

## Short Article



## THE REVERSE CONVERTIBLE: CELEBRATING ITS 25 YEARS!

I asked ChatGPT (within the rules of this new art) to write the article for me. Disappointment was not far off: Artificial Intelligence is fast, but if the subject hasn't already been treated in a certain way, it can be assumed that the result won't be up to par. However, it's quite possible that this article will serve to 'feed' the machine in the future... even without my consent!

This is the story of the first (real) launch of the reverse convertible, told in a practical manner, far from an academic approach.

### The Creation of the Reverse Convertible

It was in the spring of 1998, and Swiss (and US) interest rates were already low – the great crisis of the year 2000 would arrive two years later. For institutional investors, the goal was to optimize investments based on their medium-term views, applied to defensive stocks or stocks they were willing to accumulate if necessary. The coexistence of different time horizons is indeed a key element for this segment of investors, who use both strategic asset allocation and tactical adjustments – the latter reflecting a short-term view. A medium-term view nicely complements these two common perspectives, while avoiding leverage at the investment level (as the other key condition).

This risk-return dialogue, in order to be a creative foundation, must be supported by highly advanced technical and practical knowledge. Indeed, it involves understanding all the key mechanisms related to options. This ranges from the option pricing model and risk parameters to the relationship between two options with the same underlying asset, expiration date, and strike price – the often misunderstood “put-call parity”. Starting from the price of the put option, which gives the right to sell the underlying asset at the strike price upon expiration, one can deduce the price of the call option (with the same parameters) and vice versa: quite “simply”.

And that's how the first reverse convertible was born...

### Patrick's opinion

“Innovation in terms of investment products is always possible – even today.”

### The Reverse Convertible is so simple...

The reverse convertible is a structured product composed of a bond and a put option that is indirectly sold by the investor. It is indeed the premium resulting from the covered sale, and therefore without leverage, of the put option (hence the obligation to receive shares upon exercise at expiration – the option being European style) that significantly increases the bond's coupons. As for the investor who buys the structured product at a price of 100% - equivalent to a common bond's issuing price - they will either be repaid at 100% upon maturity of the product or receive a predetermined set of shares if their value has decreased compared to the time of issuance (of the reverse convertible). In this case, the investor incurs an unrealized loss but it can never exceed

## Short Article

100%. It is also important not to forget to consider the credit risk of the said bond.

### The true first Reverse Convertible

While the very first reverse convertible was issued on the shares of the bank (the issuer)

itself for obvious reasons of simplicity, the true first reverse convertible appeared on a specific US stock. It was the Philip Morris stock, and there were many reasons for this choice. Firstly, the stock had a well-known specific risk, and secondly, attractive characteristics of volatility and dividend were decisive factors. Indeed, with high (future) volatility and a higher dividend, the put option (which is sold) has a higher price. Now, if the bank simultaneously issues a call warrant (long-term call option) with the same key parameters, then the “put-call parity” is verified and the resulting exposure for the bank is simply being “short the underlying asset”. And there is nothing simpler to hedge than being exposed to the underlying asset, even if it is through options! Volatility is no longer a risk, and prices for investors can then be more advantageous. It truly is a win-win situation.

And it was a phenomenal success from the beginning because this new structured product met a real need for investors.

In the current regime of (higher) volatility for stocks, the reverse convertible is particularly attractive. This is especially true when interest rates are higher, while it can be estimated (this is an opinion) that the medium/long-term prospects for these rates will be better.

By the way, I know the story of the reverse convertible so well because I had the privilege of creating this brand-new structure exactly 25 years ago this year. And the true first reverse convertible was indeed repaid in cash after the three-year duration of the instrument! However, the reverse convertible is also a very interesting case of managing innovation in finance: a theme worth exploring.

### Regarding Patrick Oberhaensli

Patrick Oberhaensli, with 30 years of experience in banking and finance, is the founder/CEO of EVOLIDS FINANCE LLC, a disruptive financial services company. Since 2009, he has been teaching finance to professionals in various specialized fields. He was previously responsible for Swiss institutional development at a Dutch asset manager for over 5 years, contributing significantly to its growth. Prior to that, he held various senior client-oriented positions in a major Swiss bank for 13 years, where he notably created the reverse convertible structured product. He holds a Master's degree from Swiss Federal Institute of Technology as well as the CFA, CMT, and FRM designations and the Certificate in ESG Investing, among others.

### Regarding EVOLIDS FINANCE LLC

EVOLIDS is a disruptive company in the field of finance and advanced training. It has two core business areas: one related to quantitative asset management and advisory services, and the other focused on preparation for key diploma exams such as CFA and CAIA, as well as specific course topics including strategy, risk management, and derivatives. The training programs are organized based on two approaches: B2B or B2C, including private tutoring. The quantitative risk-based models have been developed according to observational principles and can be implemented through futures in four key market segments (equities, bonds, currencies, and commodities).