

INSIGHTS FROM CFA SOCIETY SINGAPORE

Book review: Just about all you need to know about convertible securities

By Martin Fridson

PROFESSIONALS who contemplate investing in, hedging, or issuing investment-grade or speculative-grade convertible bonds or preferreds in the public or private market in North America, Europe, or Asia will find just about everything they need to know in *Convertible Securities: A Complete Guide to Investment and Corporate Financing Strategies*.

Pointers on such matters as using convertibles to diversify a portfolio or to optimise a capital structure are meticulously supported with empirical data and amplified with case studies.

If, on certain subjects, readers desire more details than even the book's 560 pages could accommodate, they can follow up on handy references to material on the website of Advent Capital Management, where the book's authors Tracy V Maitland, F Barry Nelson and Daniel G Partlow, apply their expertise in managing convertibles.

In addition, the book recounts the asset class' evolution from its 19th century origins right through the investment implications of the Tax Cuts and Jobs Act of 2017, and recent modifications of accounting standards for convertible issuers.

The authors address a broad audience. Lay investors can apply basic financial theory, presented by way of background, to activities well outside the convertible market's confines. At the same time, the book presents quantitatively sophisticated valuation methods and trading strategies, invoking terms of art that will be new even to many seasoned practitioners – for exam-



ple, "ASCOTs"; "zomma"; "nuking"; and "happy meal".

It is incumbent on the reader to pay strict attention to the authors' carefully considered wording throughout. Recollecting his introduction to financial markets in the 1980s, Advent founder Tracy Maitland mentions in his preface "long-term returns from convertibles that were equivalent to the returns from common equities, but with significantly less risk".

Bringing the story up to date in the main text, the authors state that "convertibles historically have returned *approximately* as much as common stocks over the long-term" (italics added).

Careful to avoid overstating matters, they write at another point, "Convertibles *typically* pro-

vide less volatility than stocks." Equally circumspect is this comment: "The record of convertible indices *essentially* matching the returns of equity indices over the decades *may partly* reflect the superior growth of convertible issuers relative to the growth of companies found in the equity indices" (italics added in the preceding sentences).

One message that comes through clearly is convertibles' asymmetric behaviour, capturing much of the associated stocks' upside while cushioning the downside via the bond side of their nature.

Among many useful observations that are tangential to the main topic, two call for a bit of annotation. First, the authors state that "because risk increases with re-

spect to time, longer-term securities tend to have wider credit spreads than shorter-term securities". Records from ICE Indices, LLC, confirm that except from December 2007 to March 2009, the option-adjusted spread (OAS) on 10- to 15-year US investment-grade corporate bonds has consistently exceeded the OAS on three- to five-year issues. For high-yield bonds, however, the three- to five-year OAS has usually exceeded the 10- to 15-year OAS.

Second, the authors state that "entities that have the ability to print money are considered to be completely risk-free because under any circumstances they can repay their debt with currency that they alone can create".

Actually, control of a currency is

a necessary but not a sufficient condition for posing zero risk of default.

History records a number of sovereign defaults on debt denominated in the home currency, such as Russia's 1998 default on its ruble debt. Also worth keeping in mind in this connection is the fact that the US Treasury has a Standard & Poor's rating of only AA+, not the agency's highest rating (AAA).

"Busted" (out-of-the-money) convertibles represent another time-honoured topic in fixed-income circles. Some bond salesmen have promoted the belief that these issues invariably get neglected once they cease to be of interest to convertible investors, consequently becoming bargains with yields higher than the yields on compara-

Convertible securities have historically returned approximately as much as common stocks over the long term. PHOTO: PIXABAY

ble straight (non-convertible) bonds. Maitland, Nelson, and Partlow judiciously state that convertibles priced at discounts to par merely "*have the potential* to significantly outperform non-convertible bonds" (italics added).

As with most books, a few minor items in *Convertible Securities* bear cleaning up in a future edition. The book refers to the ICE BofA US High Yield Corporate Index by its former name, the "High Yield Master II Index". Other editorial slips include mentions of the BlackRock "Alladin" fund, the "Capital Assets Pricing Model," and the "Discounted Dividend Model".

These stylistic peccadillos do not detract from the many delights awaiting readers of *Convertible Securities*. One does not expect to discover in a weighty tome on finance the Latin antecedent of the saying, coined by Shakespeare, "It's Greek to me".

Similarly serendipitous is a Talmudic commentary on the symbolism of the Hebrew analogues of the Greek letters *gamma* and *delta*. Most important, though, are the original research contributions that enrich the coverage of every aspect of the convertible ecosystem. York Capital Management chief executive officer Jamie Dinan is right to call *Convertible Securities* a "remarkably comprehensive book."

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