Convertible debt issues and convertible arbitrage – issue characteristics, underpricing and short sales

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Abstract

We study convertible bond arbitrage for the Canadian market. Convertible bond arbitrage is the combination of a long position in underpriced convertible bonds and a short position in the underlying stock. First, we find a downward pressure on cumulative average abnormal returns of the underlying stocks between the announcement and the issuance dates of the convertible bonds. This effect is strongest for equity-like convertible bonds. Second, we find that the convertible bonds are underpriced at the issuance dates, with the equity-like convertibles being more underpriced than debt-like convertible bond issues. Third, we find increased short sales for equity-like convertibles before and after the issuance dates. These short positions remain quite persistent over longer period of time, which suggests that arbitrageurs (hedgers) are more likely to be taking those positions than speculative investors. Finally, we find that in a simple convertible arbitrage setting more equity-like convertibles earned 15 percentage points higher return over a one year period than debt-like convertibles, in particular due to gains on the short position in stock.

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