

Purchase

Export

Search ScienceDirect

Advanced search

You have **Guest** access to  
ScienceDirect Find out more...

## Journal of Empirical Finance

Volume 18, Issue 2, March 2011, Pages 175–194



## Risk and return in convertible arbitrage: Evidence from the convertible bond market

Vikas Agarwal<sup>a, b, 1</sup>, William H. Fung<sup>c, 2</sup>, Yee Cheng Loon<sup>d, 3</sup>, Narayan Y. Naik<sup>c, 4</sup>[Show more](#)

## Choose an option to locate/access this article:

Check if you have access  
through your login credentials  
or your institution[Check access](#)

Purchase \$35.95

[Get Full Text Elsewhere](#)

doi:10.1016/j.jempfin.2010.11.008

[Get rights and content](#)

## Abstract

In this paper, we identify and document the empirical characteristics of the key drivers of convertible arbitrage as a strategy and how they impact the performance of convertible arbitrage hedge funds. We show that the returns of a buy-and-hedge strategy involving taking a long position in convertible bonds (“CBs”) while hedging the equity risk alone explains a substantial amount of these funds' return dynamics. In addition, we highlight the importance of non-price variables such as extreme market-wide events and the supply of CBs on performance. Out-of-sample tests provide corroborative evidence on our model's predictions. At a more micro level, larger funds appear to be less dependent on directional exposure to CBs and more active in shorting stocks to hedge their exposure than smaller funds. They are also more vulnerable to supply shocks in the CB market. These findings are consistent with economies of scale that large funds enjoy in accessing the stock loan market. However, the friction involved in adjusting the stock of risk capital managed by a large fund can negatively impact performance when the supply of CBs declines. Taken together, our findings are consistent with convertible arbitrageurs collectively being rewarded for playing an intermediation role of funding CB issuers whilst distributing part of the equity risk of CBs to the equity market.

## JEL classification

G10; G19; G23

## Keywords

Hedge funds; Convertible bonds; Convertible arbitrage; Supply; Risk factors

Corresponding author. London Business School, Sussex Place, Regent's Park, London NW1 4SA, UK.  
Tel.: +44 20 7000 8223; fax: +44 20 7000 8201.

1 Tel.: + 1 404 413 7326; fax: + 1 404 413 7312.

2 Tel.: + 44 20 7000 8227; fax: + 44 20 7000 8201.

3 Tel.: + 1 607 777 2376; fax: + 1 607 777 4422.

Copyright © 2010 Elsevier B.V. All rights reserved.

[About ScienceDirect](#)  
[Terms and conditions](#)[Contact and support](#)  
[Privacy policy](#)

Copyright © 2016 Elsevier B.V. or its licensors or contributors. ScienceDirect® is a registered trademark of Elsevier B.V.

## Recommended articles

[Convertible bond arbitrage, liquidity exte...](#)  
2009, Journal of Financial Economics [more](#)[What drives the performance of converti...](#)  
2010, Journal of Banking & Finance [more](#)[Why do convertible issuers simultaneou...](#)  
2011, Journal of Financial Economics [more](#)[View more articles »](#)

## Citing articles (21)

## Related book content

## Articles with these JEL codes

## Search on ScienceDirect

across all JEL codes ▾

## Relevant articles across all JEL codes:

[Price formation in the OTC corporate bond markets: a field study of the inter-dealer market](#)  
Journal of Economics and Business - Anthony Saunders et al. - 2002[An empirical examination of intraday volatility in on-the-run U.S. Treasury bills](#)  
Journal of Economics and Business - Michael P. Hughes et al. - 2007[On the characteristics and performance of long-short market-neutral and bear mutual funds](#)  
Journal of Banking & Finance - S.G. Badrinath et al. - 2011[New evidence on the impact of fees on mutual fund performance of two types of funds](#)  
Journal of International Financial Markets, Institutions and Money - F. Mansor et al. - 2015[Commonality in hedge fund returns: Driving factors and implications](#)  
Journal of Banking & Finance - Matthieu Bussière et al. - 2015