

Understanding convertible bonds

What are convertible bonds?

As their name suggests, convertible bonds (or convertibles) are bonds that you can “convert” to equities in the future, with certain conditions. Like any bond, convertibles are issued with a stated coupon, maturity date and redemption value. But they also come with a conversion option that allows you to exchange them for a certain number of shares of the issuer’s stock at a stated price.

The main appeal of holding convertible bonds in a fund or portfolio is that they offer equity-like performance with

bond-like protection. Convertibles can be seen as an alternative to direct equity exposure.

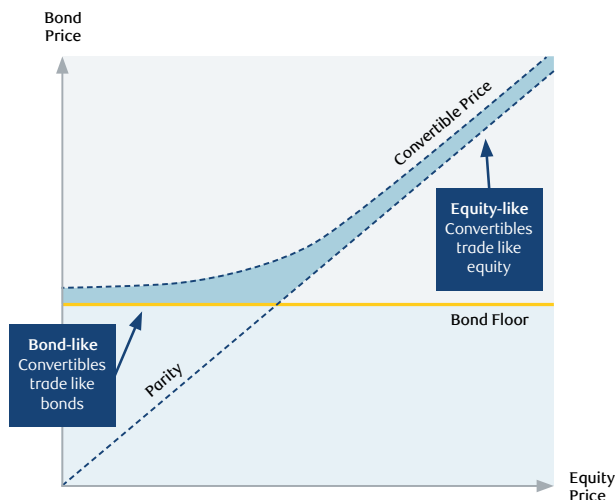
The **bond** component can provide:

- Modest current income
- Repayment of principal at maturity
- Downside protection

The **equity** component can provide:

- Potential for upside equity participation

How convertible bonds work



Breaking down the chart:

- The horizontal axis displays the issuer’s underlying share price.
- The vertical axis represents the price of the convertible bond.
- The dotted diagonal line indicates the intrinsic value, which is called parity. Parity represents the value that the investor would receive upon conversion of the bond to stock.
- The convertible price line outlines the convertible’s fair value.

If the share price FALLS

- The convertible bond’s sensitivity to its underlying share price will decrease, but the convertible bond itself will not decline to the same extent as the equity.
- The level that will prevent the convertible bond from falling further down is known as the “bond floor,” which is essentially the par value of the bond (what the issuer has promised to repay the investor).

If the share price RISES

- The fair value of the convertible bond rises.
- As the share price approaches the conversion price, the convertible bond price will show an increasingly direct relationship with the movements of the share price.
- As the share price moves above the conversion price, the convertible bond price will begin to closely mirror the share price.

Similar to any other debt instrument or bond, a convertible bond involves the risk of the issuer not being able to repay the principal at maturity. On the left-hand side of the chart above, this credit risk is expressed as the steep fall of both the bond floor and bond price.

Benefits of convertible bonds within a well-diversified portfolio

Convertible bonds can provide defensive equity exposure, especially in volatile markets. When overall market volatility increases, convertible bonds tend to do better because all of their associated defense mechanisms kick in. The fact that they have a bond floor and pay a coupon helps offset any price declines during market dips.

Low correlation to interest rate fluctuations. In a rising rate environment, there is very low correlation of convertible bonds to interest rates. This is partially because convertible bonds can have lower duration relative to conventional bonds. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates.

Yield can buffer downside. Some of the attractive features of convertible bonds are highlighted when the underlying stock price falls. This is because the current yield component of the bond may have the potential to offset some of the principal loss associated with a price decline of the underlying stock, depending on the amount of the coupon.

Active managers have an advantage. The convertible bond market tends to be inefficiently priced due to complicated issuer call features that can impact bond prices. This presents a great opportunity for professional managers who have the ability to properly assess these securities.

Balancing the risk/reward trade-off

As with all investments, when it comes to convertible bonds, there is a risk/reward trade-off that must be weighed. Issuers usually offer convertible bonds at a lower coupon than they would otherwise offer regular bonds (ones without the “exchange option” of convertible bonds).

Most convertible bonds are also the issuer’s subordinated debt; meaning, other bondholders will be paid off first in the event of bankruptcy.

It is important to understand that if the stock price does not appreciate, no conversion takes place and the investor will earn a yield below what they could have earned had they invested in a bond with no conversion feature or premium.

INCORPORATING CONVERTIBLE BONDS INTO YOUR FIXED INCOME PORTFOLIO

At their most basic, convertible bonds provide a sort of security blanket for investors who wish to participate in the growth of a particular company without all of the downside risk associated with equity investing. Holding convertible bonds also provides another way to diversify the fixed income component of a fund or portfolio.

BlueBay Global Convertible Bond Fund (Canada) allows the average Canadian investor direct access to this dynamic space with an experienced and accomplished manager investing on their behalf.

If you are interested in learning more about convertible bonds or how to invest in BlueBay Global Convertible Bond Fund (Canada), speak with your advisor.

Please consult your advisor and read the prospectus or Fund Facts document before investing. There may be commissions, trailing commissions, management fees and expenses associated with mutual fund investments. Mutual funds are not guaranteed; their values change frequently and past performance may not be repeated.

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