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New convertible arb fund aims to do without old-school investing

B. G., Opalesque Geneva for *New Managers:*

A new fund is revamping convertible arbitrage, one of the oldest hedge fund strategies, by adding a systematic layer to the common discretionary approach - where investment decisions are made at the portfolio manager's discretion.

Solken Convertible Arbitrage, a Luxembourg SICAV, launched in December 2022 and started live trading in February 2023. As of 12th April 2024, the strategy has produced a return of 9.8% with a 2% volatility.

It was developed by two managers with experience in trading and managing convertible bond portfolios: Alexis Martin, who used to work at MFM Mirante Fund Management and holds a PhD in Theoretical Physics, and Romain Cosandey, who worked at SquarePoint Capital and Jabre Capital Partners and holds MScs in Mathematics and Financial Engineering. The two partners have known each other for a number of years and have created the strategy within Solken Quantitative Research, of which they are co-founders. Then they joined DCM Systematic SA which takes care of the operational side. DCM is a FINMA-licensed manager based in Geneva, founded by two senior quants from BlueCrest in 2014 and later joined by a third principal, which now manages half a billion Swiss Francs ($556m).

The convert arb strategy

Convertible bond arbitrage is a market-neutral approach that takes simultaneous long and short positions in a convertible bond (a corporate fixed-income, interest-paying debt security that can be converted into common stock) and its underlying stock. The arbitrageur hopes to profit whether the market goes up or down by having the appropriate hedge between long and short positions. Typically, the hedge ratio is determined by the "delta" - the sensitivity of a convertible bond's price to a price change in the underlying shares. Despite focusing on absolute returns rather than beating market indices, convertible bond arbitrage strategies have outdone the MSCI World index on a risk adjusted basis over the past decade.

According to Solken, since the Covid crisis, convertible arbitrage has been enjoying a revival, generating ca. 20% performance in 2020 and demonstrating its risk-mitigation potential in 2022, on the back of the most aggressive interest rate hike in decades, widening of credit spreads and falling equity markets that hit straight bonds and long-only convertible bonds alike.

After a flat April, the HFRI RV: Fixed Income-Convertible Arbitrage Index is up 4% YTD (and 7% in the last 12 months). The Barclay Convertible Arbitrage Index is currently up 3% YTD.

An evolutionary mode

Solken Convertible Arbitrage pursues a convertible arbitrage strategy with a systematic overlay, with a view to delivering uncorrelated absolute returns and diversification.

"The traditional convertible arbitrage strategy is normally a complex one that relies upon a mathematical model to calculate the theoretical price of a convertible", explains Romain Cosandey in an interview with Opalesque. But the way traditional convertible and convertible-arb managers run their strategy tends to be driven by fundamentals (where the manager uses an in-depth analysis of a company's business, management team and market opportunity to determine the security's attractiveness before deciding whether to buy or sell).

"We observed that almost every market from FX, equities and now credit, has become more and more quantitative-driven. But that's not the case with convertible bonds yet. This is because you can't trade convertible bonds electronically. It's a pretty old-school market."

"We are applying a mindset of systematic management to collecting data, building signals, constructing portfolios and finally risk management, while some things remain manual, such as trading, for example," Alexis Martin says. "We aim to be at the forefront of introducing systematic methods to convertible bonds management and seek increasingly data-driven sources of alpha. Trading has to stay as it is for the moment, but if things, including trading, get even more digitised, then we will be ready to follow that path."

They are currently exploring every domain, he adds. What can be done in the convertible market is limited for the time being because of the nature of the data. But they have the advantage of being research-driven. So they apply an evolutionary mode, programming new models and combining a scientific approach with a hands-on, pragmatic approach to convertible bonds.

Drivers

The managers are counting on two macro drivers to reap further profits: higher volatility and new issues.

Given the macro uncertainty that currently prevails and the possibility that interest rates remain higher-for-longer, convertible arbitrage should benefit from higher regimes of volatility, they say. This would be a positive for their strategy, which is long-volatility.

They also believe that corporate CFOs will continue to consider issuing convertible bonds rather than high-yield bonds as the maturity wall looms.

"Because now that rates are high", says Cosandey, "Convertible bond issuance is a good option to reduce financing costs for a company as it can monetise the volatility of its own stock and reduce the coupon they're paying on the debt. This will likely bring many new issues to the primary market. And for us, it means many arbitrage opportunities."