Bill O'Neill

Episode 187: Convertible Market Renaissance with IR+M's Bill O'Neill

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com Podcast. My name's Stewart Foley, I'll be your host. Today's topic is convertible bonds and we're joined by Bill O'Neill, principal senior portfolio manager and member of the Investment Committee at Income Research and Management. Bill, thanks for taking the time. Thanks for being on, man.

Bill: Well, thanks very much for having me. I really appreciate it.

Stewart: We're thrilled and I love the topic. I'm somewhat familiar with converts, but I'm hoping that I get a very thorough education today. But before we go there, where did you grow up? What was your first job? Not the fancy one. And what makes insurance asset management so cool?

Bill: So I grew up in Cumberland, Rhode Island, which is right on the Massachusetts border. So pretty close to Boston, pretty close to Providence. My first job was, it was actually the same summer I became a caddy and a paperboy at the same time and very conflicting schedule sometimes, but the papers always got out and I was able to grow a love for the game of golf. So that was a very fun summer and I continued on those jobs for quite a while actually. And the last question was?

Stewart: What makes insurance asset management so cool?

Bill: Insurance asset management really plays the strengths of our firm in terms of being able to deliver a customized product for our client's needs. So every insurer that we work with has a different set of needs, different guidelines, different loss or gains needs, capital treatment methods, et cetera. So for us to be able to go in or tax rates is another great example. So for us to be able to go in, listen to a client's needs and help them really formulate a portfolio that's specific to them is very satisfying and it builds long-term relationships.

Stewart: It sure does. And I mean I've done this at a couple of different firms and my experience is that it's the same set of dials. They're just set slightly differently, sometimes materially differently at every firm. And so what I used to tell my students is insurance companies are like snowflakes right? From a distance, they all look the same but up close, they're all different and they each have their own set of requirements that an asset manager needs to be able to deliver to help them succeed and reach their goals. Yeah, well done. And that is a really good fit. The topic we're here on is convertible bonds, and I've got some history in the converts market prior. What would be really helpful I think is to kind of just start off and say, so we're all on the same sheet of music. What is a convertible bond? And maybe you can wrap in there how this convertible bond market has evolved over the last few years.

Bill: Yeah, sure. So convertible bond, I would start with the term bond first. So what you get when you buy a convertible bond is a series of typically fixed rate payments. So a very bond like in that nature, a traditional convertible bond will have a fixed maturity. And from there you can look at the coupons and figure out what the present value of those cash flows is. So that's the bond part. And then what makes a convertible is an equity option layered on top. So typically companies will, when they issue the convert bond, the option will be out of the money. And as a buyer, you're hoping to get some current income from the investment and then have the option go in the money and have the price of the issue move above its pure fixed income value. Why it's important in the capital markets is because it's an alternate path for issuers to access capital.

So if you're an issuer, you may have used the debt bucket too much and the debt markets might be tired of seeing you issue and you might not want to go into the pure equity markets because you don't want to delete yourself, you don't want to have an impact on EPS, you don't want to cross your existing shareholders. So what you'll do is you'll go right down the middle and you'll issue convertible bonds that have a piece of both that are less... it's less dilutive than pure equity, but it accesses a new set of buyers. And historically, the set of buyers for the convertible markets has been insurance companies. In our history, we've had other types of clients as well, but our largest contingent has been insurance companies. And away from us, there's a really active hedge fund community that does convert arm and a variety of different convertible strategies. But insurance and hedge funds tend to be the main buyers and they have deep pools of capital. So I think issuers like that as well.

Stewart: That's super helpful, Bill. So can you talk about the sub-rate within convertibles, right? Because as I understand it, you've got this bond-like quality, you've got this hybrid nature where you've got some equity qualities and then you've got at some point the convert acts more like an equity, right? So what are the substrates inside of the broader asset class of converts?

Bill: Yeah, you really nailed it. So given where a stock price is relative to the strike price of the convert, you can have converts that act like equities and you can have converts that act like bonds. So at the low more conservative end of the stack is something you could call a bond-like convert. The very, very bond-like converts are often referred to as busted converts in the market. And those are bonds that trade just on their pure fixed income value. So on the present value of their cash flows alone, the option is so far out of the money, it's virtually worthless. And we'll actually put those in our convertible strategies to a small degree, but from time to time we'll buy them in our straight debt strategies as well as a pure bond substitute. And if the equity does have some miraculous rally that's just gravy on top, but oftentimes they're just cheap cash flows.

So that's one end of the spectrum. The other end of the spectrum would be bonds that have had their underlying stocks run up so much that it's effectively trading like an option at a one delta. So it's way past strike price and it's a one-to-one move between the stock price and the bond price. And in the very middle is what we would call a balanced convert where you have fixed income properties. So some downside protection given that fixed income, present value of cash flows below. But then you'll also have a room for upside appreciation. So that's where the heart of the convertible market is that those good two-way movement securities called balance converts.

Stewart: And so when we think about the converts market, as I understand it, two components. There's investment grade and high yield. Can you talk a little bit about those two markets and where Income Research and Management is focused with your strategy?

Bill: The entire US convert market is $250 billion right now. The investment grade component is only $30 billion of that. So it's small, but it's growing and that's actually why we're talking today or a big reason. So high yield and non-rated are the balance of that. Over the past few years, the investment grade market has been extremely quiet, but this year it reignited, which is why we've been getting in front of some clients and prospects and talking about the renaissance of the investment grade convertible market. Just a little bit of a history lesson. So I started with Income Research in 2004 and my first job was as a convertible bond trader and analyst. And at that time, convert assets were about 20% of our AUM. And we've had tremendous growth and we've been very fortunate. But what we also saw during that growth was QE and with low interest rates, there was really not a reason for issuers to issue converts.

There was no incentive because typically an issuer will issue converts to buy their coupon down and to get a lower cost of financing. So with no incentive to issue converts, we saw issuers leave the market and the investment grade market get very, very narrow. And to some degree, we actually counseled ourselves out of business because we started to talk to a lot of our clients and said, "It's hard to deliver a diversified portfolio. Can we create some hybrid portfolios where we have straight debt and convertible debt?" And we have some clients that have stuck with us through that, but now we're actually shifting those portfolios back to all convertibles because the market is alive again. And the reason the market's alive is because of higher interest rates. So if you're an investment grade issuer, you can save about 2.5% of coupon on average by issuing a convertible debt over straight debt. So it really becomes appealing for issuers, given investment grade yields of 5.5%, 6% are not uncommon now.

Stewart: And so can you talk a little bit about, when you look at the issuance, it's about one-third, two-thirds investment grade versus high yield, right?

Bill: Yes.

Stewart: Are there particular industries that issue converts more frequently? Is there a type of issuer that is more common than others? I mean, what can you tell me about, just kind of paint a picture there and then let's step back and let's really get in the weeds and talk about some particular issues.

Bill: Yeah, sure. So in the heyday of the converts market pre-GFC, you'd see converts from a variety of different issuers, railroads, banks, a variety of different industrials within the investment grade space. And then the same would go for high yield. But through GFC and through zero interest rate policy, the market really shifted to high yield. And in particular with high-yield was technology, sciences, bio, and the like. So basically smaller issuers that had a lot of equity volatility that they could monetize and use that in the form of an option, solid option to buy their coupon down. So it was a pretty smart trade for them and it was an area of the capital markets access point where they could issue capital and not have to do it in the equity market. So that was very popular. But as rates have come up, we're starting to see investment grade issuance in particularly really in two places.

One is REITs and the other is utilities. And the commonality between these two types of issuers is that they've had a tough time in the traditional debt capital markets. Utilities have this big overhang due to infrastructure issues. As you can imagine, a lot of the West Coast utilities have had a tough time with wildfires, and I think there's a pervasive fear around the CapEx needed to maintain the safety of utilities, and thus they've really gotten beat up in the debt market. So I think convertible utility issuers have looked at the convert market as a new place to access capital and not to have the debt markets as frequently. REITs are the same way. So we saw actually an issue from Ventas recently. They're a healthcare REIT, very well capitalized company, but this is a new avenue of capital for them.

Stewart: That's outstanding. And so our audience as you well know, is predominantly insurance investors and there are a ton of what a good friend of mine refers to as externalities with insurance companies. And these are considerations that are outside of the capital market realm market that impact their ability to invest in certain asset classes. So one of those things is capital treatment, right? So how are convertibles treated for statutory accounting and capital? Can you tell me about that aspect of this asset class?

Bill: Sure. Yeah. So I can comment on our client's experiences. I'm not by no means an insurance accountant.

Stewart: Yeah, no, me either. For all the people in the accounting profession, let me apologize in advance for anything that I may get wrong here. So yeah, no, we both have the same disclaimers. Go ahead.

Bill: But it's pretty widely understood for US domiciled insurers, convertible bonds, especially on the investment grade side, are just treated like bonds. So they're held on balance sheet at costs. Any income that comes from those investments flows through to the income statement and they're amortized whether you buy them in a par premium or amortized or created to par to maturity. So from that aspect, they are treated like bonds. Everything we buy on behalf of our clients is rated and you get the capital charge that that is associated with that corporate bond rating.

Stewart: You mentioned a moment ago that there's a rebound in issuance. What is driving that? Is it that rates are materially higher and people don't pay them and the convert feature gets them 200, 250 basis points cheaper coupon? Is that the main driver?

Bill: I think there's two main drivers. Actually, let's call it three main drivers. So one would be that coupon savings. Number two would be a diversified access to the capital markets, which we spoke about a bit. And then number three would be really a regulatory or an accounting standards changed. So recently FASB came through with what's called ASU or Accounting Standard Update 2020-06, which went into effect in late December 22. And what that does is it allows issuers to convert on their balance sheet as debt. So in years prior when a convert issuer would issue, they would have to account for the bond-like portion as debt on their balance sheet and the option to the point that if converted, if it was at any point equity-like, that would have to be counted as equity. And it was very, very difficult for the issuers from a compliance perspective figuring out what that split was, updating that split every quarter.

And I think a lot of CFOs and treasurers looked at it and they said, "This is just too complex. I don't like the updates here. I don't like complying to these accounting standards," so they really ignored the market. The other thing that was penalized was they would have to account for the convertible income, not at its coupon value. So you could issue a convert at a significant discount to the bullet bond, but you still had to account for some phantom income that you would pay that was spread between the two. So you weren't getting any income benefits. You were getting maybe a cashflow benefit because you were paying the coupon on the cashflow, but you were still paying additional income in terms of how it hit your income statement above that. So it wasn't very issuer friendly. But recently with this accounting standards change, what issuers can do now is effectively account for convertible as debt on their books.

So it starts life as debt, and then once it gets above... once it starts to trade at a premium and equity value becomes above par, then they start to treat that as equity. So what that does is immediately is less dilutive and it's just much more simple to carry on a balance sheet. Also, the income properties of that are they're just paying that coupon as income, so that's the only thing that it hits their cash flows and it hits their expense line in terms of their cash flow statement. So it's very clean and it's very repeatable. So I think issuers are getting talked to by bankers, and obviously bankers want to sell, that's bankers nature, but they're appealing to issuers and saying, "Hey, you can get a lower coupon, you can access a new variety of buyers and it's easy to carry now. So please open your eyes to this type of security." And I think some issuers have been listening.

Stewart: Income Research and Management has a long history managing convertible bonds. Can you tell us a little bit about that history? And as I mentioned, I've got a little bit of background in converts and it's a compelling asset class for insurance companies, and I'm actually very happy to hear that it's going through a bit of a revival. So that history I think would be helpful to know.

Bill: Yeah, sure. So we've been managing convertible bond portfolios since 1991 and our strategy has been very consistent. So what we offer is what we call bond-like convertibles. So we focus on convertibles that are very, very close to their fixed income value. So as you can imagine, we talked about that scale. At the top end of that scale is bonds that are appreciated significantly and they're very, very far away in market price relative to the present value of their cash flows. We like to buy bonds that are close to the present value of cash flows so you have a floor, but you also have the significant possibility of equity upside. So a lot of our clients, specifically the insurance clients have looked at having that bond-like consistency, but having equity-like upside and it's an important part of their portfolio. A lot of our competitors do a great job, but they're a little bit more exotic in what they carry. We're focused on the US dollar market within investment grade within those lower delta bond-like convertibles. So our strategy is really tailored towards, I would say the less volatile, more income oriented convert buyer.

Stewart: And what about a little bit more on your investment management approach? Are you doing fundamental bottom up research like old school roll up your sleeves? Is that kind of how you come at this market or is it more quantitative or how are you running money?

Bill: Yeah, so research leads everything we do and it's corny, but we like to say that at Income Research and Management research is our middle name. We're bond pickers, so away from converts, we have a deep corporate bond and securitized team and municipal team. And what we're doing is looking in the market every day for the best risk adjusted relative return. We're thinking about cash flows and how to price those cash flows, and that's where we start with converts. So everything that gets in our convertible portfolios is underwritten as a credit, is underwritten as a bond first. What we're looking for in our companies is durability, solid management, and really the ability and willingness to continue to pay on those bonds. So if you can get that past that check and we will eliminate some issuers because of our credit check, then we get to the structure of the convert.

And that's where some of our quantitative work comes in. And we're always thinking about the valuation of the parts. And as you can imagine it, convertible bonds are very fun to value. You've got the present value of the cash flows. You can observe volatility and value the option from volatility in the listed option markets and you can come up with a theoretical value and you can trade these bonds around that theoretical value in the distance from that theoretical value. So we do a lot of quantitative work when it comes to structure. We're always trying to find bonds that are better than the next bond. There are some bonds that have a better appreciation-depreciation profile, meaning they'll outperform on the way up and they'll outperform on the way down given their distance from that bond floor or their ability to appreciate and equity rise. So we mix fundamental and quantitative work and we pick our bonds from the bottom up.

Stewart: That's really helpful because I think that it really speaks to how repeatable the approach is. I mean, when you're talking about going back to '91, this convertible bond market has changed a lot and it seems like it's getting back to the center of the fairway halfway where it began. When investors are looking at this, and I mean again, I'm drawing on my ancient history experience, but the way that these were typically presented was equity-like returns with bond-like characteristics. And that upside with volatility with less volatility was attractive to our clients at that point. Can you give me a little sense of why insurance companies may find convertibles attractive versus conventional bonds or equity?

Bill: One chart that we have that's great, we put in our client books is if you were to draw a capital market line between bonds, so let's use intermediate government credit as bonds and the S&P 500, you'd get some normally sloping line with more risk and more return on equities of course. But if you plot out convertibles, be it our accounts or our composite or the benchmarks, the common investment grade benchmarks, you get excess return for that straight line risk. So if you were to take a portfolio of bonds and stocks and blend those, for that given amount of risk, you could actually do better in the convert market just given their inherent upside-downside property. So I think it's appealing to insurance companies because of that, but I think it's also appealing because it's somewhat anti-cyclical for insurance companies. So we had a client that we were talking to yesterday and they showed us their... we're talking about their convert return relative to the returns on the rest of their portfolio.

And as you can imagine with rates off last year, their bond portfolio had negative total returns, but their convert portfolio had positive total returns. So that is an important aspect of their returns. And then if you were to even take that back 10 years, we were looking at their 10-year total returns, their 10-year total returns for converts are much higher than their 10-year bond total returns. And that might not be the case going forward with bond yields being so high, but what they can do is just give you, again, that bond-like capital treatment, bond-like downside protection, but differentiated returns on the upside.

Stewart: I've got some notes here and I want to just kind of close with a little bit of detail on that FASB, ASU 2020-06. So if we look at the three bullet points to highlight on that change, there's no bifurcation of debt and equity, debt carried on the balance sheet at par. This is a summary as we know it with all the necessary disclaimers about do your own research.

Bill: That's right, yes.

Stewart: Interest expenses, the coupon rate of the convertible debt versus the marginal cost of debt under the old method, which is important. Again, simplifying holding these or issuing these and issuers retain flexibility to use if converted method or treasury stock method for EPS dilution calculations. Are those the right three? Have I got those right?

Bill: Yeah, that's correct. So that if converted method, there's another way to put that. It's called net share settlement. And what that means is it effectively doesn't count for equity until the bond is over par price or until that option is in the money, and then the company will have to start to account for that as equity. To elect for that treatment, you have to effectively promise to pay the par back of the convert in dollars, so you can't pay it back in stock. So you're using it as... you're borrowing as a bond and you're paying any extra off in stock or it's really the choice of the issuer, but you can pay off that extra in bond or stock, but you have to pay the base off in cash. So if you elect that, then you get all these features in terms of being able to hold it at par as debt with the low coupon. It's very important.

Stewart: Very cool. So if we can leave our audience with three takeaways today out of the converts market, what would they be?

Bill: Yeah, so the takeaways would be that the convert market is back. We're seeing a renaissance and I would expect with if higher for longer, and those are some famous words there, if higher for longer holds, I would expect the convert market to maintain this issuance pace and more issuers to come into the market. So really what that means to buyers is the ability to build a diversified portfolio that is high quality, that is of issuers that you want to own, that is quickly coming back. The other part of it would be the ability to have differentiated returns relative to fixed income. So for an insurer to put this on your balance sheet, have bond-like capital treatment, to have equity-like upside, especially in some regions and some domiciles, there's not a lot of other flexibility in terms of what they can do with their balance sheets. But we've found our clients are able to benefit from converts pretty readily. So the ability to hold it but hold it in a diversified protecting way, we think is going to be very attractive to our clients.

Stewart: That's outstanding. I've learned so much today and I really appreciate you being on Bill. I've got a couple of fun ones for you out the door. You can take either of these or both. Lots of our guests take both. No pressure. What's the best piece of advice you've ever gotten and who would you most like to have lunch with alive or dead?

Bill: So the best piece of advice, so this is a little bit technical, but I was a senior at the University of Rhode Island, the prestigious learning institution there, and the class was being loud one day and the professor turned around and he goes, "Hey, you're about to graduate from the University of Rhode Island. Nobody's going to pay attention to you, nobody's going to take you seriously. So you need to be able to differentiate yourself." So he told us to take the CFA program as soon as we got out, and I took him seriously. So I graduated from college in 2000, and by 2003 I was done the third test. And that really got me on the map in terms of showing engagement as a young person in Boston, in the asset management community. And then I was with Income Research in 2004. So that was very helpful and that professor actually wrote the math textbooks for the CFA, so I think he had some other incentive, but it was very helpful and it really helped my career in terms of being on the buy side.

Stewart: That's great advice. And I mean, I can tell you we have a really good relationship with some of the CFA societies around, in particular the one here in Chicago. Chris Vincent is the CEO there, and just does an amazing job with connectivity among the financial services community in Chicago. In fact, it's been announced that Chicago is the site of the 2025 CFA Global Event is going to be here along with the 100th anniversary of the Chicago Society Chapter. So I think that absolutely that curriculum is first-rate and it has evolved as markets have evolved, but there's also a networking and social component. The events that they do are terrific, and I think there's a lot of reasons to do the CFA, so I'm 100% on board with that one. And who would you most like to have lunch with alive or dead?

Bill: I think given current times and geopolitics, I actually love to have lunch with Barack Obama, President Obama, and get his take on world current events and get his perspective on his presidency and what he thinks that we need going forward. I think a lot of folks reflecting back on him don't realize how centrist he was, and I think we need some more leadership like that.

Stewart: Yeah, it's not hard to look centrist today.

Bill: Yeah, that's a good point. Yeah.

Stewart: Yeah. So we have been joined today by Bill O'Neill, principal senior portfolio manager and member of the Investment Committee at Income Research and Management, talking about convertibles. Bill, thanks so much for being on.

Bill: Appreciate it. Thanks for having me.

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