

Convertible Bonds and Perpetual Bonds

Convertible Bond

In Theory

A convertible bond ("CB") is a type of bond that, during its tenure, gives an investor the option to convert the bond into a fixed number of equity shares of the issuer. The embedded conversion option ("equity call") of a CB provides an investor the opportunity to participate in the upside potential of its underlying equity. In other words, it has the potential of high equity-like returns, but with less volatility.

However, investors should note several key issues of CBs at the time of issuance:

- The number of shares that can be converted from the CB
- The share price at the time of conversion
- The tenure of the CB

CBs offer investors the benefits of debt instruments in that they are redeemable upon maturity at par value and pay fixed coupons (typically lower than in regular bonds) or zero coupons. CBs are deemed a safer investment compared to preferred or common stocks as it is primarily a debt instrument which ranks higher than equity, in terms of repayment seniority, in the capital structure. It also provides asset protection because the value of a CB will only fall to the value of the bond floor.

From an issuer's perspective, the key benefit of raising money by selling CBs is the reduced cash interest payment compared to regular bonds. However, in exchange for that benefit, the value of shareholder's equity will potentially be reduced due to stock dilution expected when CB holders convert their CBs into new shares.

In the Real World

The CB market collapsed in September 2008 after the fall of Lehman Brothers Holdings Inc. This forced over-leveraged hedge funds that have taken long position on CBs to sell their convertible holdings at massive losses in order to fund a deluge of redemption requests from investors. However, certain fund managers saw the historically cheap CB prices as an opportunity, as the prices did not reflect higher risk of default by the issuers. As such, by the end of November 2008, the CB market turned positive on a wave of bargain buying leading it to outperform stocks by a wide margin within two months period.

Perpetual Bond

In Theory

A perpetual bond ("Perp") is a type of hybrid security, which occupies the space between debt and equity. Generally, Perps are bonds with no maturity date, however, under current market practice, most Perps issued have very long-dated maturity date, typically 30 years to 50 years' tenure. Most of the Perps issued are callable, the first call date is usually 10 years from the date of issuance. The issuer has the option, but not the obligation, to redeem Perps at the call date. Non-redemption of a Perp during the call-dates does not constitute a default. However, non-redemption typically would raise investors' fear about the capital strength of the issuer, which in turn could cause the market value of the instrument to fall. Nevertheless, Perps pay coupons throughout its tenure, provided that other more senior debt obligations are fulfilled. The coupon rate of the Perp is usually re-set based on a pre-specified formula if the Perp is not redeemed at the call dates. Perps are deeply subordinated bonds, typically ranked one notch above common equity in terms of repayment seniority.

In the Real World

Perps issued by banks are categorised as Tier 1 capital, and help the banks fulfill their capital requirements. A Perp's function is hugely important in squeezing extra funding into banks' balance sheets since the financial crisis exploded.

The current dislocation of risk due to the global financial crisis is causing the US Dollar (USD) denominated bonds to be trading at large discounts compared to Asian local currency denominated bonds. This scenario has opened a window of opportunity to acquire good quality Asian banks' Perps at attractive yields. With the same credit risk, the yield gap between a USD and a local currency Asian bank Perp could be as wide as 10% per annum. Good quality Asian banks have been more resilient during the global financial crisis as they have little or no exposure to toxic assets in the US and Europe. Additionally, these banks still have strong access to local currency markets and are able to issue bank capital (subordinated debt, Tier-1 and Rights) at a relatively cheap level, therefore risk of non-call event on these Perps is minimal.

Economics: GDP

What is GDP?

Gross Domestic Product (GDP) is a basic measurement of the economic activity or the value of goods and services produced in a country in any given year. There are a few ways to calculate a country's GDP. The most common approach is the expenditure method:

$GDP = C + I + G + (X - M)$ where,

C = Consumption; I = Gross Investment; G = Government Spending; (X - M) = Export - Import

Consumption (C) includes personal expenditures by individuals or households (e.g. food and clothing), while Gross Investment (I) means the investment by business or households in capital (e.g. purchase on machinery and new houses). Government spending (G) consists of expenditure on final goods and services by the Government (e.g. salaries and investment) and Net Export (X - M) is the net income received from the production and consumption of goods and services.

GDP is often used by market participants to measure the economic growth of a country as it represents the country's economic health.

A View on the Market

Amidst the current financial and credit crisis, many countries are expected to have a lower GDP growth and have been slashing interest rates. Global economy hit the bottom during the last quarter of 2008 and has yet to normalize, even though several major banks in the US have reported profit during early 2009 and loan application in the US has also shown a relative increase. To aid economic recovery, many countries around the world have come out with large financial and fiscal stimulus packages. As at the time of writing, the US Federal Reserve (The 'Fed') has spent approximately USD18.5 billion out of the USD787 billion US stimulus package announced.

In the Asia region, China has done relatively well compared to its peers. During the first quarter of 2009, its GDP growth (6.1% over year ago) was higher than expected although it was lower compared to the last quarter of 2008 (GDP growth at 6.8%). The economic growth was mainly due to a rise in domestic demand with some improvement in the trade data for China.

Views and Expectations on GDP

The global GDP growth has fallen at an average annualized 6% over the last quarter of 2008 with the current quarter expected to fall at an annual rate of 5.7%. With a glimpse of recovery sighted during the early months of 2009, many countries are expected to see an increase in their GDP growth in 2010. Global GDP is expected to increase by 1.9% compared to its current -2.8% with the highest GDP growth expectation on China. Table 1 below shows the GDP growth data for several countries in 2008 and the expected figures in 2009 and 2010. Despite the global economic crisis, China and India's GDP growth should remain high at an estimated 8.5% and 7.0% respectively in 2010.

FY	REAL GDP GROWTH (% OVER A YEAR AGO)								
	World	US	China	Malaysia	Singapore	India	UK	Russia	Brazil
2008	1.6	1.1	9.0	4.6	1.1	6.0	0.7	5.6	5.1
*2009	-2.8	-2.6	7.2	0.3	-4.5	5.2	-3.7	-3.5	-1.4
*2010	1.9	1.9	8.5	4.6	4.0	7.0	0.5	1.5	3.0

Table 1: Real GDP Outlook

Source: JPMorgan, 1 April 2009

*Estimated Data

The swine flu outbreak that has been happening recently appeared to be spreading fast around the world. Travel and hospitality stocks continue to slide while stock prices on pharmaceutical are expected to increase amidst all the uncertainties surrounding the pandemic. The outbreak may lead to a prolonged economic recession and a further fall on GDP growth as witnessed in the past outbreak of SARS (Severe Acute Respiratory Syndrome).

Nevertheless, all is not lost. With the quantitative easing policy, aggressive interest rate cuts and numerous financial aid programs (Trouble Asset Relief Program "TARP", Public-Private Investment Program "PPIP") initiated by the Fed, the US economy is expected to recover by 2010. As a result, the world economy is also expected to see some signs of recovery by next year where GDP growth will be strengthened.

(Source: JPMorgan as at 1 April 2009 & money.cnn.com as at 27 April 2009)