

FINalternatives

Published on FINalternatives (<http://www.finalternatives.com>)

Opportunity And Risk In Convertible Arbitrage

Mar 5 2009 | 1:24am ET

By Charles Hage -- The first and last requirement of good investment management is that the interest of the investor and the interest of the manager be one and the same. At the outset, the levels of opportunity to be pursued and the concomitant risk to be incurred must be clearly understood and agreed. In particular, investors should not be misled by the hordes of risk gurus and their large body of literature into thinking that there is a solid connection between popularized risk measures and every-day portfolio decisions.

Let's Be Clear

A scorecard that doesn't separate luck from skill may be sufficient for games of sport, but investors demand better. They need to distinguish between two managers who post the same return over the same period of time. Investors are well served in this respect by alpha, beta and Omega Ratio; they are ill served by risk-adjusted return and other Gaussian-based measures that lack validity, especially when applied to the ideal fat head / thin tail return profile.

There is but one reason to incur risk, which is to pursue opportunity. Every investment decision by a manager must deal simultaneously with opportunity and risk in an attempt to optimize the mix. Yet a one-sided body of risk terminology and history of risk data has developed that submerges the subject of opportunity. This distortion of risk as something apart from opportunity panders to a natural fear of loss and misrepresents the balance that investment managers must strike in each decision they make. It is worth remembering that opportunity and risk are what might happen pending a decision, while gains and losses are what actually happen after a decision is made.

Let's Be Smart

What makes convertible arbitrage interesting is that it offers a rich spectrum of trading variety in hybrid corporate securities for which opportunity is sensitive to many market factors. In fact, the complexities of convertible securities and arbitrage drive many managers to emphasize either credit-sensitive or equity-sensitive trades, be outright holders of convertible bonds, or manage convertarb only as part of a multi-strat fund.

Mohican is founded on and dedicated to convertible arbitrage in US securities, with practiced skills in the full range of trade types that best meet every market condition. Further, Mohican concentrates on convertible bonds of small and mid cap companies, where deal size, supply and demand favor the nimble, experienced manager. This

combination of versatility and focus distinguishes Mohican from the field of convertible arbitrage managers.

Discipline is the other distinctive feature of Mohican. Every trade is made with a respect for uncertainty that transcends even the best research; hedging and limits are used in maintaining a diverse, balanced portfolio. Every trade must pass a detailed test of risk and opportunity based on

in-house credit research that is intensive. Every trade must enhance the prospects for the portfolio, with adjustments continually made in response to signs of changing market conditions.

Let's Be Good

The business operations of a manager create no opportunity in a portfolio, but can introduce risk for the investor. In building its team, selecting service providers, pricing securities and maintaining internal controls, Mohican takes great care to prevent unjustified operational risk so that it can concentrate management time on investment decisions.

While changes in a portfolio are always being made at the margin, the need to change is driven by market dynamics that involve fundamental and far-reaching shifts over time. The investor should understand how risk and opportunity are affected by these shifts, and how the manager anticipates, prepares for, and reacts to these shifts. Two major market shifts during the past decade illustrate effects in convertible arbitrage and what Mohican does to protect and grow investor assets.

Leading up to 2005, expectations for gains in convertible arbitrage grew, fueled by repeatedly high returns over several years. Plentiful cash had poured into the strategy and valuations of convertible securities were high. In 2004 gains were low, but investors and managers hung on in a hope that volatility in equities would return to again satisfy expectations. In early 2005, a tender offer from Kirk Kerkorian for GM stock ruined the widely-held short positions of convertible arbitrageurs and served as a catalyst for what happened next. A correction in convertible securities lasting months occurred when investors finally pulled their assets, causing valuations across the board to drop. In the lead-up to the correction, Mohican had recognized the threat and made defensive decisions, keeping leverage low and trading in shorter paper with better yield-to-call. These actions minimized the length and depth of loss during a period when many managers were going out of business. During 2005 and into 2006, Mohican then doubled leverage to realize gains from the opportunity presented by cheap merchandise.

Overlapping these conditions, corporate credit spreads had been steadily narrowing for several years leading up to mid 2007. During the first half of 2007, Mohican gradually reduced leverage, put a larger portion of assets into volatility-sensitive trades, and increased levels of credit hedge. In August of 2007 the collapse of subprime lending caused credit spreads to widen dramatically, with Mohican increasing credit and interest

rate hedges and further reducing leverage in early 2008. As troubled financial institutions needed to raise capital, they issued large-size convertible preferreds which multi-strat funds bought up, and much of the hedge world became heavily concentrated in levered financial paper. Then a number of large financial converts went to zero, beginning a chain of events leading to a downward spiral in prices. Mohican avoided damage by eliminating leverage early, avoiding financial paper, selling ahead of the market to raise cash, remaining averse to concentrated trades, and sticking with its small/mid cap focus.

Let's Be Patient

Mohican will not be quick to use leverage until liquidity returns to credit markets, and will not miss the chance to do so because liquidity will return slowly. There will be time to buy on the way up, especially if bumps in the road arise, and we will avoid being forced to sell.

The convertible market today looks much like it did in the mid 1990's when large volume originated from long-only investors and hedge funds were niche players, a market that is ideal for arbitrageurs. Large and lasting opportunity has amassed in this market as a result of:

Exodus of investors and managers from the strategy in the last few years
Cheap merchandise, wide credit spreads, and robust issuance

Mohican has positioned itself to exploit this situation and will do so while managing risk with the same diligence that it has always practiced.

Charles Hage is director of compliance at [Mohican Financial Management](#) [1].

Source URL:

<http://www.finalternatives.com/node/7140>