



Convertible Bond Primer

A Strategic Asset for Mutuals, Captives and Risk Retention Groups

Convertible bonds, with their hybrid structure combining fixed income and equity features, are increasingly relevant to small and mid-sized insurers. For insurers seeking capital efficiency, enhanced diversification, and improved risk-adjusted returns, convertibles merit close attention within an optimized strategic asset allocation (SAA).

Superior Risk/Return Characteristics

Convertibles offer a compelling return profile, participating meaningfully in equity market rallies while providing downside protection through their bond component. Historically, convertibles have delivered strong risk-adjusted performance—with a beta of 0.73 to the S&P 500 and long-term alpha exceeding 250 basis points per annum. Their asymmetric return profile enables participation in roughly 86% of equity upside but only 49% of the downside, with volatility significantly lower than equities. Over the past two decades, convertibles have outperformed the traditional 60/40 portfolio by nearly 200 basis points annually while exhibiting 30% lower volatility than equities.

This favorable convexity positions convertibles in the top-left quadrant of efficient frontier analyses—higher returns without a proportionate increase in risk. For insurers, which tend to operate conservatively with limited appetite for equity volatility, this asymmetric payoff is a strategic advantage.

Diversification and Correlation Dynamics

Convertible bonds are distinct in their correlation behavior. Their returns tend to sit between those of equities and traditional fixed income, providing a natural bridge between the two. This moderates overall portfolio volatility and reduces reliance on either asset class. Notably, convertibles exhibit low correlation with core fixed income and moderate correlation with equities—particularly when the underlying stock is in-the-money.

In portfolio optimization frameworks, introducing even a modest allocation (e.g., 2–12%) consistently improves Sharpe ratios, reduces value at risk (VaR), and enhances diversification—particularly valuable for insurers with concentrated exposure to underwriting risk.

Capital Efficiency Under RBC Frameworks

Regulatory capital treatment is a central consideration for statutory filers. Convertible bonds are generally categorized under Schedule D Part 1 of NAIC filings, receiving bond-like RBC charges—significantly lower than those assigned to equities. For example, under S&P's capital



model, a portfolio of BBB/BB-rated convertibles might incur an average 6% capital charge at a 99.99% confidence level, compared to ~55% for equities.

Recent changes to NAIC bond factors (expanding from 6 to 20 categories currently only applicable to Life companies) have added granularity, but convertibles remain capital-efficient for most insurers, particularly those holding investment-grade issues. Moreover, RBC covariance adjustments—used by NAIC, AM Best, and S&P—further mitigate capital impacts by recognizing the diversification benefit of convertibles, particularly in portfolios with low equity exposure. Adding convertibles can reduce the RBC burden more effectively than adding high-yield bonds or additional equities.

Practical Implementation

Despite their merits, convertibles remain underutilized by smaller insurers. Several barriers exist, including limited internal expertise and concerns around liquidity or valuation. However, evolving market conditions and increased issuance—particularly post-2020—have improved accessibility. Allocations of 0.5% to 2.5%, funded by trimming low-yielding government bonds or capital-intensive equities, offer a pragmatic starting point.

Convertibles align well with most insurer's key investment objectives: preserving capital, supporting claim obligations, and modestly enhancing returns. Their hybrid nature supports asset-liability matching and provides a valuable hedge in uncertain interest rate or inflation environments.

Regulatory and Strategic Considerations

Insurers operating under NAIC guidelines or under the Liability Risk Retention Act (LRRA), are typically subject to tighter regulatory scrutiny and capital constraints. Convertibles' flexible classification (bond or equity) necessitates careful monitoring to ensure RBC treatment remains favorable. Insurers must also evaluate convertibles within their enterprise-wide asset allocation strategies, particularly given their unique liability profiles and typically conservative investment postures.

Stress testing under scenarios such as equity drawdowns or rising interest rates (asset allocation stress testing) is essential, as is alignment with ALM frameworks. Partnering with specialized asset managers, preferably source using CFA Institute-prescribed methodologies) can help bridge internal resource gaps and ensure convertibles are effectively integrated within broader investment mandates.

Conclusion

For small to mid-sized insurers, convertible bonds offer a strategic opportunity to enhance portfolio performance without materially increasing risk or regulatory capital requirements. With



proper structuring, convertibles deliver equity-like upside, bond-like protection, and efficient RBC treatment—making them uniquely suited to insurers seeking diversification, capital efficiency, and improved returns in a low-yield, high-volatility environment.

A disciplined, measured allocation—combined with robust monitoring and external support—can position convertibles as a core component of the CFO or Investment Committee’s investment toolkit.

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