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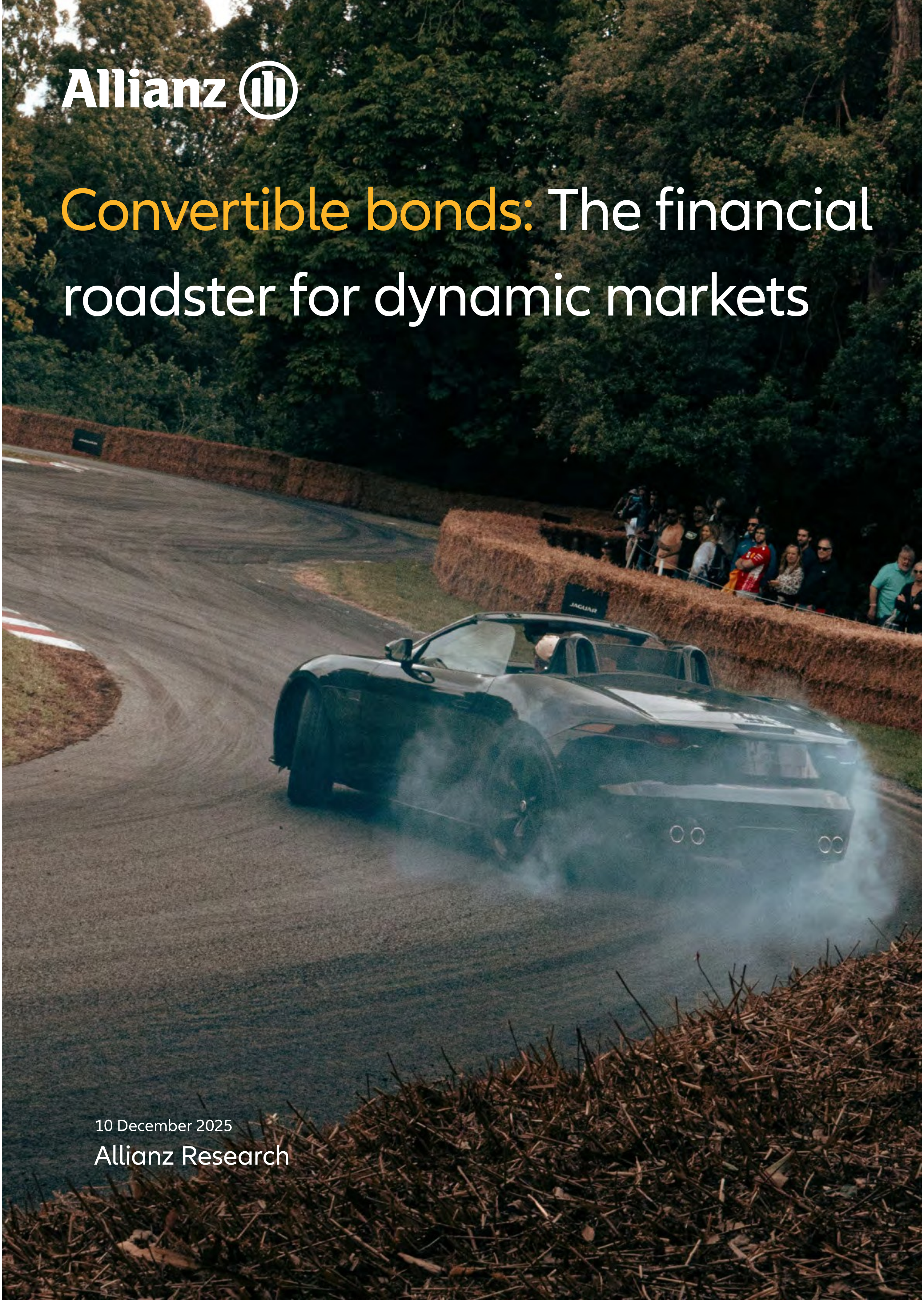
Convertible bonds: The financial roadster for dynamic markets



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Content

Executive Summary

Nils Bradtke
Lead Investment Strategist
nils.bradtke@allianz.com

Alexander Hirt
Head of Credit and Equity
alexander.hirt@allianz.com

Ano Kuhanathan
Head of Corporate Research
ano.kuhanathan@allianz-trade.com

Lina Manthey
Senior Investment Strategis
lina.manthey@allianz.com

Marcel Schwartz
Investment Manager
marcel.schwartz@allianz.com

- **From niche market to the center of attention?** Convertible bonds – i.e. corporate bonds with an attached equity call option – are often overlooked in asset allocation but their performance in 2025 has sprung them into the spotlight. Over the last 30 years, convertibles delivered 70% of equity returns but with only 35% of the volatility (6.7% p.a.). 2025 has topped this performance, with convertibles outperforming both equities and bonds (Sharpe ratio 2 vs. 1.0 and 0.1), helped by falling interest rates, the rise of technology, balanced technicals and resilience during volatility. The attractive yields, moderate conversion premiums and healthy new issuance reinforced the technical strength of the market. Global issuance hit a five-year peak of about USD81bn, driven by growth sectors like tech and biotech, as well as companies seeking flexible funding amid elevated rates.
- **Convertibles offer a unique blend of appealing bond and equity features, making them a highly attractive option for both corporates and investors.** Investors receive the downside protection of a bond but benefit from the upside potential of equities when market performance is strong (on average starting at >6% p.a. equity performance). Corporate issuers are particularly attracted when facing higher financing-cost pressures as the equity option lowers the burden. This is of particular value to growth companies and during restructurings, both of which are highly represented in the US, which accounts for 75% of issuance and outstanding volume. Moreover, convertibles are hardly a speculative asset: The credit quality of these investments has improved significantly, with a blend of investment grade, high yield and non-rated. As a further mitigant, short-duration (1.5 years) has been shown to reduce risk.
- **The performance of the market is being driven by the macroeconomic regime as well as equity and bond fundamentals, particularly in the technology and small-cap sectors.** The value of convertibles is driven by stock option value and valuation, as well as the bond's yield. Higher volatility tends to increase convertible prices, while rising rates or widening spreads tend to decrease them. We define Yield to Worst (YTW) as a key indicator of downside risk, with lower YTW indicating minimal yield provision and reduced stability. Convertibles demonstrate strong performance during periods of market crises, due to their role in providing protection through bond instruments. But in robust bull markets these instruments tend to limit equity sensitivity (Delta) to below 1, resulting in suboptimal performance. A factor analysis reveals a notable exposure to smaller, less mature firms with lower profitability. This also explains the underperformance observed during periods of tightening cycles and the absence of substantial momentum from the large-cap technology sectors, especially between 2022 and 2024. Despite occasional setbacks,