Convertible catalysts

Polygon nears a decade of unbroken gains with its unique event-driven approach to convertible arbitrage trading

Hugh Leask

22 FEB 2019

The Polygon Convertible Opportunity Fund, founded by veteran convertible bond specialist Mike Humphries, marks its tenth anniversary in May.

Since launching the fund in the wake of the financial crisis, London-based CIO Humphries, along with New York-based portfolio manager Michael Gunner and a seven-strong team of specialist investors and analysts, has never suffered a down year.

The team has plotted the strategy's path to success by marrying traditional convertible arbitrage trading with a distinct event- and catalyst-driven approach to the asset class.

The portfolio is more concentrated and heavily-researched than traditional convertible funds, with the team conducting deep-dive analysis into more idiosyncratic and esoteric opportunities, in which the catalysts and ideas differ sharply from one trade to the next.

"It's a cornerstone of how we like to invest," Humphries says of the strategy. "We look for idiosyncratic positions, and uncorrelated names, which hopefully create a less correlated book, and it really helps in terms of portfolio construction and from a risk perspective."

With a global focus across a range of sectors, the fund aims to capitalise on a broad array of corporate actions, catalysts and events affecting convertible bond issuers. These can range from new issuances, balance sheet-targeted exercises, and bond buybacks, to corporate restructurings, recapitalisations, liability management exercises, distressed or insolvency processes, and M&A events.

It's an approach that Humphries and Gunner – who grew up near each other in Ottawa, attending the same high school and university together – have honed and refined over more than two decades on the frontline of the convertible bond market.

Humphries began his career in 1993 as an analyst at James Capel in Toronto before spending eight years at Goldman Sachs, where he first focused on convertibles. His time there overlapped with Gunner, who spent four years with Goldman between 1992 and 1995 before joining Deutsche Bank.

Their careers overlapped again at US manager Sagamore Hill before Humphries co-founded multi-strategy hedge fund MKM Longboat, which ran from 2005 until the 2008 crisis. Prior to re-joining Humphries at Polygon in 2012, he was a managing director and head of US convertible arbitrage at Natixis Capital Markets.

Events and catalysts

While typical convertible arbitrage trades focus squarely on capitalising on mispriced securities, they often involve smaller margins. In contrast, corporate actions or events – be it a special dividend, a change of control, a recapitalisation, a rights issue – could have an outsized impact on the valuation of convertibles.

“If I make a generalisation – which arguably may be unfair – it’s that the traditional converts funds tend to have a fairly diversified book of names where the underlying thesis is that the convertible structure is mispriced,” Humphries observes. “They approach the market from a ‘cheapness’ perspective, and so their trades are all quite similar to each other.”

Such portfolios – comprising a generally diversified book of cheap convertible names – reflect the risk premium in convertible market pricing, he says. “The problem, though, is that this risk premium is correlated to general appetite for risk as is evidenced in credit risk premium and equity risk premium, and so when the market sells off, credits go wider or equities go lower, convertibles also tend to cheapen, and there’s a pattern which repeats itself over and over again.”

For Humphries, Polygon’s multi-strategy approach – which has reaped gains during various market environments – offers more ways to make money in an asset class which is meaningfully cheap only on a cyclical basis.

“We were both drawn more to the catalyst-driven situations as being a way to make money in the converts space, alongside doing the arbitrage,” he says. “Our book is generally uncorrelated and so doesn’t behave in a sympathetic fashion to bouts of risk-on or risk-off, compared to a traditional convertible book which tends to be correlated to risk.

“As a starting point it allows us to hedge overall exposure more subtly without worrying about a book which becomes correlated and more risky in a down tape.”

Geographically, the fund's area of focus predominantly skews towards North America and Europe, where the firm has local presences, though there are also smaller pockets of exposure to Asian convertibles where several of the team members have significant experience.

The fund will look at typical arbitrage trades in almost any industry, but the more fundamentally-driven positions will utilise the team's deep resources and long-standing experiences of certain industries. These include industrials, energy, steel and mining, and related sectors where the cycles are correlated, such as oil services and shipping, where the team will dig further into the fundamentals of a company.

"These are sectors which are often misunderstood, especially in the credit context and even more so in the converts context," says Humphries. "It's a luxury to have someone in a convertible fund who knows so much about a distressed mining name, for instance."

Elsewhere, the strategy has also made money in financials, particularly in distressed situations, as well as in biotech where there is a burgeoning number of convertible issuers.

"We're not trying to be the best in every security. But what we're trying to do is pick those situations where we feel the combination of skills that we have internally will give us a competitive edge versus the peers that are trading these assets," he adds.

This approach has allowed the fund to venture into more niche areas not explored by other funds.

"We'll look at every piece of the capital structure," Gunner says. "It's an ongoing process, to analyse all the indentures and corporate filings, all the documents, for every given capital structure. As a result, we've found some very interesting features in a number of securities which have proved to be a great source of alpha over the years."

Having rolled out in May 2009, the fund generated an eye-catching 40% return that year. In 2010, its first full year of trading, it was up more than 25%. Since then, the fund has gained every year, by double digits more often than not, leading it to victory in the Convertibles and Volatility category at the annual EuroHedge Awards no fewer than five times.

More recently, it finished 2018 up 1.8%, winning it a nomination at the recent awards, and advanced 0.6% in January.

Ruptures and recovery

The 2008 crash proved cataclysmic for the convertible bond market – with leverage and liquidity evaporating, investment banks' shuttering their prop trading desks, and much of the investor base retreating. But positive performance in the asset class in recent years may have brought about a thawing in investor sentiment.

"The opportunity set has become more attractive in light of higher yields and volatility, though elevated issuance may pressure secondary market valuations in the near term," said Man Group's hedge fund investing unit in a year-end note. "We will continue to opportunistically increase allocations to convertible arbitrage managers driven by bottom-up manager selection."

Humphries admits his strategy sits within an unusual subset of the investing world. "There's a finite number of people who know it even exists, never mind understand it," he says. "But I definitely think people's scepticism around whether you could make money in this market for more than a 12 to 24-month period is parked a bit more at the door now."

He adds: "You could find the odd niche savvy investor who understood the opportunity and consciously wanted to be in the converts space because everybody else was repelled by that idea. That caught on, and it did become a bit more fashionable. It created some warmth for the strategy.

"But you needed to look for them because most wanted nothing to do with the asset class at all having been quite badly burnt by it."

Looking ahead to the strategy's tenth anniversary later this year, the pair view their success as being partly down to the collaborative and almost family-like environment that the team has fostered over the past decade.

"We've traded through several cycles together – the 1997-98 Asian crisis, the early 2000s dotcom bubble, and the 2008 Global Financial Crisis – and we've been involved in just about every pocket of convertible arbitrage or capital structure arbitrage that there is," Gunner reflects.

"There has certainly been a lot of evolution from when Mike and I first started trading converts in the mid-1990s," adds Humphries, pointing to the advances in trading models as well as increased sophistication within the credit default swaps and options markets.

"The market for credit default swaps, which evolved at the end of the 1990s into the early 2000s, really created transparency around the creditworthiness of many different issuers which didn't exist before, as well as a means to hedge the credit when it was a much harder proposition before," explains Humphries.

At the same time, the option market has evolved from being short-dated-centric to a more liquid and longer-dated sector, in turn providing greater transparency around what longer-dated options are worth compared to what one- or two-month options are worth.

Meanwhile, prime brokers extending leverage now place considerably greater emphasis on ratings, issuer size, and where the issuers are based. "What used to be a one-page rule sheet on how much margin would be extended against different positions is now much more thoughtful," adds Humphries.

Causes for optimism

Despite all the market upheaval and shifting dynamics over the past decade, the team continues to uncover investment themes and ideas amid the dramatically altered investment landscape.

One positive, they say, is that fewer hedge fund competitors and essentially no bank prop desks operate within the converts space, owning less of the asset universe, while the long-only convertible funds are focused on a different proposition. "They're totally different – they want to own bonds that are going higher, not necessarily ones that are 'arbitrageably' cheap," Humphries says.

Post-2008, the appetite for extending leverage to convertible funds evaporated, creating greater obstacles for traditional convertible arbitrage strategies.

"Sensibly it isn't what it was before, though I'm sure it's more generous now than it was in 2009," Humphries says of leverage. "But for those strategies to extract similar types of returns as before, they need things to be cheaper or to revert to mean more quickly.

"If that's your bread and butter, and how you make your money, you're not going to survive many cycles. When the market is expensive, or there is not much new issuance, or things are not priced cheaply, convertible arbitrage can be a dull and almost-dead strategy for years at a time."

In contrast, both Humphries and Gunner say their catalyst-focused, multi-strategy approach gives cause for optimism, with an opportunity set that is constantly evolving.

"The pendulum has swung back and forth," Gunner says. Between 2012 and 2014, most of the opportunities lay in Europe, while from 2015 until 2017, focus shifted more towards the US exposure. "The capital will flow where the opportunity set is greatest. Today, it's a little bit more balanced between the two."

He continues: "The other thing we are excited about, particularly in the US, is that much of the new issuance now is coming from smaller growth companies in the technology sector, in biotech and in healthcare. In many cases, these are companies that don't have a lot of analyst coverage, and which perhaps aren't followed as closely."