JPMorgan Global Convertibles Income Fund

Income from a niche market

Investment companies

JPMorgan Global Convertibles Income Fund Limited (JGCI) targets income and capital growth through investment in a globally diversified portfolio of convertible securities. The fund's yield of over 4% is roughly two percentage points above the world index and one percent above the FTSE All-Share. A key attraction of convertibles is that they offer potential downside protection in the event of a market downturn and a degree of participation in a stronger equity market, with lower volatility.

Investment strategy

The fund focuses on high-yield bond-like and balanced convertibles to provide an appropriate mix of income and growth potential. The fund has a relatively high exposure to small- and mid-cap companies reflecting both the nature of the convertibles market and the fund's income mandate. The managers have a strong emphasis on repeatable process, employing a customised screening tool before applying more detailed credit and equity analysis to investment candidates.

Rationale for convertible investment

Convertibles can offer a combination of equity and bond characteristics, providing yield and potential downside protection, but also participation in equity upside. Historically, over significant periods, they have delivered superior risk-adjusted rewards versus bonds and equities (see page 6, Edison initiation note 13 June 2013.

Convertibles are something of a niche market and active management in this area calls for a combination of skills. This, together with the relatively dynamic behaviour of some convertible securities and the value of accessing new issues, argues for investment through a managed fund. As in the corporate bond market, many convertible issues can be relatively illiquid, which could be problematic for an open-ended fund: hence a closed-end structure is particularly well suited to such a fund.

Valuation and outlook

Since inception (11 July 2013) the fund has delivered a total return of 7.5%, just ahead of the MSCI World index. This and the attractive indicative yield of over 4% have contributed to a modest premium to NAV of 2% (cum-income).

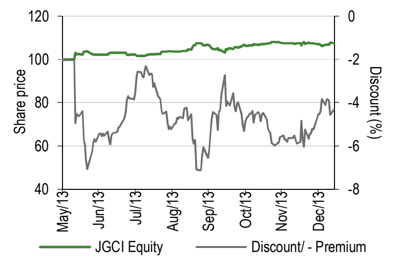
Looking ahead, uncertainty over both fixed income and equity market outlooks, given QE tapering and the expanded P/E multiples that the equity market now trades on, suggests an environment in which convertible characteristics could be appealing to many investors.

The managers are moderating interest rate risk by maintaining a relatively short duration (3.1) and are looking to take advantage of rotation between sectors by taking profits on some of the better performing holdings and identifying fresh opportunities in less favoured sectors such as commodities and oil services where valuations have become attractive.

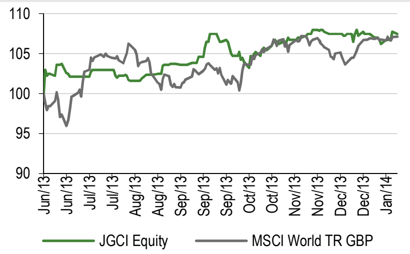
27 January 2014

Price	**107.5p**
Market cap	**£170m**
AUM	**£168m**
NAV*	103.30p
Premium to NAV*	4.1%
NAV**	105.25p
Premium to NAV**	2.1%
Yield	4.2%
*Excluding income. **Including income*	
Ordinary shares in issue	159m
Code	JGCI
Primary exchange	LSE
AIC sector	Sector specialist: Debt

Share price/discount performance*



Cumulative perf. graph



High/low from 11/6/13	108.5p	100p
NAV* high/low	103.73p	96.39p

*Excluding income. Dealings commenced 11 June 2013.

Gearing

Gross	0.0%
Net	0.0%

Company website

am.jpmorgan.co.uk/investment-trusts/global-convertibles-income-fund-limited

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JPMorgan Global Convertibles Income Fund is a research client of Edison Investment Research Ltd

Exhibit 1: Fund at a glance

Investment objective and fund background

JGCI seeks to generate dividend income combined with the potential for long-term capital growth by investing in a globally diversified portfolio of convertible securities and other suitable instruments exhibiting convertible or exchangeable characteristics. The company set a target of an initial gross dividend yield of 4.5%, reflecting the opportunity the manager sees to generate income, particularly in the high-yield sub-sector. The dedicated convertibles team at JPMorgan Asset Management follows a well-developed process that combines equity and credit selection techniques. The MSCI World index is the reference index. Currency exposures for capital and income are hedged.

Forthcoming announcements/catalysts		Capital structure		Fund details	
Year end	30 June	Gearing	Up to 20%	Group	JPMorgan Asset Management
Dividend paid*	Quarterly	Annual mgmt fee	0.75% of net assets	Manager	Team led by Antony Vallee
		Performance fee	None	Address	1st Floor, Les Echelons Court, Les Echelons, South Esplanade, St Peter Port, Guernsey, GY1 1AR
Cont. vote	At the AGM in 2018 and thereafter every third year				

Dividend policy

In the first year dividends are to be paid half-yearly with the intention to move to quarterly payments thereafter. The target is for a gross dividend yield of 4.5% on the issue price (100p) and the manager reports the fund is on track to deliver this. The company aims to smooth dividend payments over time.

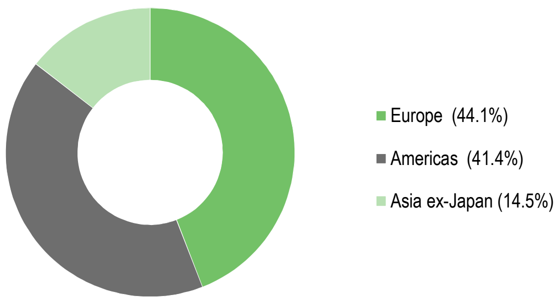
Share buy-back policy

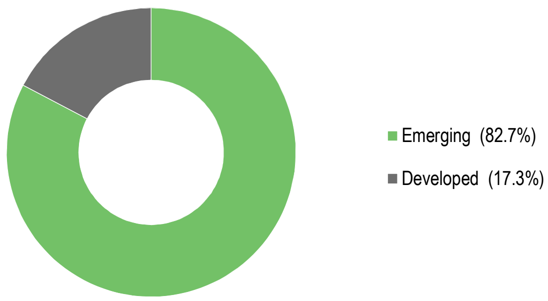
Company may buy back up to 14.99% of the issued share capital. Subject, among other things, to directors' discretion, the company would expect to make purchases if the share price discount to net asset value exceeds 5% for any significant period of time.

Portfolio characteristics 31 December 2013	
Portfolio yield to best**	5.0%
Delta (a measure of sensitivity to equity movements)	30.7%
Duration (to put)	3.1 years
Number of securities	78
Available cash	0.5%
Bond quality	
Investment grade	15.6%
Sub-Investment grade	38.2%
Non Rated	46.2%
	100.0%

Portfolio allocation 31 December 2013 (%)	
Sector	
Consumer Cyclicals	16.4
Industrial	15.4
Basic Materials	15.3
Real Estate	13.5
Other Financials	11.6
Energy	8.7
Cons. Non-Cyclicals	5.0
Communications	4.8
Utilities	4.1
Technology	3.3
Banks	1.9
Total	**100.0**

Regional portfolio analysis (as at 31 December 2013)





Source: JPMorgan Global Convertibles Income Fund. Note: *See dividend policy. **Yield to best: highest yield for each bond with all future put dates treated as possible maturity dates and a yield-to-maturity calculation performed for each date. Yield to maturity is the internal rate of return of a bond for an investor holding it to maturity.

Convertible bonds in brief

- Convertible bonds combine characteristics of bonds and equities.
- Issued as bonds, the holder has the option to convert into the equity, normally at a premium to the share price at the time of issue.
- At the time of issue, the yield is usually below the level of an equivalent straight bond but above the equity yield of the issuer.
- Convertibles participate in the upside of the underlying equity.
- As bonds, there is potential downside protection if the underlying equity price falls.
- The option to convert becomes more valuable if the equity volatility increases.
- The equity component reduces a bond's sensitivity to interest rate changes.
- Like corporate bonds they are exposed to default risk.

What are convertible bonds?

Convertible bonds combine characteristics of a bond and an equity investment. A typical convertible bond, like a corporate bond, pays a fixed income (coupon) with the option of redemption at face value (like a normal bond) or conversion into the underlying equity at a predetermined rate (for example, at a 30% premium to the equity price at time of the bond issue) at a particular date.

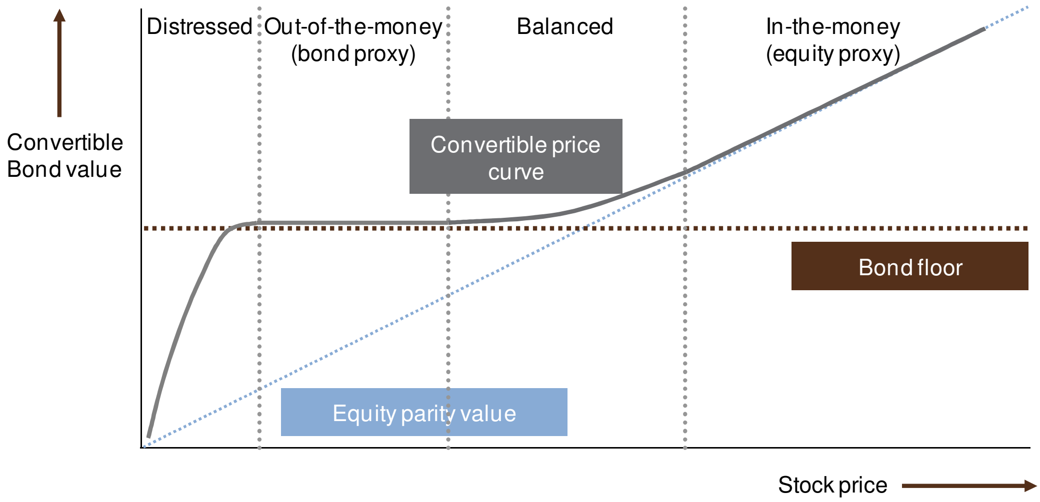
From the issuing company's perspective, a convertible bond offers a way of raising capital to fund growth or to refinance that costs less in terms of interest coupon than a straight loan and may have less restrictive covenants. The conversion rate is set at a premium to the current stock price and a convertible can also find a more ready acceptance than a straight equity issue, depending on market timing and the specific circumstances of the issuer.

For the investor, a convertible bond offers a way of investing in a company that provides fixed income initially with the potential for participation in equity upside thanks to the conversion option that forms part of the bond. In addition to a normal yield premium compared with the equity, the bond element of the security confers some downside protection in the event of adverse developments relating either to the specific issuer or for the equity market in general.

Exhibit 2 is an illustration of how the bond and equity components of a convertible bond might interact at different stock price levels (horizontal axis). The solid line represents the price of the convertible. At the right-hand side of the chart, where the conversion price is below the stock price, the convertible is in-the-money and its price moves closely with the equity price. Towards the left-hand side, in the out-of-the-money segment, the convertible is valued as a bond and does not respond significantly to marginal moves in the stock price; this is where the downside protection, or bond floor, of a convertible is evident. On the extreme left, were the company to become distressed, the bond, as with any corporate bond, is exposed to default risk: hence the illustrative price line trends to zero in this segment. The fund primarily invests in the out-of-the money and balanced segments in order to benefit from superior yield compared with the in-the-money category and the potential for selected bonds to move up the curve between categories.

Risks to consider with convertibles include the potential for default (as with an equivalent straight bond). Companies issuing convertibles generally do so because other financing options are less readily available, meaning that diversification and credit analysis are important measures to mitigate the resulting risks. As with corporate bonds, the liquidity of many issues can be limited, meaning there is a risk of being exposed to crowded trades. Again diversification may ameliorate this risk and, from JGCI's perspective, being a closed end fund is helpful as it does not have to allow for potential redemptions.

Exhibit 2: Illustration of interaction of bond and equity components of convertible bond

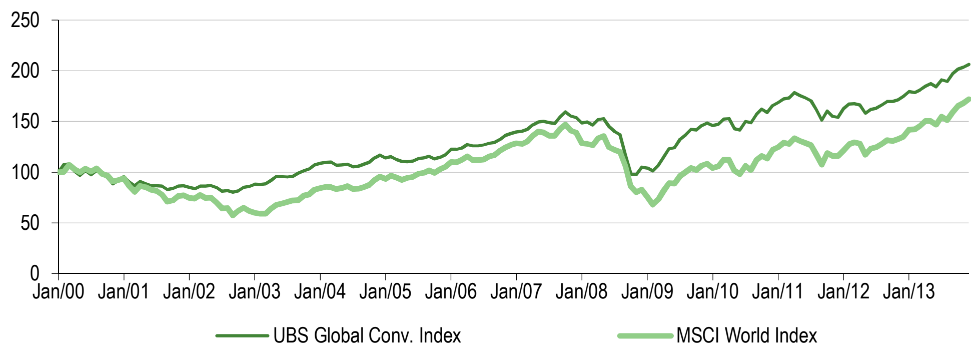


Source: JPMorgan Global Convertibles Income Fund

Outlook for the convertible market

To give a longer-term perspective on how the convertible market has performed to date, Exhibit 3 shows the performance of the UBS Global Convertible index and the MSCI World index (both total return and US $ basis) from the beginning of 2000. This shows the relative resilience of convertibles in the post tech bubble and financial crisis periods. The equity index did outpace convertibles from its low point during the financial crisis but, over the whole period convertibles did outperform noticeably.

Exhibit 3: Global convertible index versus world equity index



Source: Datastream, JPMorgan Global Convertibles Income Fund

Looking ahead, we would argue the relative attractions of the convertible market are clear, particularly for those uncertain about the outlook and seeking income. The bond component in a convertible provides some downside protection in the event of an equity market correction. While there are concerns about rising interest rates, long bond yields have already risen significantly over the last year and any weakness in bond markets would be ameliorated by the equity exposure within convertible bonds (historically convertibles have had a stronger correlation with the equity than the fixed income market). A further sharp rise in the equity market would probably leave convertibles lagging, but still better off than a straight bond investment.

Fund profile

JPMorgan Global Convertibles Income Fund Limited (JGCI) is an investment company, incorporated in Guernsey and listed on the main market of the London Stock Exchange. A placing and offer at 100p per share raised £136m before expenses, and dealings commenced on 11 June 2013. The fund aims to deliver income together with potential long-term growth. The investment universe consists of global convertible bonds and other suitable instruments exhibiting convertible or exchangeable characteristics (portfolio allocation by sector and region together with other characteristics are summarised in Exhibit 1). While a significant category with a global value of circa $400bn, it qualifies as a niche segment when compared with equities and bonds. The fund is the only UK-listed, closed-end fund addressing this market.

The managers' view

Antony Vallee, Natalia Bucci and Robin Dunmall

The company listed in early June, and Antony Vallee comments that following an initial phase of investment in short-dated high-yield bonds, the managers paused purchases as taper-talk had a negative impact on the market. This pause allowed the managers to invest about 35% of the fund's assets at lower prices, which has benefited the early performance; since inception the total return has been 7.5%, marginally ahead of the MSCI World index.

Given the relatively small size of many issues, price movements can be quite sharp and the managers have already taken profits on some early holdings. Areas they are looking at for fresh investments include commodities and oil services, where valuations have become attractive. In contrast the managers see the Technology sector as having become relatively expensive. They see the potential for investment in areas like Spain and Greece, where there are potentially relatively attractive issues, but neither of these is likely to account for a large part of the portfolio.

The managers are encouraged by a strengthening of new issuance over the last year and expect more in 2014, potentially moving the global convertibles market into positive net issuance. This is healthy for the convertible market, and the fund participated in nine issues in Q413. Nevertheless, most of the investment opportunities identified are in the secondary market where the managers find greater value is available. They are hopeful that rising rates will encourage cyclical companies to move from bond issuance to the convertible market. The potential for cyclical upside with bond protection on the downside is appealing.

On interest rate risk, Antony Vallee is reasonably sanguine for the near-term, but is tempering the fund's exposure by holding positions with a shorter overall duration of 3.1 years compared with the indicative 4.0 years suggested before the fund's launch.

So far the fund has not employed gearing, as the managers want to demonstrate performance on an ungeared basis. Looking ahead, gearing of around 5% is seen as normal.

Investment strategy and process

- The managers select from bond-like and balanced convertibles to meet the company's objective of generating income and long-term growth.
- Equity sensitivity is enhanced by relatively high small-/mid-cap exposure.
- Liquidity could be an issue in the convertible market but is less pressing for a closed-end fund.
- The investment team follow a repeatable process, using a customised screening tool as part of this, followed by appropriate credit or equity analysis.

To achieve the company's objective of providing investors with income and the potential for long-term growth, the managers invest in both bond-like convertibles, where yield is the key attribute, and the balanced segment, where bonds are closer to in-the-money convertibles, which are equity proxies. The portfolio includes high-coupon convertibles issued by small- and mid-cap companies where a liquidity premium helps to boost income, and higher equity betas increase the equity sensitivity of the portfolio. The MSCI World is the reference index for the fund, but the portfolio is not benchmark-driven.

The managers take into account top-down and bottom-up considerations. From a top-down perspective the managers intend to rotate strategically between more defensive bond-like convertibles and more equity-sensitive securities, according to an assessment of the prospects for yields and overall convertible market valuations. Bottom-up factors include individual company analysis, industry outlook and technical factors for the specific convertible.

Investment constraints: Risk mitigation

Investment restrictions set by the company include: no exposure to a company greater than 10% of gross assets, no single counterparty exposure over 10%, unlisted holdings will not normally exceed 5%, no more than 10% of assets in investment funds at time of investment, and no more than 15% in other closed-end investment companies.

There are no formal constraints on geographical, sector or market capitalisation exposure. However, the managers have indicated that the investment process (see below) dictates practical limits to mitigate risk, and in practice individual holdings are unlikely to be above 5% of assets. In September last year the largest holding accounted for 2.6% of the portfolio (see top 10 Exhibit 1). The expected range of holdings is between 60 and 80 securities (end December 78). The portfolio is diversified by geography and market capitalisation helping to meet the requirement that "the company will at all times invest and manage the portfolio in a manner consistent with spreading investment risk".

Investment team and process

An active manager in the convertibles area requires a blend of equity and credit-related skills. The portfolio is managed by Antony Vallee, who heads the five-strong JPMorgan Asset Management convertibles investment team, together with Natalie Bucci and Robin Dunmall. The convertibles team is able to draw on the substantial resources of the wider JPMorgan Asset Management business, including approximately 300 equity analysts.

Antony Vallee has 15 years' experience in the convertibles market, both in long-only and arbitrage strategies. He places great emphasis on maintaining a consistent process in managing funds. He regards this as important in enabling repeatability and analysis of decisions.

The investment strategy for the company has a clear focus on income, so the initial strategy-setting part of the investment process is predetermined and the managers will set risk allocation and positioning based on this.

An important tool for the convertibles team is the customised screening system that has been developed over four years based on Monis software. It covers the global convertibles universe facilitating convertible pricing and provides a range of portfolio management tools. Screening trims the number of candidate investments and is a necessary but not sufficient step in the investment process.

Having narrowed the search, the team will then, depending on the nature of the company, carry out more or less in-depth research covering convertible bond technical aspects and credit and/or equity analysis of the situation. The managers may attend company meetings and also work with analysts and portfolio managers from other teams within JPMorgan Asset Management to keep track of companies' progress. Fuller analysis tends to be carried out on smaller names as these are less likely to be followed by the equity team at JPMorgan Asset Management.

In order to ensure clarity of communication among the team and with dealers, the team allocates a ranking to the companies it is following. Simplistically, stocks in the top category would all be given an equal weighting in the portfolio to ensure that each of the selections is able to have an equal impact on performance.

Capital structure, fees and other items

The company's placing and offer of 136m ordinary shares raised £136m before costs (approximately £133m net of costs). The company has the authority to issue further shares on a non-dilutive basis and, in September 2013, issued a prospectus relating to a placing programme for up to 150m shares, providing the ability to respond to demand for the shares and enlarge the company, thereby spreading costs and improving liquidity in the shares. In the period since the placing and offer (to 3 January 2014) a further 22.3m shares have been issued, raising a further £23m. There is only one class of share.

The annual management fee is 0.75% per annum of net assets calculated and paid monthly in arrears. There is no performance fee.

The fund management contract is terminable on six months' notice by either party although notice cannot be served in the first two years of the fund's establishment.

As noted in Exhibit 1, the company has the ability to use gearing of up to 20% of net assets but does not intend to deploy this in the near term, and the managers regard this as a tactical tool rather than a structural feature to enhance income, for example.

The company has an indefinite life, subject to a continuation vote at the fifth AGM and three yearly continuation votes thereafter.

Discount management: the company will seek annual shareholder approval for buy-backs up to 14.99%. Subject, among other things, to directors' discretion, the company would expect to make purchases if the share price discount to net asset value exceeds 5% for any significant period of time. The share issuance mentioned above has acted to moderate the premium the shares have traded on.

Dividend policy and tax treatment

For the first accounting period, to the end of June 2014, the company targets an initial gross dividend of 4.5p (4.5% based on the 100p issue price). Dividends will be payable half-yearly in this period (the first dividend is expected to be declared in February for the period to end December 2013). The intention is to move to quarterly payments thereafter.

Subject to an individual's tax position, the treatment of dividends from the company may be more favourable in the UK than would be the case for income from an open-ended fund. Distributions from an open-ended convertibles or bond fund may be counted as savings income and hence incur the investor's marginal tax rate. The proposed company, by dint of its Guernsey incorporation, may pay no tax itself on interest receipts and a UK investor may pay the lower marginal rate of tax that applies to dividends.

Other closed-end convertible funds

We have already noted the advantage of a closed-end structure for investing in this area because of the liquidity limitations for some issues. Given this, and to give greater comparability with JGCI, we have focused our comparative table on closed-end funds. We have also excluded four funds with exposure of 30% or less to convertible instruments. This leaves six funds, all of which are US-based and predominantly invested in US securities and therefore differentiated from JGCI with its UK listing and global diversification.

Exhibit 4 below shows selected data for these funds and the averages for the group. The average total returns for the one, three and five year periods are below those for the MSCI World Index in line with the convertibles index performance shown in Exhibit 3 earlier and we note the average Sharpe ratios for all periods are at values of one or above pointing to attractive risk-adjusted returns.

Exhibit 4: Closed end funds investing in convertibles – yield, total returns, Sharpe ratios and discounts

Fund	Ticker	Market Cap	Yield %	TR 1Y %	TR 3Y %	TR 5Y %	Sharpe 1Y ratio	Sharpe 3Y ratio	Sharpe 5Y ratio	Discount (ex Par) %
Advent Claymore Cnvt Secs&Inc	AGC	148.0	6.9	16.3	8.2	74.2	2.4	0.4	1.0	-9.9
Advent Claymore Conv & Income	AVK	268.3	6.0	16.3	20.1	107.7	2.4	0.8	1.4	-7.9
Bancroft Fund	BCV	61.3	4.3	14.7	18.9	84.0	2.8	0.9	1.5	-16.5
Calamos Convertible & High	CHY	566.5	5.3	12.1	30.0	117.3	2.0	1.3	2.0	-7.8
Ellsworth Fund	ECF	67.6	2.9	15.0	21.4	84.3	3.0	1.0	1.5	-16.4
Putnam High Income Securities	PCF	84.0	3.7	9.7	21.4	99.1	2.9	1.1	1.6	-9.6
Weighted average			**5.3**	**13.7**	**23.4**	**105.0**	**2.3**	**1.0**	**1.6**	**-9.2**
MSCI World index				**23.2**	**54.7**	**123.2**				

Source: Morningstar, Edison Investment Research as of 13 January 2014. Note: Total returns (TR) are cumulative.

The board

The board comprises four directors all of whom are independent: Simon Miller (chairman and chairman of the Remuneration and Nomination Committees), Philip Taylor FCA (chairman of the Audit Committee), Paul Meader, and Charlotte Valeur Adu.

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