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Where Are The Convertible Bond Arbitrage Managers?

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The Convertible Bond Arbitrage Strategy was once sufficiently populated to rightly earn its very own nomenclature in the classification of the hedge fund universe. Only a few years ago, the strategy-style numbered multiple hundreds of participants. However, this number has since dwindled to less than fifty.

Where Are They?

Where are they? What market or industry events have contributed to their near-extinction? Numerous conversations with current and former convertible bond managers and traders that were active in the 1990's agree that the opportunity set was then nothing short of fertile. To quote a previous proprietary trading desk colleague: "it's like shooting rats in a barrel".

With time, the convertible arbitrage strategy evolved in sophistication as participants gradually focused on specific subsets of the universe, i.e. within the "Delta" spectrum of the opportunity set. Some were focused on the credit, distressed or busted convertible bond. Some focused on the volatility arbitrage, on the event driven themes, or on the directional equity component. As well, others deployed all the subsets of the strategy spectrum in their single fund offering.

By virtue of the complex and multi-dimensional convertible bond underlying risk and return components, the strategy required an elaborate skill-set to execute effectively. These skills included, among others, concepts relating to optionality, volatility, delta hedging or calibration, trading, as well as fundamental credit, covenant, equity, and event risk analysis. Few other strategies, if any, required an equally-diverse arsenal.

Their near-extinction cannot be attributed by any single catalyst, but through several market and industry events, regulation, as well as through a sequence of market regime-shifts. Perhaps a retrospective review of these events may lead to some lessons learned and to be retained for the benefit of the hedge fund investor, and possibly for the capital markets industry as well.

The 2004-2005 era witnessed a significant transformational phase for the convertible arbitrage space, as well as for the hedge fund industry generally.

This period, with the exception of the credit event of spring 2005, was characterized with little or no direction and a compressed volatility regime. Hedge funds, as well as their investors, where looking for more "octane" to meet return objectives and expectations. To meet this demand and attract capital, some funds significantly increased leverage and others migrated or encroached to the lower-end of the liquidity spectrum, or a combination of both. A significant amount of emerging market funds were launched, as well as a large number of "best ideas" and more leveraged and concentrated versions of the existing flagship strategies were being offered.

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In the case of the convertible arbitrage space, given the broad depth of the underlying skill-set, the evolution and transformation was far more significant since a large number of managers migrated towards a Multi-Strategy offering.

The Multi-Strategy space became a systemic breeding ground for what is referred as "style drift". For what was once a convertible bond arbitrage manager, then evolved to a leveraged mandate that deployed an elaborate array of sub-strategies such as long-only distressed debt, credit long-short, equity long-short, equity relative value, statistical arbitrage, volatility arbitrage, event driven, illiquid investments, as well as commodities and (oh yes!) natural gas trading.

Of the existing Multi-Strategy funds being offered today, much of their DNA include traces of the convertible bond arbitrage strategy. For others that are no longer active, their over-leveraged and over-expanded menu ultimately led to their demise.

The 2005 credit event did leave its mark on the convertible bond arbitrage space. As credit spreads gapped and as contagion extended, those who were over-leveraged and invested into the illiquid spectrum (to enhance returns as mentioned above) became stressed and non-economic sellers of securities as they were forced to de-leverage, take risk out of the portfolio, and honor redemption requests. In many cases, loss was incurred on both the core positions and on the relevant credit hedges. The episode marked the end of many convertible arbitrage managers, and to the benefit of the few with dry power left to deploy."We are kids in a candy store" said a manager operating at the time. But this offered little comfort for what was to happen in 2008.

New convertible bond issuance was at a recent record-low in 2005. Issuance is an important driver of returns for managers. Fast-forward to the current situation, new issuance has steadily been declining since the peak of 2007 that preceded the 2008 market crisis event that further affected the convertible arbitrage space, and from multiple facets.

The effects of the 2008 crisis included major setback to the stock borrowing and repo market activities, two important components in the convertible arbitrage toolbox. Without the proper toolbox, and facing redemptions from Funds of Funds going out of business as well as from investors redeeming as a result of losses in their long-only portfolio and/or their leveraged disastrous portable alpha program, the vast majority of convertible bond arbitrage managers were shut down.

For much of the post 2008 era thus far, the market has generally exhibited a pattern that can be described as "choppy", i.e. lacking significant directionality, up & down in a generally sideways market. This choppiness has been experienced on a day-to-day basis, up one day then down the next, or even on an intraday basis. In the case of the convertible bond manager who is carefully monitoring exposure and delta-hedging, this has become and significant cost to managing the portfolio. Delta hedging involves selling and buying the underlying stocks as prices increase or decrease. The process' related transaction costs, if repeated excessively, can completely erode the economics of the trade.

The 2008 events, the resulting de-leveraging, and the significant reduction in the number of convertible arbitrage managers completely shifted the environment. The market is now dominated by the long-only investor that is mostly focused on the yield characteristics of securities rather than the relative valuations. The absolute and relative "cheapness" and "richness" of the underlying option and opportunity set simply matters-less. They tend to under-value the embedded option. As well, the Volcker Rule (proprietary trading ban by commercial banks) has meant a complete extinction of a once dominant market participant, including before hedge funds became a household name.

This shift has completely changed the convertible bond arbitrage dynamics, the velocity of the "Alpha" process, and the behaviour of its participants.

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Those Left Standing

From the very few convertible bond arbitrage managers with a track record extending back beyond 2004, we can identify very few common denominators. Essentially, they do not dwell on systemic mean-reversion to derive returns. They respect the market's recurring and overwhelming forces, and they effectively navigate in the market's ever-changing sentiment. They are applying a nimble and adaptive style in the deployment of the strategy along with the prevailing market regime. As well, they exercise a disciplined approach to the use of leverage to generate returns.

Going Forward

The consequences of the Volcker Rule on the capital market environment have yet to be fully discounted. Regulation is a reactive behavior and will continue to be as such. In this case, it is the result of the financial crisis and the ensuing bailing-out that was required for the greater good. For some reason, the regulators somehow confused proprietary trading with overzealous structured credit transactions as the root of some of the factors that ultimately led to the financial crisis. Both the diagnostic and the prescription are blatantly wrong. As a result, the regulators are blindly taking the whole system back in time and effectively increasing level of systemic risk.

Nevertheless, the banks are no longer warehousing market risk and thus no longer acting as a buffer to smooth-out the imbalances between buyers and sellers. This fact alone may well explain the market's "choppiness" exhibited for the last 2-3 years. Arguably, the big banks had been an important pillar contributing to the stability of the capital markets by virtue of their proprietary trading activities. This was a pivotal supporting element that led to the "Big Bang" enacted in 1986 by the UK Government and thus allowing banks to assume market risk, and thus diversifying away the credit risk already undertaken.

Hedge funds may have filled only part of the gap left behind by the effects of the Volcker Rule. But in the case of the convertible bond market, the exodus is much more pronounced.

The convertible bond market may well serve as a barometer, or as the canary in the coal mine, of this ill-directed regulation. Its consequences may become better known as the next significant and inevitable market dislocation episode arises.

These episodes are an integral and perhaps essential part of the system; we shall then see who will be the rats in the barrel.

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