

# The Rise and Demise of the Convertible Arbitrage Strategy

Igor Loncarski, Jenke ter Horst and Chris Veld

In this paper we analyze the convertible arbitrage strategy, one of the most successful hedge fund strategies at the end of the 1990s and the beginning of the 2000s. Hedge funds engaged in this strategy are important investors in the primary as well as the secondary market of convertibles. Closely following the performance of the convertible arbitrage funds over the years, the inflows into these hedge funds increased exponentially but decreased sharply more recently. This raises two important economic questions. First, what are the determinants of the convertible arbitrage returns? Second, who wins and who loses in this strategy?

In order to shed some light on these two economic issues, we examine the following. First, we identify convertible arbitrage strategies. Since hedge funds are not required to report their holdings, a direct identification of the strategy is not possible. With convertible arbitrage funds being important investors in convertible bonds, we expect to detect the following developments around the issuance of convertible bonds. First, convertible bonds are expected to be underpriced at the issue in order to provide a potential arbitrage gain. Second, we expect to observe a significant increase in short positions of the underlying stocks after the announcement of the issue.

Our analysis leads to the following findings. First, we find convertible bonds to be underpriced. Second, we find that short positions in the underlying stocks strongly increase around the issuance date. Both effects are stronger for equity-like than for debt-like convertible bonds. Moreover, we find that the increases in short positions negatively affect abnormal returns around the issue date of convertibles. This has important negative implications for shareholders and existing debt holders of the issuing companies.

Finally, when examining the returns of convertible arbitrage strategies, we find that equity-like convertible bonds have earned much higher returns than debt-like convertible bonds. The difference is about 23 percentage points during the first year following the issue. Returns on the convertible arbitrage strategy strongly decrease

towards the end of the sample period. This is mostly caused by the fact that convertible bond issues and issuers became more debt-like compared to the early years in our sample. This is in our opinion not surprising. The high returns of the hedge funds came at the expense of the companies issuing convertible bonds. In order to cap their losses, they apparently either switched to issuing less underpriced debt-like convertible bonds or they moved out of the convertible bond market.