Convertibles' Muted Volatility and Enhanced Return Proven During Pandemic

April 2020

Convertibles: Winning by Losing Less

While we do not suggest that we are out of the woods yet as it relates to COVID-19 and its impact on global financial markets, we do think now is an opportune time to highlight several developments in the convertible asset class, most notably as it relates to the downside protection convertibles have provided thus far in 2020, the increased issuance from companies choosing convertibles as their preferred financing option, and details on secondary market opportunities.

Downside Protection, or "Structural Alpha" – A Unique Feature of Convertible Securities

Convertible securities are typically positioned as a defensive way to access the equity markets, since instead of buying the equity outright and being exposed to unlimited downside losses, an investor is buying an equity option attached to a bond or preferred, which typically pays interest semi-annually and repays principal at maturity. As a result of these stabilizing bond-like features, convertibles typically exhibit positive asymmetry, or "structural alpha"—that is, they are expected to capture a majority of the equity market upside, while only suffering a portion of equity price declines.

Clearly, this year has seen equity market volatility spike to unparalleled levels, as the VIX in March alone reached four of its five all-time intraday highs. While convertible managers are not rooting for equity markets to be down 20%, periods like this do serve as a good litmus test for the asset class. Again, while uncertainty related to medical, economic, political, financial market and other factors remains elevated, the convertible asset class has performed well thus far in 2020 relative to equity and some fixed income markets. **The broad U.S. convertible market, as represented by the ICE BofA All Convertibles Index (VXA0), was down 8.29% year-to-date (as of April 15th), as compared to the S&P 500 and Russell 2000 indices, which were down 13.34% and 28.73%, respectively.** Convertible issuers are generally a blend of the companies in the S&P 500 and the Russell 2000, so in assessing year-to-date downside capture, **broad convertibles have protected on the downside by only capturing 40% of the average return of the S&P 500 and Russell 2000**. Since many investors also consider convertibles as an enhanced fixed income strategy, it is worth noting that the broader convertible market has also outperformed asset classes like high yield, which is down over 9% during this same year-to-date period (ICE BofA U.S. High Yield Index). The convertible market also has roughly 25% exposure to investment grade companies and relative to other fixed income asset classes, convertibles have a much larger allocation to technology (where convertibles are typically the only debt in a company's capital structure) and healthcare companies. In addition, convertibles have experienced a much lower historical default rate than asset classes like bank loans and high yield.

Convertibles Have Done Well

Index [1]	YTD (as of 4/15)
Convertibles	-8.29%
High Yield	-9.13%
S&P 500	-13.34%
Russell 2000	-28.73%

Source: ICE Data Services, Bloomberg

Positive Global Issuance Trends Continue with Favorable Terms for Investors

While global issuance trends have been quite strong since a trough year in 2012, the continuing momentum seen in this pandemic has been even more encouraging. Calendar year 2019 was the strongest year of global issuance since 2009 and the strongest year of U.S. issuance since 2007. That momentum continued into January and February of this year, when issuance was 50% higher than it had been during the first two months of 2019. Issuance slowed in March as credit spreads widened

[1] Convertibles represent the ICE BofA U.S. Convertible Index (VXA0). High Yield represents the ICE BofA U.S. High Yield Index (H0A0).

and volatility spiked, but since March 27th, an increasing number of companies have utilized convertibles as a financing tool. Companies like Carnival Corporation, Burlington Stores, and Booking Holdings have issued convertibles to shore up liquidity to enable themselves to weather the near term slowdown in their respective businesses. The issuance terms for these convertibles have been very favorable for investors, particularly since these companies' stock prices sold off substantially this year. For example, Carnival (CCL), an investment grade issuer, whose stock price had declined nearly 85% since January, issued a $2 billion convertible bond on April 1 with a 5.75% coupon, a 3 year maturity, and a 25% conversion premium, all of which combined to create a very attractive structure for investors. The company also issued a high yield bond on the same day, maturing in three years with an 11.5% coupon. **To illustrate the positive asymmetry, or "structural alpha" that differentiates convertibles, the price of the convertible has risen from 100 to over 135 (as of April 15), while the high yield bond appreciated from 100 to 103.5 in the same time period.**

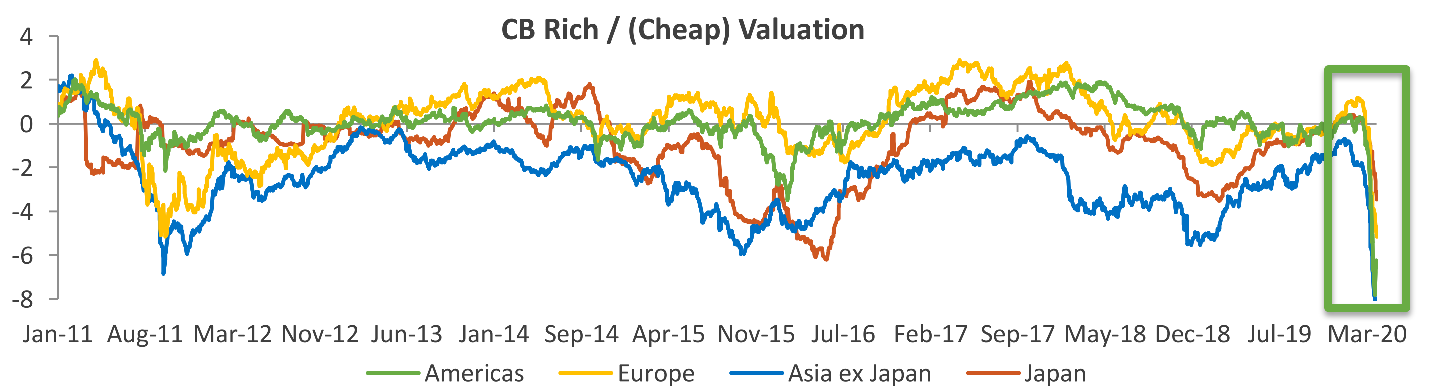
Recent Carnival (CCL) Issuance

	Convertible	High Yield
Deal Size	$2 Billion	$4 Billion
Coupon	5.75%	11.5%
Maturity	3 Years	3 Years
Price at Issuance	$100	$100
Price (as of 4/15)	$135.85	$103.50

Source: Bloomberg

Secondary Market Opportunities

In addition to the attractive convertibles that have come through the primary market, the severity of the recent market dislocation has also led to many opportunities in the secondary market. For a broader market perspective, please see the chart below, which illustrates that **convertible securities are at their cheapest levels since 2011** (Source: Nomura). At the security level, we have observed **certain convertibles that are trading closer in yield to their straight bond equivalent, and therefore creates a relative value opportunity, since you can access the upside potential of the equity through, in many cases, a shorter duraton convertible security.** For example, Twitter has a convertible that matures in 2024 and is priced at a discount (92.5), which is trading at a wider implied credit spread relative to Twitter pari passu straight debt, which is priced at 100.875, and matures 3.5 years after the convertible. Fortive (FTV), a diversified industrial conglomerate that was spun off from Danaher in 2016, and NRG Energy, are additional companies where this dynamic exists. While these opportunities are noteworthy, the issuer overlap between the convertible market and the investment grade and high yield credit markets is extremely low, and therefore is a way to diversify your fixed income allocation and reduce risk. In fact, **there is only 4.3% overlap between investment grade and U.S. convertible issuers, and only 4.6% overlap between high yield and U.S. convertible issuers.** [2]



[2] Overlap, when comparing two indices, is calculated by taking the lowest weighting for each issuer in the respective indices and summing the weight for each issuer.

Final Thoughts

Investing in convertible securities, which have on average less than a 5 year maturity, where deep credit work has been performed to gain conviction that a company is creditworthy, is a high value added way to generate equity like returns with only a portion of the risk. Convertibles have protected well in this period of elevated market volatility, the primary and secondary convertible market opportunities continue to be worthy of consideration, and valuations are at their cheapest levels in nearly a decade. Should you have interest in learning more about how convertible strategies can provide diversification benefits by either bolstering downside protection or by enhancing fixed income returns, please reach out to our client advisory team at clientadvisory@adventcap.com or 212-479-0649.

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