Are convertible bonds still earning their place in credit portfolios

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Convertibles, once prized for diversification and equity upside, have underperformed traditional credit sectors like high yield bonds in recent years. This is largely due to conservative management styles, sector exclusions, and structural biases that have limited their returns—leading many investors to rethink their role in credit portfolios.

In this article, we take a deep dive into the convertibles market, looking at the different types of convertibles and their use in credit portfolios—and the potential reasons why convertibles, and particularly the active managers that use them, have underperformed expectations.

What are convertible bonds?

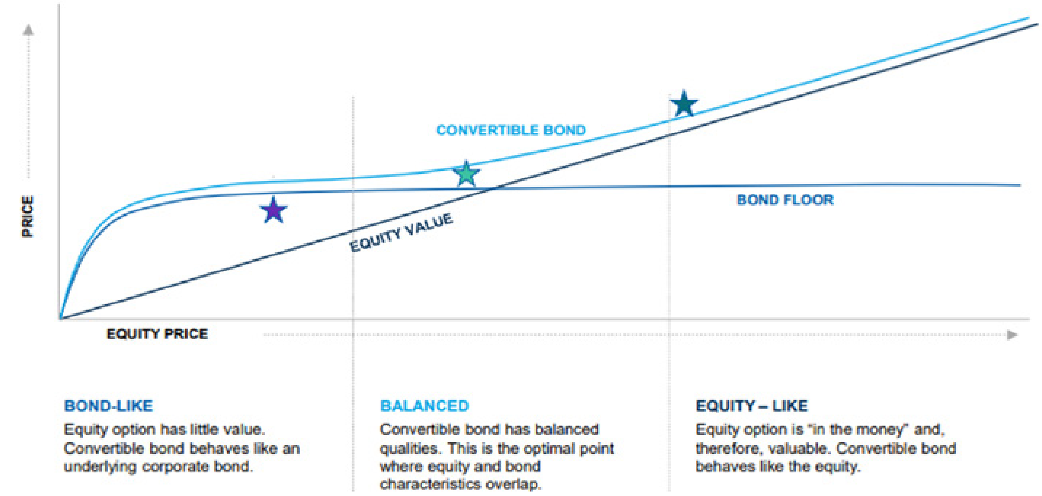
Convertible bonds are a type of debt issued by companies as an alternate form of financing to the typical issuance of debt or equity, with characteristics somewhere in between the two. A convertible bond is structured as a fixed rate bond, with a call option embedded within, allowing the bondholder to convert the security into equity of the issuing company, once the company's stock price moves above a certain threshold (known as the option's strike price). Convertible bonds may be either mandatory or non-mandatory; that is conversion to stock is forced or optional once the equity price reaches the strike price.

To compensate for this added benefit within the bond, the fixed yield of the bond component is typically lower than that of an otherwise comparable fixed rate bond issued by the same or similar entity. This is clearly beneficial for those able to issue convertible bonds, as the lower coupon to the investor means a lower cost of capital for the issuer. Typically, these issuers are sub-investment grade companies who are seeking cheap sources of funding—in decades past, this was often after tapping other lines of debt and equity. However this has changed—with many issuers today being high-growth high-ROE issuers where every dollar reinvested is worth any potential stock dilution, that is, the cheaper funding costs allow higher reinvestment which in turn further perpetuates the company's growth (and ROE) despite the stock dilution.

Where are convertible bonds used in portfolios?

Because the typical issuers are sub-investment grade companies, when combined with the potential upside to returns through the conversion option, convertible bonds are typically seen in mid-risk, credit-type portfolios. Convertibles can be included as a stand-alone strategy within these portfolios, or more commonly included as an allowable investment within multi-sector strategies to sit alongside typical sectors such as bank loans, high yield bonds and structured or securitised allocations.

Figure 1. Different types of convertible bonds



Source: Morgan Stanley.

Thus, most investors we have seen use convertible bonds want them to provide diversification within their multi-sector credit portfolios and to give a potential boost to the returns within these portfolios–given their complexity and especially if equity markets are strong.

What are the different types of convertible bonds?

Convertible bonds, due to their combined bond and equity characteristics, are often classified via their delta. Delta is the sensitivity of the convertible bonds' value to underlying changes in the company's stock price, that is, a delta of 0.5 would conclude that the convertible bond will move $0.5 for every $1 move in stock price. Typically, deltas of 0-0.3 are classified as 'busted', that is, the equity component does not drive the value, and these trade more bond-like. Deltas in the range of 0.4-0.6 exhibit both bond and equity-like characteristics—and deltas >0.6 are often seen as equity-like (Figure 1). For context, convertibles are typically issued around the 0.5 delta range, with the delta evolving over time as the underlying equity moves higher towards the strike, or lower towards the convertible becoming 'busted'.

Different manager styles in convertible bond strategies

There are several different strategy types with regards to portfolio management styles of convertible bonds. Mainly, the differences relate to how managers treat convertible bonds with regards to their mixture and degree of debt and equity components. Below are a few of the different broad approaches within this asset class—note that the names attributed are JANA's descriptors and in general, not industry standard.

i) Buy and hold: Delta agnostic

A manager may choose to invest in a convertible bond in which the value of the debt and equity components in totality appear cheap—and then continue to hold that bond regardless of how the delta (equity sensitivity) evolves. This would typically require the combined resourcing of both a debt team and equity team due to the mixture of debt and equity components within the instrument, and the potential for the bond to have a high degree of equity sensitivity.

The benefit of this type of strategy is that it is not confined to just trading the debt piece and missing out on the full, potentially significant, upside that the equity optionality provides for a bond. The downside of this type of strategy is the resourcing needed due to the bond and equity components, as well as the potential volatility in the return profile as the bond becomes more 'equity-like'.

ii) Buy and sell: Delta sensitive

Another, similar strategy to the above can be implemented in which both the debt and equity option in totality look to be cheap, but the manager would tend to sell the security well before the option is exercised (if mandatory), or sell if the equity component rises enough to dominate the security value (that is, sell as delta approaches 1, typically greater than 0.6).

The benefits of this strategy are that the resourcing required is lower due to the option value, linked to the value of the companies' equities, being a much lower component of the security value, as well as the allocation aligning more with the end investors' expectations of a credit allocation—that is, it not being dominated by equity level of risk.

Disadvantages include missing out on the full potential equity upside that the convertible bond gives, as well as the potential difficulty in outperforming some convertible bond indices which follow different approaches including holding higher delta convertibles or even holding converted equity.

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The quote

Since 2021, convertibles have consistently lagged traditional credit sectors.

Figure 2. Convertible bond issuer sectors

Sector	Convertible Bonds	High-Yield Bonds	Commentary
Technology	High (~35-40%)	Low (~5-10%)	Growth firms prefer convertibles for flexibility and equity upside.
Healthcare	Moderate (~15-20%)	Moderate (~10-15%)	Both markets include biotech/pharma, but convertibles attract more early-stage firms.
Consumer Discretionary	Moderate (~10-15%)	High (~20-25%)	HY market includes more cyclical, lower-rated firms.
EneΩrgy	Low (~5-10%)	High (~15-20%)	HY market reflects credit risk in commodity-driven sectors.
Industrials	Moderate (~10%)	Moderate (~10%)	Similar representation, often mid-cap issuers.
Financials	Low (~5%)	Low (~5%)	Less common in both markets due to regulatory constraints.

Source: JANA.

iii) Convertible arbitrage: Hedge fund like

The convertible arbitrage strategy is perhaps the most complicated strategy of the three broad types. This strategy seeks to discover and take advantage of mispricings that exist between the convertible bond and the companies' stock due to the embedded option—the manager will then seek to hedge away the other risks associated with the convertible bond. In this strategy, the manager will buy the convertible bond and short the underlying stock (with the amount varying by the delta of the convertible bond). This leads to a fixed rate only exposure via the bond.

As this strategy is complicated, it opens the manager up to liquidity risk within the convertible bonds (which are typically less liquid), which may lead to trading slippage when exiting the trade. This strategy requires the ability to short equity, and is almost always confined to hedge fund strategies / 'alternative' asset classes.

What sectors are the convertible bond issuers from?

Convertible bond issuers have tended to be from different sectors when compared to other credit sectors such as high yield (HY) bonds. Convertible bonds have tended to be favoured by growth-oriented, equity-sensitive sectors—while high yield bonds are more prevalent in cyclical and credit-risk-heavy sectors. This reflects the different risk-return profiles and strategic financing needs of issuers. As such, the sector weightings of typical convertible bond indices or strategies tend to be quite different from those in high yield bonds. This diversification is a key reason why investors have included convertibles within the credit portfolios.

Figure 2 compares the sector weightings across the two markets.

How have convertible bonds performed against other credit asset classes?

Given their typical role within leveraged credit portfolios, such as multi-sector credit strategies, it is useful to compare how the convertible bond markets have performed against the broader credit market.

Figure 3 shows the performance for three commonly used benchmarks for global convertibles (hedged to USD)—ICE BofA, FTSE, and Bloomberg Global Convertibles indices.

Two important points jump out of the performance profile in Figure 3:

Firstly, over the period 2017 to 2020, especially in the

Figure 3. Performance against benchmarks

	2017	2018	2019	2020	2021	2022	2023	2024	2025 YTD (May)
ICE BofA Global Convertibles Index Hedged to USD	13.18%	-1.97%	18.12%	37.96%	3.82%	-16.40%	11.66%	11.53%	5.28%
FTSE Global Convertibles Focus Index Hedged to USD	6.00%	-3.01%	13.10%	22.84%	-1.11%	-16.00%	9.84%	8.62%	4.90%
Bloomberg Global Convertibles (USDH)	13.81%	-2.32%	18.36%	37.31%	4.04%	-16.59%	12.49%	11.32%	5.33%
5050 HY/LL	6.12%	-0.39%	11.33%	4.69%	4.22%	-6.27%	13.04%	9.16%	2.37%
HY	7.02%	-2.37%	14.00%	5.48%	5.49%	-10.55%	13.55%	7.94%	2.48%

Source: JANA.

post-COVID part of 2020, convertibles strongly outperformed high yield bonds. However, in the nearly four and a half years since the end of 2020, convertibles have performed much less strongly. Whilst absolute returns are good, their performance against broader credit markets has materially degraded, and importantly convertibles have lagged high yield bonds over this period. Since the start of 2021, convertible bonds are behind high yield bonds by between 82bp per annum (using the FTSE Index) and 302bp per annum (using the Bloomberg Index).

The other point that jumps out from the above table is the difference in return profiles across the different convertibles indices. Whilst the ICE and Bloomberg indices are broadly aligned, the FTSE index return profile is very different—almost always materially beneath the performance of the other two indices across the last years.

The main reason for this different return profile is the way the index providers treat higher delta and/or mandatory convertible bonds. Specifically, the FTSE index excludes both mandatory convertibles and convertible bonds where the 'delta' (equity sensitivity) gets too high. Thus, the ICE and Bloomberg indices are much more akin to the 'buy and hold' approach with regards to convertible securities, whilst the FTSE index is much more akin to the 'buy and sell' approach—both discussed earlier.

How have active managers performed with their convertibles?

JANA has found that credit managers most often follow the 'buy and sell' approach to convertibles—buying low delta convertibles that they think are attractive—but then selling those convertibles if the delta rises above a certain level—typically 0.6 or higher. As such, many credit managers adopt a rather conservative approach, and typically have benchmarks similar in nature to the FTSE benchmark above.

Furthermore, JANA has found that many convertible bond managers have struggled to outperform even these lower-octane convertible indices such as FTSE over the past three years. The average convertible bond strategy in the eVestment(1) universe has underperformed the FTSE benchmark by some 130bp per annum over the past three years to March 2025.

Given the FTSE benchmark itself has underperformed US high yield bonds over the three years to March 2025 by some 200bp per annum—it is clear that active credit managers who have allocated to convertibles for diversification and returns, have performed poorly against those mangers who have stuck with just the core credit sectors such as leveraged loans, structured credit and high yield bonds.

Many of the managers JANA has spoken to have attributed the underperformance to their strategies' avoidance of 'crypto-related' issuers, many of which do not pass their credit risk analysis, such as MicroStrategy, Marathon Digital and Riot Platforms, as well as their underweight position to Chinese issuers such as Alibaba or JD.com.

However, JANA notes that these sectors are not a significantly large part of the market, with Chinese issuers representing 5-10% of the US convertible bond market, while crypto-related issuers represent only 2-3% of the market—though we do acknowledge that some of these names have performed incredibly strongly, and have had an outsized impact on the returns of the benchmark.

As such, managers who have avoided these issuer types have suffered.

But we suspect the other reason that many managers have underperformed even the lower octane indices such as FTSE index is a structural bias in their approach to lower risk exposures. Most active managers follow a highly diversified, 'balanced' convertible strategy, favouring bonds with moderate delta (approximately 40–60) to maintain a mix of equity upside and bond protection. This can be compared to the FTSE index, which is market-cap weighted and which can be more heavily tilted towards larger, higher delta issues.

Managers also seem quite quick to trim positions as delta rises. As such, managers seem to have a structural bias toward lower delta convertibles. Further, many managers had cash buffers and use equity hedges to manage downside risk—and in the rising market over the past few years this has created a significant performance drag relative to a fully invested index.

Managers may also have been slow to add new deals to their portfolios, compared to indices which automatically include them. In fast-moving sectors such as AI or semiconductors, this slowness to add can also cause performance drag. And finally, we suspect that post-2022 some managers have drifted in style towards more defensive positioning both in sector and security selection, due to rate hike and recession fears.

Conclusion: A reassessment of convertibles?

In conclusion, recent years have prompted a critical reassessment of the role that convertible bonds play within credit portfolios. Traditionally valued for their unique ability to combine equity participation with the downside protection of fixed income, convertibles have, in recent years, struggled to fulfil this dual mandate effectively.

While their outperformance during the immediate aftermath of the COVID market dislocation was notable, convertibles have, since 2021, consistently lagged traditional credit sectors, despite the strength of the equity market. This underperformance is particularly consequential given that investors have historically allocated to convertibles with the expectation of diversification and enhanced returns—outcomes that have, by and large, not been realised.

Performance comparisons between the convertible bond market and broader credit markets demonstrate notable shortcomings across both higher octane styles of convertible portfolio management (as represented by such indices as the Bloomberg and ICE benchmarks

The quote

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The quote

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which hold on to higher delta convertibles), and especially within the lower octane styles of convertibles (as represented by the FTSE index which rotates out of convertibles when their delta rises above 0.6).

The FTSE index has persistently underperformed credit markets, consistently trailing US high yield bonds by a significant margin over the past four years or so. This persistent underperformance has eroded the investment case for convertibles as either a superior or even a complementary component within credit portfolios, particularly in a period characterised by strong returns in both credit and equity markets. Given their lower coupons, convertibles are not expected to perform strongly against vanilla high yield bonds if equity markets are flat or in a period of decline in the quarters or years ahead.

Of particular importance is the observation that active managers within the convertible space have generally failed to deliver excess returns—underperforming even the lower-octane FTSE benchmark. While some managers attribute this disappointing performance to sector exclusions, cautious positioning, or specific risk management strategies, the aggregate results are clear—there has been a widespread failure to add value relative to the indices over recent years.

Underperforming the convertible index, which itself has underperformed the broader credit markets, is a disappointing result for credit investors. Consequently, investors are now re-evaluating the appropriateness of holding convertibles in their credit allocations—reconsidering their strategic role in light of sustained underperformance during an otherwise favourable environment for risk assets. **FS**

Notes

(1) eVestment, now part of Nasdaq, is a platform that provides institutional investment data, analytics, and market intelligence to asset managers, institutional investors, and consultants.