ABR Dynamic Funds' Portfolio Construction Series: Part 14

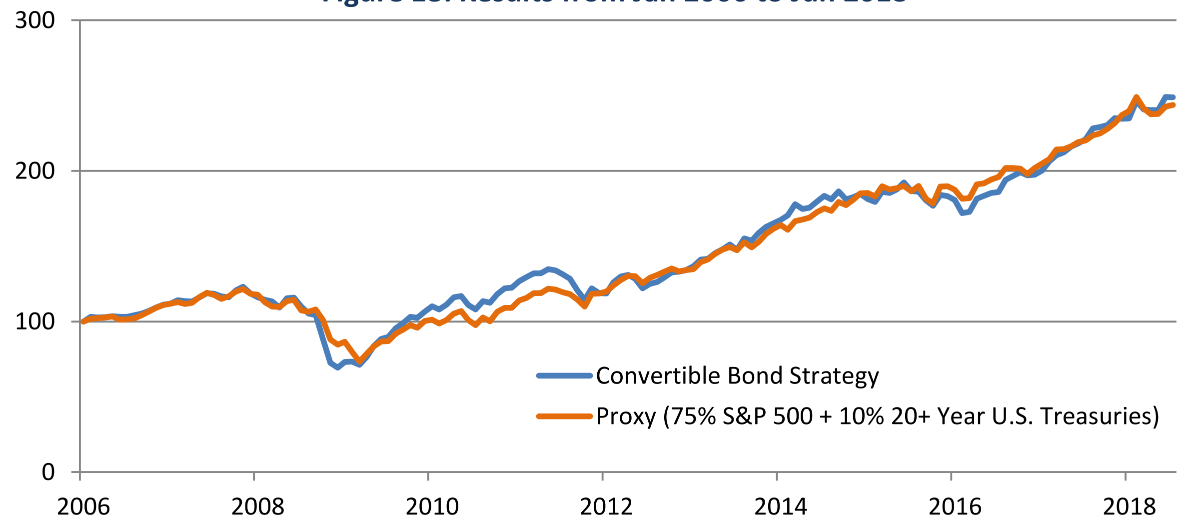
Fooled by the Wrapper VI: Convertible bonds have mostly just provided core exposure

Convertible bonds may sound pretty good. If equity prices drop, investors have the security of a bond. If equity prices rally, that bond can be converted into equity, allowing investors to participate in the rally. The supposed ability to participate only in the upside of equity rallies is found in other instruments as well, especially equity "call" options. In other words, a convertible bond is part bond and part equity call option, and it is priced as such.

However, the price of an equity call option moves along with the stock itself. **Therefore, a convertible bond is part bond and part stock. Of course, the core of a portfolio is also part bond and part stock. That may warrant some skepticism that convertible bond strategies have provided meaningful diversification to portfolios.** As with previous "Fooled by the Wrapper" installments, we will seek to identify any true diversification value by recreating a convertible bond strategy with a proxy of just simple core allocations.

- **Convertible Bond Strategy vs. Proxy**
    - Proxy Allocations:
        - 75% equity behavior (SPY – S&P 500 ETF)
        - 10% interest rate behavior (TLT – 20+ Year U.S. treasury ETF)
        - 15% idle capital

Figure 18: Results from Jan 2006 to Jun 2018



Source: ABR white paper (data from Bloomberg)

The convertible bond strategy was basically just a core allocation, including in market downturns and the Financial Crisis. There was no meaningful security or protection in dropping equity markets from the debt portion of the convertible bond strategy. Furthermore, the proxy for the convertible bond strategy left 15% of capital completely idle, not even earning the risk-free rate. The following excerpt from ABR's white paper on portfolio construction discusses the shortcomings of so-called alternatives that can easily be mimicked with core exposures, especially with reduced amounts of core exposures. It will be familiar to readers who have been following this series on portfolio construction.

Excerpt from ABR's white paper on portfolio construction

Perhaps most importantly, the proxies for typical forms of many of these "alternative" strategies use *reduced amounts* of core exposure to achieve results similar to the "alternative" strategies. This feature, while touted by some managers as a benefit in the form of volatility reduction, is actually quite detrimental to investors.

For example, consider an "alternative" that always moved half as much as equity behavior (0.50 beta), in the same direction as equity behavior (1.00 correlation). This hypothetical alternative:

- Tied up twice as much capital as direct exposure to the equity behavior it mimicked.
    - That capital should have been hard at work elsewhere. Diluting exposure to equity, or any other, behavior only serves to tie up more capital and require more leverage to reach the target exposure level.

- Provided no diversification value whatsoever to the equity behavior it mimicked.
    - It lost every time equity behavior lost, totally eliminating the only free lunch in investing.

- Generated a diluted return compared to the equity behavior it mimicked.
    - Diluted equity returns may have been a luxury investors could afford in a raging bull market, but what if future S&P 500 returns are much lower? How will investors feel about diluting already low returns?

We wish to note that this example should not be taken to mean that all forms of convertible bond strategies are bad. The ones that carry the features just discussed may be, but that is not intended as a criticism of the ones that do not.

Next Week's Preview: A typical investMENT has generated considerably better returns than its typical investOR.