# Convertible Securities

## Trump Era: Why Investing in Convertibles Makes Sense

**Convertibles have historically performed well in a rising interest rate environment.**

## Trump Economics

The Republican sweep of both the White House and Congress creates the opportunity for President-elect Donald Trump to implement the majority of his economic policies. To put this into perspective, a study by Moody's Investors Service estimated that should Trump's policy initiatives be fully implemented, such as tax cuts, capital repatriation, higher defense spending, protectionist tariffs, the mass deportation of undocumented immigrant workers, and no change to entitlement spending, the U.S. budget deficit would increase by approximately 7 trillion dollars, pushing the federal debt/GDP ratio from its current 74% to 100% by 2020.[1] It is anticipated that these policies could lead to an increase in GDP growth, more inflation, higher interest rates, a steeper yield curve, an extension of the business cycle, tighter credit spreads, lower default rates, a stronger U.S. dollar, and greater volatility in the equity market. We are considering the outcomes of Trump's policies, but more specifically, we are evaluating how the new Trump administration could impact convertible investors.

| Potential Market Outcome | Favorable Impact On The Convertible Market |
|---|---|
| Higher Interest Rates | In periods of rising interest rates, convertibles perform better and new issuance increases. |
| Greater Economic Growth | The convertible market is dominated by fast growing companies. |
| Extension of Business Cycle | Lower default rates and tighter credit spreads will benefit sub-investment grade convertible issuers. |
| Capital Repatriation | Convertible investors benefit from dividend protection and takeover ratchet features as capital is returned to shareholders and merger and acquisition activity accelerates. |
| Increased Volatility | The convertible's embedded equity option becomes more valuable. |

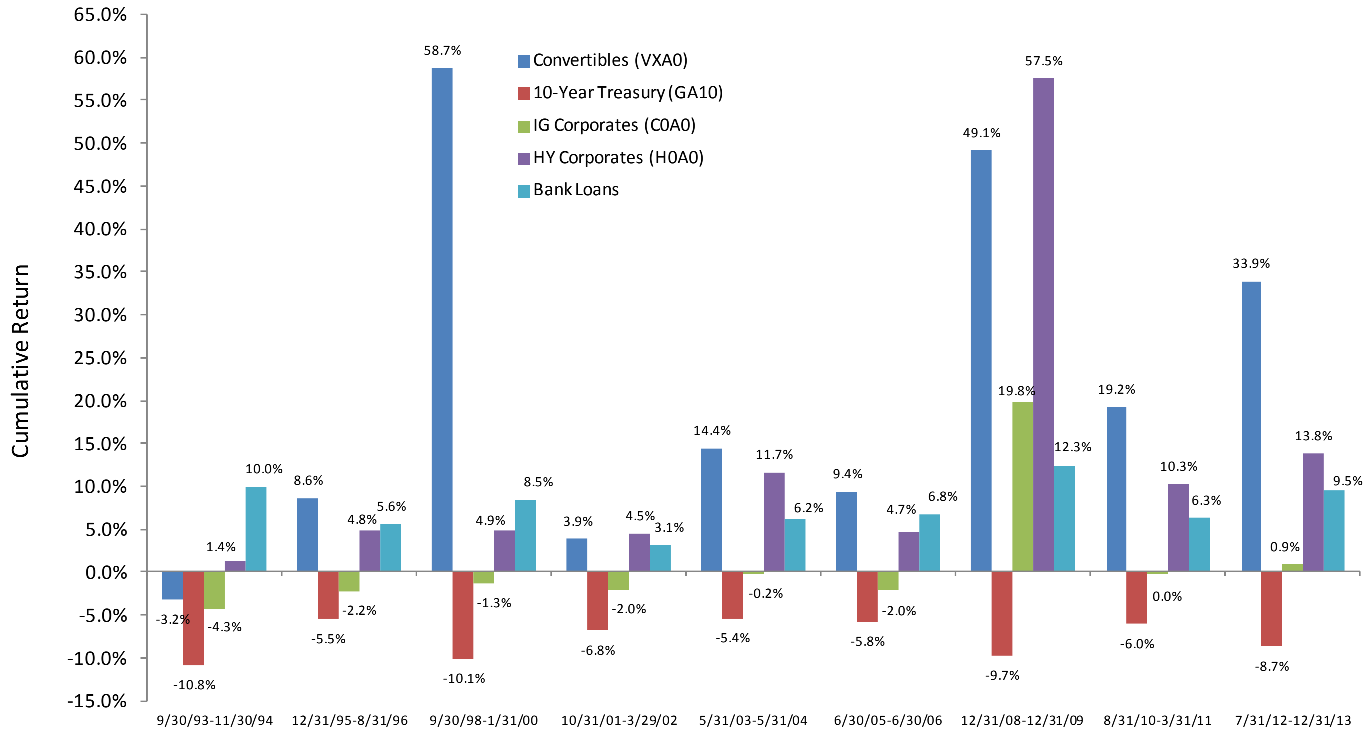
## Higher Interest Rates

Trump's economic policies are likely to boost inflation, and thus interest rates, due to the combined effect of deficit spending, and his trade and immigration initiatives which will increase wages at a time of low unemployment. Convertibles are suited to perform well in this environment because of their relatively low interest rate risk compared to other fixed income investments. In fact, convertibles have an average life of about four years and a duration risk (rho risk) of about two years, or about half that of an equivalent straight bond. When interest rates rise, although the market value of the convertible's bond component falls, the value of the convertible is partially protected by the embedded option component, which benefits from higher rates when all else is equal. When interest rate increases are precipitated by a strengthening economy, convertibles tend to perform well as equity markets rise, as illustrated in Figure 1.

Global convertible new issuance also typically increases when interest rates rise, as convertibles become increasingly a more attractive financing option when compared to straight fixed income alternatives.

[1]Robis, R. (Ed.). (November 2016). Is the Trump Bump To Bond Yields Sustainable? BCA Research.pg. 5.

**FIGURE 1: Convertibles Have Outperformed OTHER FIXED INCOME INVESTMENTS IN PERIODS OF RISING RATES SINCE 1992[2]**



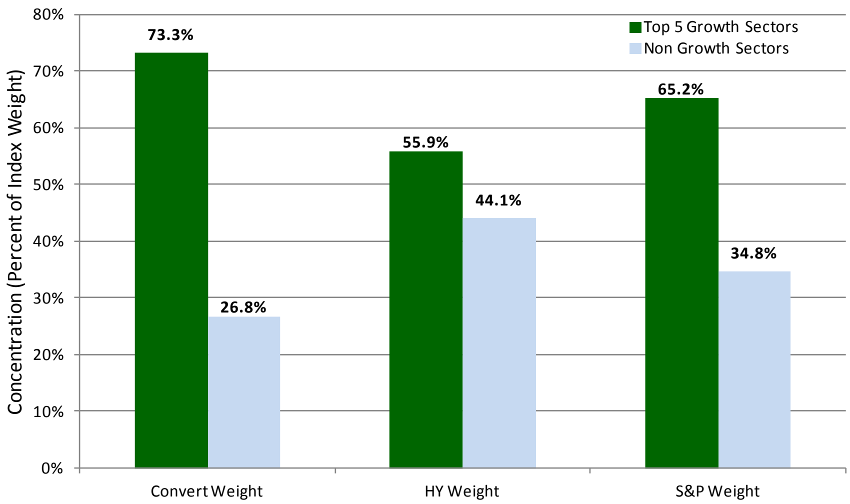

| Rise in 10-Year Treasury Yield | 252 bps | 137bps | 225 bps | 116 bps | 128 bps | 122 bps | 163 bps | 100 bps | 156 bps |
|---|---|---|---|---|---|---|---|---|---|

## GREATER ECONOMIC GROWTH

Although Trump's policies may lead to greater economic growth, and by extension higher earnings and stock prices, this could be offset by a rise in interest rates and a stronger U.S. dollar. Under such conditions, stocks with higher growth rates, which may allow them to protect margins even in an inflationary environment, could outperform. As shown in Figure 2, growth stocks dominate issuers in the convertible market because growth companies are frequently in need of capital. Convertible securities serve as an ideal financing tool for these issuers because as the share price rises, the convertible, which was previously sold at a premium to the existing share price, can be exchanged for stock, thereby strengthening the company's now enlarged balance sheet.

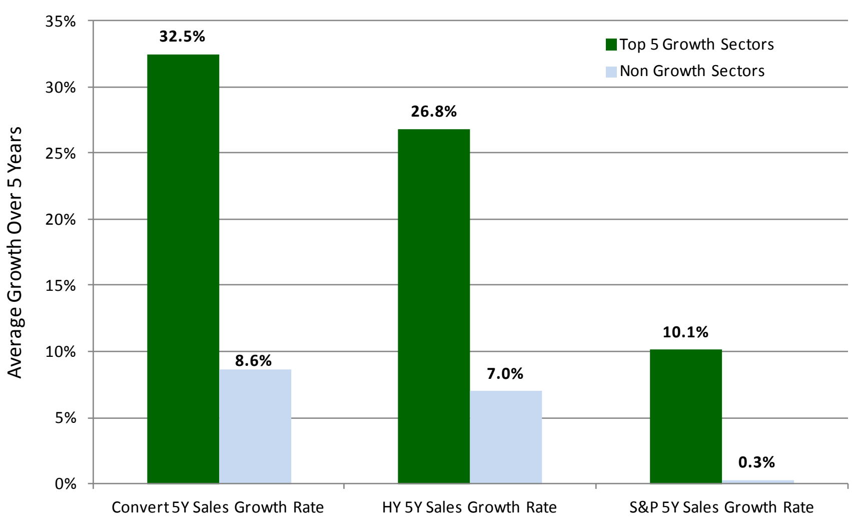
[2]Sources: Bank of America Merrill Lynch Convertible Research; www.federalreserve.gov; Bloomberg, Credit Suisse. VXA0 is the Bank of America Merrill Lynch All U.S. Convertibles Index. GA10 is the Bank of America Merrill Lynch Current 10-Year U.S. Treasury Index. C0A0 is the Bank of America Merrill Lynch Corporate Master Index. H0A0 is the Bank of America Merrill Lynch High Yield Master II Index. Bank loan performance is represented by the Credit Suisse Institutional Leveraged Loan Index (CSILL). Periods of rising interest rates are defined as an increase in the 10-year Treasury Yield of 100 basis points (1%) or more. Information is shown for the periods since the inception of CSILL on January 1, 1992.

## FIGURE 2: GROWTH SECTOR CONCENTRATION IS GREATER IN CONVERTIBLES VERSUS FIXED INCOME AND EQUITY[3]




While the convertible market has significant exposure to growth companies, it is noteworthy that the convertible issuers' growth rate is typically faster than the growth rate of issuers in other markets, as illustrated in Figure 3. If Trump's policies result in a steeper yield curve, capital repatriation, and less government regulation the financials, technology, and healthcare sectors would benefit, respectively; all of which are included in the Top 5 Growth Sectors.

## FIGURE 3: CONVERTIBLES HAVE A HIGHER FIVE YEAR SALES GROWTH RATE VERSUS FIXED INCOME AND EQUITY[4]




[3]Top 5 Average Growth Rate Sectors are determined by identifying the top 5 average sales growth sectors for companies included in the VXA0, the S&P 500, and all public companies in the H0A0 Indices. The Top 5 Growth Sectors include the following: Information Technology, Healthcare, Financials, Consumer Discretionary and Telecom¬munications. Non Growth sectors include the remaining GICS sectors. Data is as of 9/30/2016, using the VXA0 Bank of America Merrill Lynch All U.S. Convertibles Index for the Convert Weight and the H0A0 Bank of America Merrill Lynch High Yield Master II Index for the HY Weight. S&P is the S&P 500 Index. Source: Bloomberg

[4]Five Year Sales Growth Rate is calculated as the sum of most recent five year revenue growth year over year divided by 5. Data is as of 9/30/2016, using the VXA0 Bank of America Merrill Lynch All U.S. Convertibles Index for the Convertible 5Y Sales Growth Rate and the H0A0 Bank of America Merrill Lynch High Yield Master II Index for the HY 5Y Sales Growth Rate. S&P is the S&P 500 Index. The Top 5 Growth Sectors include the following: Healthcare , Telecommunications, Consumer Discretionary, Information Technology, and Financials. Non Growth sectors include the remaining GICS sectors. Source: Bloomberg

## EXTENSION OF BUSINESS CYCLE

Trump's economic policies, if they are successful in increasing nominal economic growth into the 2-6% range, could extend the expected life of this credit cycle by several years. The excess return of corporate debt over Treasuries tends to be higher during periods when nominal GDP growth, currently 2.8%, is expanding as default rates fall and credit spreads tighten. This market environment is advantageous for the convertible asset class as the fixed income component of convertibles will benefit from stable-to-improving credit spreads.

## CAPITAL REPATRIATION

Capital Economics estimates that U.S. companies are hoarding 2.5 trillion USD overseas, or about 14% of GDP[5]. Should a Trump tax policy encourage some of these funds to return home, it is likely that a portion would be used for merger and acquisition activity or to return cash to shareholders in the form of stock buybacks and dividend increases. There are two ways in which convertible investors could benefit. First, since there is a significant number of convertible issuers with market capitalizations under 10 billion USD, they often make attractive targets for larger suitors. In fact, year-to-date, there have been 21 such transactions including Oracle's purchase of NetSuite, Qualcomm's acquisition of NXP Semiconductors, and Medtronic's takeover of HeartWare. Second, over the last ten years, convertible securities have undergone a significant positive structural transformation whereby investors typically receive more shares in the convertible when a company raises its dividend or is acquired, which allows convertible investors to better enjoy the fruits of a takeover premium alongside equity investors.

## INCREASED VOLATILITY

Trump's policy initiatives, both domestic and foreign, are only likely to exacerbate the possibility of increased equity market volatility already provoked by differing central bank monetary policies, forthcoming political contests in Europe, commodity price fluctuations, and concerns in emerging markets. As an asset class, convertible securities are beneficiaries of rising volatility as the **embedded equity component becomes more valuable,** all else being equal. Because convertible securities become more bond-like (defensive) when equities fall, but more equity-like when they rise, convertibles demonstrate positive asymmetry, or structural alpha, that is difficult to replicate.

## CONCLUSION

Although often overlooked, convertibles are a separate asset class that have a long track record of delivering equity-like returns with less risk and lower correlation to equity and fixed income securities. Consequently, convertibles add value when included in either a bond or stock portfolio. As the Trump Era unfolds, convertibles offer a unique solution for improving the diversification and positive asymmetry of a portfolio.

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[5]Hunter, Andrew. (September 19, 2016). US Economic Update. Capital Economics.

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