



IN OUR VIEW

Convertible Arbitrage Market Dynamics

Sculptor

A conversation between

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MICHAEL GUBENKO

Following a quiet period of new issues in, the Convertible Bond ("CB") market, it now seems to have regained vigor. What are the main dynamics at play?

STEPHANE MANTELIN

Coming into the new year market, participants were very optimistic about primary issuance in 2024 and beyond for a number of reasons. For one, higher interest rates correlate positively to issuance volumes. Oftentimes when an issuer contemplates issuing new debt, the choice between a convertible and a straight bond is effectively a trade-off between the cost of their respective coupons, the willingness to sell equity optionality and the possibility to incur future dilution. That choice was a no-brainer for much of the last decade, as low interest rates allowed corporates to finance themselves extremely cheaply in the fixed income market without any dilutive component. Within the now prevailing higher rate environment, the debate is much more nuanced; a typical High Yield issuer is bound to save several percentage points of annual interest expense by issuing a convertible bond, making it more palatable for corporates at a time of increased scrutiny on cash flows.

At the same time, there is a very large debt maturity schedule approaching between 2024-2026. Much of this is accounted for by debt that was originated immediately after the onset of COVID and is coming

to maturity, whether that's existing convertible, straight Investment Grade ("IG") or straight High Yield-rated debt. We expect the convertible market to capture a bigger slice of these elevated refinancing volumes.

Lastly, and this is mostly relevant in the US, the economy is doing relatively well and markets are at or near their all-time highs. This dynamic should support more activity in primary markets as corporates that find themselves on a strong foothold are willing to invest in their businesses, in capacity, in CapEx or M&A. We expect to see these factors also contribute to more issuance in convertible bonds.

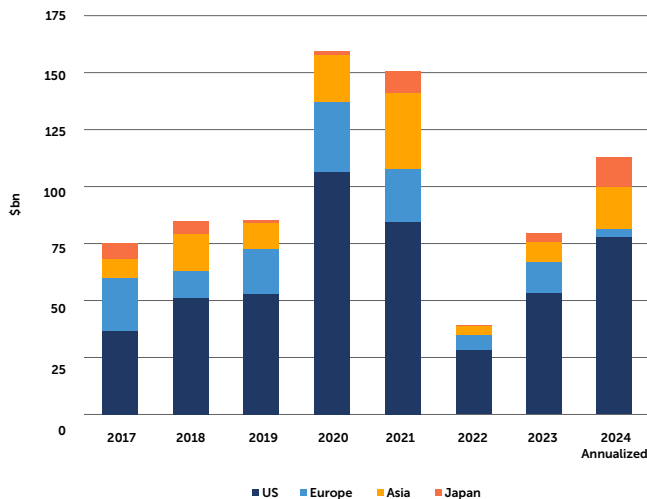
MICHAEL GUBENKO

When thinking about the convertible bond market, what's different today versus the recent past?

STEPHANE MANTELIN

I believe over the next few years we will see a broader spectrum of issuers. The CB market has historically been preferred by High Yield borrowers and non-profitable growth companies. You rarely saw, particularly in the US, issuers rated "A" or above tap the CB market. We still expect High Yield borrowers to be very active over the next couple of years, but because of the coupon saving differential, we're seeing a noticeable pickup in issuance from non-traditional, higher rated, more rate-sensitive sectors like Utilities or REITs. In the US and Europe, we've seen a dozen or so very large transactions for A-rated Utility companies

and that momentum is likely to continue as corporate advisors educate issuers on this additional financing option. That is great news for the convertible market as it's a sign of maturity and less reliance on the high growth businesses that typically use the product. For investors, this diversity will translate into a more balanced portfolio in terms of types of businesses, industry, and credit ratings.

GLOBAL CB ISSUANCE¹

MICHAEL GUBENKO

What do you consider critical for success in your investment approach?

STEPHANE MANTELIN

The two core risk factors that make up a convertible are its credit and equity components. For IG names, which benefit from a visible credit curve based on straight debt or CDS that you can use as a benchmark, it becomes relatively straightforward to pinpoint the right assumptions to make and gives you the ability to value a convert with a high degree of precision. When dealing with smaller, higher growth companies which do not have any other debt on the balance sheet, fundamental analysis becomes critical to understanding whether an instrument's credit spread should be 300 or 600. The credit component is a key input in how we approach trade construction and assess hedge effectiveness. This is why we spend a

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disproportionate amount of time underwriting the credit of a CB than we do in underwriting the equity. This is a key differentiator in our style of arbitrage investing. Sculptor has a large team dedicated to opportunistic credit that we collaborate with daily, as well as a centralized multi-asset investment platform that we can lean on for investment insights. In addition, we continue to grow the team, including dedicated credit analysis, to expand our underwriting capacity amidst the fertile opportunity set.

Managing the equity risk factor is easier, because it is relatively easy to hedge, and we benefit tremendously from having access to a best in class dedicated team of Portfolio Finance specialists. Outside of that, no analysis is complete without looking at other factors as well, such as legal (prospectus) risk, liquidity and of course, the interest rate component.

MICHAEL GUBENKO

What does the recent rally in equity and credit markets mean for CBs?

STEPHANE MANTELIN

We spend a lot of time analyzing how equity and credit valuations feed through to the convertible pricing, as any delayed reaction creates opportunity when the convertible market doesn't adjust for those moves. The more volatile the environment, the more often you see these dislocations and because of our flexible structure we can lean in when valuations are cheapening and harvest returns when pricing feels rich, without taking an outright view on market direction.

MICHAEL GUBENKO

Who's buying convertible bonds?

STEPHANE MANTELIN

For the first time since the Global Financial Crisis (GFC) hedge funds have returned as the dominant force and marginal buyer for CBs. The GFC triggered a mass exodus of hedge funds whose excessive use of leverage combined with a sudden shift in liquidity led to extreme poor performance. That void was ultimately filled by the long-only community who bought convertibles as a way of expressing directional views on equity and credit. Over the last several years, long-only influence became even more pronounced due to the growth of passive investing and ETFs. This meant trading activity became correlated to underlying investor flows, as opposed to fundamentals. This resulted in a lack of price discipline that pushed valuations to extreme levels. So much so that a large part of our activity became shorting CBs against buying the hedges because too much money was chasing too little paper.

We have seen this trend reverse over the past two years as the dramatic underperformance of long-only funds became obvious through recent market swings. As a direct consequence of that, their importance within the market dwindled dramatically, and hedge funds again became dominant in influencing valuations which has translated to more discipline in pricing primary deals.

That said, we are cognizant that a less diverse investor base can have an impact on liquidity. When there's a broad market move downwards, or even when a single stock goes through a negative fundamental development, a more homogenous market structure can pose a headwind. This forces us to consider holding periods when entering a position. We now assume as our base case that we are going to own an instrument until maturity. This inherently raises the threshold on purchasing a CB in the first place and results in lower turnover. Part of this risk does however

get priced in, which goes back to needing to exercise better price discipline.

MICHAEL GUBENKO

Why is pricing discipline so important?

STEPHANE MANTELIN

If we see signs of deterioration to economic health, the bar to successfully refinance debt will rise meaningfully which means that effective credit underwriting could unveil a number of opportunities. This could also be a source of upside for those with the right skill set in credit and trade construction.

MICHAEL GUBENKO

Where can investors expect opportunities to invest and what areas are you cautious on?

STEPHANE MANTELIN

It's all contingent on the magnitude of risk. At one extreme we see a lot of implied cheapness in Asian credits given the challenges there on the back of Chinese macroeconomic concerns and geopolitical tensions. When assessing more speculative business models or any industries that might be sensitive to geopolitical issues (e.g., semiconductors), we add several additional levels of scrutiny in our underwriting. On the flipside, one can extract good risk/reward in situations with low credit volatility and a liquid stock. In other regions, you have situations like the IG-rated issuers I mentioned earlier where simpler trade constructs means margins are much thinner, but the risk is dramatically lower hence there's a great opportunity to deploy capital in size.

Due to the stability of our capital as part of a multi-strategy fund, our financing, how we calibrate our hedges, and how we manage liquidity pockets, we have consistently done well navigating episodes of market stress by taking a longer-term view and we look forward to taking advantage of more of them in the future.

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1. BofA Global Research, as of May 2024

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