believe there are a number of key investment themes that could prove beneficial for convertible bonds: rising equity markets, lower default rates and higher yields for core government markets and value in emerging market credit and equity markets which should help them outperform developed markets.

'Key investment themes in 2014 could prove beneficial for convertible bonds'

Avoiding the dangers of duration

As global growth improves and the Fed begins to taper, we anticipate a normalisation of US interest rates.

Given current market inflation expectations, this implies a yield on 10-year US Treasuries of between 3.5% and 4%. An improving global economy would benefit credit spreads, but the magnitude of tightening would be unlikely to compensate corporate bond investors for losses incurred due to rising risk-free interest rates. Although convertible bonds are fixed income instruments, the equity component in their hybrid structure has historically allowed them to generate positive returns in periods of rising interest rates. A number of factors contribute to this performance, but primarily equities generally perform well in periods where core government bond yields rise due to an improving growth outlook. Therefore, although the fixed income element of a convertible will likely suffer some losses in this environment, the convertible price is likely to increase due to the rise in value of the equity element.

Equity markets have the potential to rise

With analysts forecasting earnings for the US S&P 500 Index will rise 10.6% in 2014. This puts the index on a forward price/earnings (P/E) ratio of approximately 14.2x, which is below



Mike Reed
Partner & Senior Portfolio Manager

the historical average of around 16x. Consequently the current price level of the index appears undemanding and equities could have room to rise further. Equities in Europe on a forward P/E of 2.5x and emerging markets on 10.3x also trade at a discount relative to historic averages of 13.6x and 13.3x respectively. The earnings prospects of global companies currently provide a strong argument for investment in equities versus bonds on a relative value basis. This can be seen by expressing corporate earnings in a yield format and charting them against

the yield on fixed income instruments, which highlights the divergence in relative value that has occurred over recent years (see graph below). This is driving companies to issue corporate bonds and buy back their equities to improve their return on equity. We also believe it should give rise to a return of leveraged buyouts, as public and private firms take advantage of this dislocation. An active M&A market has historically driven strong returns from equity and convertible markets.

'We believe the case for investing in convertible bonds in the current market environment appears compelling'

Credit spreads offer value

The second major driver of convertible returns is credit spreads. Although credit spreads have tightened for investment grade and high yield bonds, they still appear attractive relative to anticipated default rates. Although forecast to rise, interest rates currently remain low and thus the interest rate burden for companies is undemanding. With the global economy growing, the likelihood of companies defaulting remains low and thus we believe investors are currently overcompensated for the risk of default-related losses. Convertible bonds generally rank pari passu with general corporate bond issuance in the capital structure and are therefore priced using the same corporate credit spread. Thus convertible investors can benefit as credit spreads tighten.

Opportunities in emerging markets

Emerging market economies are

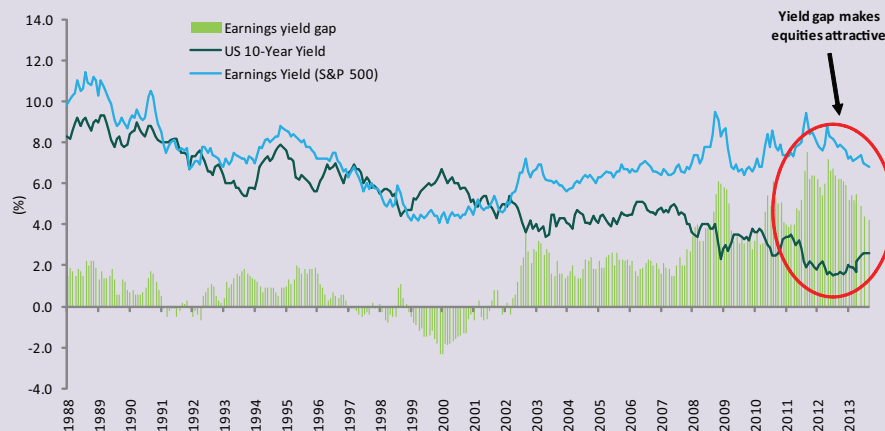
expected to continue to expand at around two and a half times the rate of those in the developed world. However, credit spreads in emerging markets remain wider and equities undervalued relative to their developed market counterparts. Leverage ratios have historically been a key measure used to highlight credit risk. However, leverage ratios in emerging markets are lower than developed markets. Anomalies such as this can provide investors the opportunity to diversify their portfolios and generate alpha. Investors in emerging market convertible bonds can benefit from improving credit spreads and the equity potential of these high growth companies. Emerging market convertible bonds have historically demonstrated considerably lower price volatility than direct equity investment and therefore a better risk/reward ratio.

Conclusion

We believe the case for investing in convertible bonds in the current

market environment appears compelling. In our view, the coming year promises improved growth prospects for the global economy that should prove beneficial for equity and credit markets. However, core government bond yields are widely expected to rise. This could prove a drag on returns for pure fixed income portfolios. Convertible bonds, with their ability to participate in rising equity prices and improving credit markets, appear to offer an attractive investment opportunity. We believe these factors, combined with the historic ability of convertibles to generate positive returns in rising interest rate environments, make an investment at this time particularly attractive. The global convertible universe offers a diverse range of investment opportunities on a regional and sector basis. In our view an actively managed fund can provide opportunity to participate in the upside potential, but also provide convexity of returns in the event of market volatility.

EARNINGS YIELD GAP IS DRIVING CORPORATE BUYBACKS



Source: Goldman Sachs, as at 30 September 2013

rapidly, we sold our entire exposure to Portugal, Italy, Greece and Spain,' he recalls. 'However, from a series of meetings with high-ranking German and EU officials we established the opinion that northern European countries would remain strong backers of the euro. This allowed us to take advantage of the depressed prices of many peripheral bonds.'

On the negative side, the fund underweighted US exposure in favour of Asian in 2013, believing that the political headwinds in the US would cause turbulence in US equities. 'This hasn't been the case and although we have generated positive returns from our Asian exposure the US has offered better returns in general this year,' says Reed.

A 360-degree approach is applied to portfolio construction, which combines macro views, fundamental credit/equity analysis and technical valuation techniques to establish portfolios with strong asymmetric returns.

When it comes to current positioning he is attracted to Chinese/Hong Kong names.

'The economy is stronger than anticipated, and due to the sell-off this year in the emerging market space, investors are over compensated for credit risks, while equity markets have the potential to perform,' he says. 'We also like biopharmaceuticals where the large amount of M&A has the potential to offer significant upside to the holdings we have established.'

Reed is also constructive on both credit and equity markets. 'Current credit spreads appear to over-compensate investors for the risk of defaults when analysed on a bottom-up basis,' he says. 'Equity markets have the potential to perform in 2014 as earnings are still rising and, relative to fixed income markets, valuations appear attractive.'

Gains all round

As hybrid instruments, convertibles can benefit from both tightening credit spreads and rising equity markets. 'Due to their hybrid nature convertibles can offer investors protection against rising rates,' he adds. 'In 1994, 1999, 2009 and 2013,

Top Global Convertible Bond fund managers by Manager Ratio over five years

Manager name	Total return (%)	Manager ratio	Contributing funds	Citywire rating
Jacques Berghmans	123.48	0.47	TreeTop Convertible International A EUR, TreeTop Scolea SICAV International	citywire +
Hubert d'Ansembourg	123.48	0.47	TreeTop Convertible International A EUR, TreeTop Scolea SICAV International	citywire +
Stefan Meyer	98.99	0.41	FISCH CB Hybrid International CHF HB	citywire A
Michel Fest	96.24	-0.01	Man Convertibles Global MUS D7 EUR	
Miles Geldard	77.75	-0.08	Jupiter JGF Global Convertibles L EUR	
David Clott	73.02	-0.11	Aviva Investors Global Convertibles B	
Shawn Mato	73.02	-0.11	AVIVA INVESTORS GLOBAL CONVERTIBLES B	
Alexander Müller	86.44	-0.17	CONVERTIBLE GLOBAL DIVERSIFIED UI	
Thorsten Vetter	104.88	-0.21	Flossbach von Storch - Wandelanleihen Global F	
Rupert Mathews	76.64	-0.22	Salar A1 USD Acc	

CITYWIRE MANAGER RATIO: Manager Ratio reflects how much 'added value' in terms of outperformance against the benchmark the fund manager delivers for each unit of risk assumed, where risk is defined as not mirroring the index's return. It ties together the fund manager's personal career history with the Information Ratio of the underlying funds

convertibles have posted positive returns during years when core fixed income investments have lost money.'

Peter Reinmuth, the fund manager of Schroder ISF Global Convertible Bond and Schroder ISF Asian Convertible Bond, agrees Japan has been the best contributor to performance since late 2012, thanks to the monetary policy of the Bank of Japan and the yen weakening. Reinmuth, ranked 12th in the three-year table, says: 'This year we have been successful in the US with consumer discretionary and IT companies, both hardware and software, and difficult credit positions like IVG and Pescanova,' he says. 'We also did very well with new issues Nokia, Sony and Tesla.'

On the negative side, an underweight in European names, principally due to concerns about southern European countries, hit performance, while the fund also missed the strong turnaround of Alcatel earlier this year.

As far as investment philosophy is concerned, Reinmuth highlights the unconstrained approach, the strong bottom-up investment process with a focus on credit analysis and security selection, and broad diversification within regions,

countries and sectors.

In particular he likes strong credits with good bond floors that, if possible, provide a positive yield contribution. 'We like CapitaLand as it's a strong AAA credit with a decent yield and backing from Singapore's government,' he says. 'It's a play on the Chinese housing market with solid downside protection.'

Pacific Basin is another that he favours. 'Its management has a good track record and it's a conservatively run company with a good balance sheet,' he says. 'It is a good play on the cyclical recovery of the global shipping market.'

Looking to the future, Mato at Aviva Investors is confident there will be enough attractive convertibles in the marketplace and believes that people are increasingly viewing convertibles as an interesting way to play equities.

'Some people love convertibles and will always invest in them whereas others won't because they don't understand the asset class and don't want to take the time to understand the minutiae, but we are spending as much time as ever talking about them.' ●

How are fund pickers using the convertibles market?

Fund analysts give us their view on the outlook for this asset class and name the funds they are using or watching

ROBERTA CASTALDELLO
EUROMOBILIARE ASSET MANAGEMENT

After some difficult years, the primary market has reported a renewed interest in convertibles. The prospective return on this asset class is clearly linked to the equity component today. In addition to that, given the low levels of implied volatility, the premium that you pay for the optionality is low.

Today, the players involved in the market are mainly long-only funds with a less aggressive and more stable approach compared with hedge funds and investment banks. Historically, we prefer funds characterised by a balanced profile (with a 0.5 delta) aiming to maximise the convexity. These funds represent a structural component of our allocation, which has remained stable throughout the year, with no increments being planned for the time being.

We have invested in portfolios managed by **Miles Geldard**, whose distinctive trait is to run convertible bonds with a solid macro overlay. We have also invested in the **GLG Global Convertible** fund, as the company has a consolidated experience of European convertible bonds fund management with a balanced-aggressive approach.



I think convertible bonds have been popular for some time now, and the mutual funds investing in this asset class have performed well even prior to 2013. It is, however, a complex asset, suitable only for the most experienced investors: when it comes to convertibles, investors can hardly go DIY.

This year, convertibles have presented good opportunities and I believe that, if handled properly, they will continue to offer value. I think the **DNCA Invest Convertibles** fund is quite balanced, with volatility rates that I find acceptable.

Having said that, I don't think I will take an overweight in this asset class in the near future. Instead, I will be on the lookout for clearer indications from the Fed as to when tapering finally begins, to see how interest rates react, how it will reflect on the equity and fixed income markets, and whether the two asset classes will prove to be correlated or not.

Broadly speaking, I don't think one should allocate more than 15% of the portfolio to convertibles.

FRANCESCO FREN
FAMILY ADVISORY SIM

There are two reasons why a multi-asset manager may decide to invest in this asset class: either as a result of a bullish stance on convertibles – and this is not our case – or because one wants to add a little equity component to the portfolio, when it has already reached the maximum of the buffer.

From my point of view, the target is to always keep a small exposure to convertibles by drawing on the expertise of an active manager, who is able to guarantee a high turnover and the maximisation of the alpha component.

However, I would never take a big bet on convertibles as they are a rather illiquid asset class, which doesn't allow selectors to enter and exit the market with ease.

In one of the most recent portfolios we've built, I have included a 2.5% exposure to the **Amundi Convertible Europe** fund – enough to add some equity to a standard risk-averse approach.

Other funds I have invested in the past include **RWC Global Convertibles**, managed by Davide Basile, **Man Convertibles America**, **UBS (Lux) Bond Convert Europe** and **Fisch CB - International Convertible Expert**.

THE VIEW
FROM **TURIN**



THE VIEW
FROM **COLOGNE**



DANIEL KNÖRR
AMPEGA INVESTMENT

We have been broadly invested in convertibles in our multi-asset strategies since 2009. At that time, the asset class was historically cheap as many hedge funds had been invested in them during the financial crisis and as such convertibles saw extreme losses on this as these players had to unwind their positions to provide liquidity to their investors.

I think valuations have become much less attractive in the US and Europe and the asset class has been strongly overbought. There is potentially some more opportunity when you look towards Asia but otherwise the valuations are starting to look quite stretched, mostly in the secondary market, and we wouldn't be increasing our exposure.

The pitch from sales is that you will always be heavily protected on the downside but actually, I think that if we were to get a strong correction on equities, we would also see convertibles take a big hit.

We are invested in **Miles Geldard's** fund at **Jupiter** and still see good returns coming from this. As we see convertibles as a substitute for bond investments, we especially like the manager's cautious delta positioning but also his avoidance of taking synthetic positions with investment banks. Other asset managers we might have considered if we saw potential in the asset class are the funds at **RWC** or **UBS**.



THE VIEW FROM MADRID

FELIX LÓPEZ
ATL CAPITAL GESTIÓN

We have been invested in convertibles for the last two-and-a-half years. Last year was good, but 2013 has been fantastic both in absolute and relative terms – it's probably the best asset class in the fixed income space this year.

A key point at this moment in time is that it is beginning to get more expensive than two years ago but I do see some more potential for the asset class. We might not see the same

Europe and Asia are likely to perform the best in the convertibles space as the US looks pricey

Europe and Asia are likely to perform the best in the convertibles space going forward as the US looks a bit pricey.

We are invested in two convertible funds. One is the **Salar** fund run by the convertibles specialists at **Ferox Capital** and the other is the **M&G Global Convertibles** fund run by **Leonard Vinville**.

outperformance as in 2013 and 2012 but I think that in relative terms, convertibles still carry a lot of value in the fixed income space.

We will be upping our exposure to equities and reducing fixed income. Within this strategy, we think that convertibles still offer and carry some value.

MICHAEL ODERMATT
HELVINVEST

About one year ago we decided to significantly increase our exposure: on the one hand to hedge our positions in investment grade corporates against a possible great rotation scenario, and on the other to benefit from the asset reflation due to quantitative easing by the Fed. For the moment we hardly see any signs of the great rotation out of bonds into equity markets that was anticipated by other market participants.

Without a doubt equity markets are the biggest risk to convertible bonds. Despite the recent rally in this asset class, equities are still relatively cheap. That's why we currently don't expect much downside in convertible bonds. Besides that, liquidity risk is definitely a factor to consider. The market has seen large inflows and we are not sure whether there is enough liquidity to absorb potential outflows.

Equities are still relatively cheap, so we don't expect much downside in convertible bonds

Currently there is limited potential to increase our weighting due to stretched valuations. We prefer both **Léonard Vinville's M&G Global Convertible Bond** fund because of his bottom-up driven and benchmark unaware philosophy and **Michael Reed's BlueBay Convertible Bond** fund because of his experienced credit research capabilities and fixed income-oriented investment style.



THE VIEW FROM ZURICH

SPONSORED STATEMENT

Advantages in all market conditions

Convertibles offer unique potential for investors now that Europe is on the mend

For the last 18 years, Oddo Asset Management has taken a leading position in offering investors the performance and protection benefits of convertible bonds. Its range, led by the eurozone Oddo Convertibles Taux fund, is expanding with the imminent launch of a global strategy.

Luc Varenne, head of convertible bond management, explains why convertibles make sound investment sense.

'Convertibles offer a good risk-reward profile, with two main characteristics. On the one hand, convertible bonds protect in case of downturn. And on the other, convertibles capture the main part of equity performance as markets rise. The explanation is convexity. Convertibles stop losing thanks to their bond floors and lock in equity performance,' he says.

Varenne calculates that an investor investing at a market peak, such as at the end of June 2007, would have eventually earned an annualised return of 3.2% by the end of September 2013 by following the UBS Europe Hedged index. An investor following the DJ EURO STOXX equity index would have suffered an annual loss of 3.3%. Balanced investors splitting their investment equally between the EURO STOXX and Barclays Euro Aggregate Bond would have earned a modest 1.2%.

In rising equity markets, convertible index returns are even stronger. The fortunate investor who timed their entry well at the market's February 2009 low would have captured over 80% of the equity upside via convertibles.

Following the same indices, the bullish convertible investor would have gained an annualised 12.7%, not far from the annual 14.2% gained by a pure equity investor. A

balanced investor would have seen returns of 11.4% per year. A pure bond investor would have fared less well, with annualised returns of just 7.9%.

Convertible investors need to consider their time frames. As robust as convertibles are, they can suffer in extreme market conditions. The eurozone's recent liquidity crisis is a case in point.

'Bond floors and valuation can prove vulnerable in the phases of liquidity crisis. During the 2008 crisis, from September to October, European convertible bonds lost 25% - as much as equities. But in the recovery, they rocketed with a gain of 11.8% from November 2008 to March 2009,' says Varenne.

'Convertibles offer a good risk-reward profile'

When convertibles climbed, equities failed to match their returns. Varenne says they lost an additional 18.8% in that short period to the end of Q1 2009.

Overall, during the highly volatile conditions that affected all markets worldwide from the end of 2007 to the lows of September 2009, the bond floors proved their worth. Convertibles lost less than 3%, whilst equities fell over 30%.

The downside risks to convertibles need serious consideration. European issues tend to be small and mid-cap companies and high yield issuers. As such, they are more impacted when risk aversion increases, just as the equity of similar issuers are. Luc Varenne also



Luc Varenne
Head of convertible bond management

points out that the types of issuers in the market also led to outsize falls five years ago.

'In 2008 around 70% of participants were leveraged ones, including hedge funds, banks and convertible bond brokers. Many of them were ousted from the market at that time, which explains the similar crisis in 2011 was milder,' he says.

To mitigate such downside extremes, Luc Varenne and the Oddo convertible team focus on convexity, favouring balanced convertible bonds particularly the ones issued in the primary market at reasonable valuations. Liquidity issues, especially when risk aversion rises, are managed by Oddo's internal guidelines and fund strategy limitations on maximum issuer weightings based on credit ratings and market capitalisation.

Today's market has moved on from its darkest days. Varenne notes that global investors are keen to take on more risk, particularly in Europe as the worst of the eurozone's political and country crises seem to have passed. But at a global level, the move towards risk is not yet firing on all cylinders. Investors are discerning.

'There are several reasons for this rediscovered appetite for European convertibles and for their relative richness. The richness is more pronounced for Blue Chip and Investment Grade convertibles. Many European investors still favour European securities, with only a few looking for global exposure,' says Varenne.



The European primary market is also more active than in recent years. That has very recently helped push valuations to more reasonable levels. Lower interest rates, lower credit spreads and the recent equity rally are also working in favour of primary issue convertibles.

Further afield, US convertibles are also benefiting from equity performance and tightening credit spreads. Japanese convertibles have posted spectacular returns too, rising 33% in the first five months of the year. Luc Varenne remains wary.

'Capturing that amazing Japanese performance was not easy. The strongest performing convertibles quickly reached a 100% equity sensitivity. The equity market's continued rise meant they just kept on performing. But that has left them non-investable, as they now have a huge premium to their bond floors. It is only through the primary market that we have been able to enhance our Japanese allocation,' he says.

Upside performance potential across the global convertibles universe is also affected by the types of issuers and issues on offer. Pure cyclical sectors such as raw materials and consumer discretionary are more strongly represented, whereas consumer staples are significantly under-represented.

In the European sphere, a lack of non-real estate financial sector issuers means that the recent rebound in periphery banking stock

prices has not been fully captured by convertible strategies.

Some funds work around this issue using 'synthetic convertibles'. Luc Varenne preferred to steer clear of the sector. He makes use of synthetic convertibles as a useful alternatives to convertibles judged too expensive or lacking convexity. He creates its own synthetics buying a straight corporate bond and a listed call option on the issuer's equity.

'Many European investors still favour European securities'

But that does not leave the Oddo convertible team stuck for other investment opportunities and structures. Exchangeables - where the issuer is different from the underlying equity - have accounted for nearly 40% of issue volumes in Europe this year.

'Exchangeables are an interesting opportunity as they have helpfully reinforced the weight of investment grade issues in 2013,' says Varenne.

Europe also has a considerable weighting to cyclical industrial sectors, including materials, energy and infrastructures. Issuing companies usually have a global exposure. That same global focus can also be found in luxury goods and automobiles, both sectors where Europe

leads. Asia is another good source of consumer discretionary opportunities.

The US paints a different picture. It provides the bulk of biotech and tech stocks, usually fast-growing niche issuers, rather than mature companies. Such issuers can be found in two of the world's fastest growing sub-segments: touch screens and cloud computing. Again, Asia is also on the rise in the tech space.

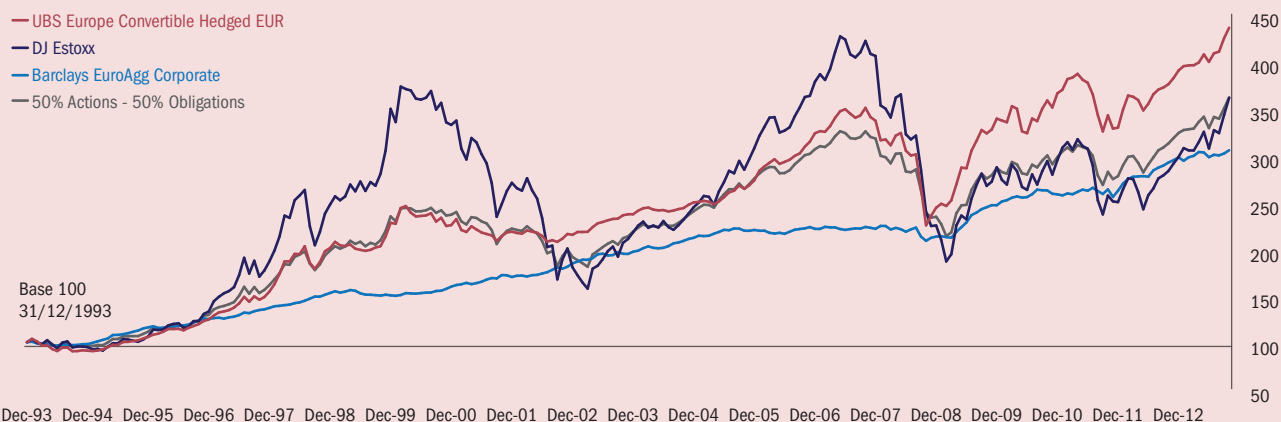
But it is back in Europe where Luc Varenne sees many current opportunities. Banking and pure financials may be essentially off the cards, but the Oddo convertibles team is still spoilt for choice.

'The recent rebound in Southern Europe has opened up many opportunities, particularly in the industrial sector and mis-judged credit situations,' says Varenne.

Amongst the industrial names he likes are Portuguese petroleum group Galp, cable manufacturer Prysmian, Italian cement maker Buzzi Unicem and Spanish consulting and technology group Indra.

Spain is also home to mis-judged credit situations, such as renewables and technology firm Abengoa, construction firm ACS and travel company Grupo Vilar. The country even recently offered the opportunity to invest in the banking sector with the issuance by La Caixa. The Portuguese holding company Parpública, with stakes in the national airline, water company and others, is also a beneficiary of a more positive view on Southern Europe.

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