INVESTMENT NOTE

Convertible Bonds:

A Balanced Opportunity in an Uncertain Market

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SHENKMAN

As the United States enters the twelfth year of the longest bull market in history, many investors are looking to balance the desire for continued upside participation with the need for adequate downside protection. While many asset classes have seen higher valuations over the last decade in the wake of asset price inflation, a resurgence of new issuance in the convertible market has helped rebalance the sector's opportunity set. Coupled with the convertible market's natural benefit from volatility as well as its positioning towards less cyclical industries, now may be a good time to consider an allocation toward convertible bonds.

What Are Convertible Bonds?

Convertible bonds are hybrid securities that have properties of both traditional bonds and of equities. Similar to traditional bonds, companies issue convertibles with the obligation to repay the holder par at maturity. In addition, the holder has the right, at his or her option, to exchange the convertible bond for equity in the company. Economically, a convertible bond can be thought of as a traditional bond combined with an equity warrant.

The result of this bond and warrant combination produces a security with asymmetric upside return potential:

> **On the downside:** If the company's stock trades down, the convertible bond will generally only trade down to a level commensurate with the company's credit quality, and the holder remains entitled to full principal repayment at maturity. We refer to this minimum credit-based trading price as the "bond floor."
>
> **On the upside:** If the company's stock trades up, the convertible bond holder may elect to exchange their bond into stock, thus participating in a portion of the equity return.

Why Now for Convertible Bonds?

1. Equity Upside with Less Downside

While equity markets have hit their highest valuations since 2002, the convertible market has remained in a "balanced" position, meaning they exhibit the potential for positive asymmetric returns. As shown in in Exhibit 1, while prices in broader asset classes have generally increased, the balanced portion of the convertible market has maintained a similar technical valuation as it did five years ago (based on its premium to underlying equity value). The resurgence of new issuance in 2018 and 2019, the biggest convertible issuance years since 2008, has replenished the opportunity set for long only active managers, allowing for continued upside participation to equities while continuing to prudently protect against downside risk.

Exhibit 1

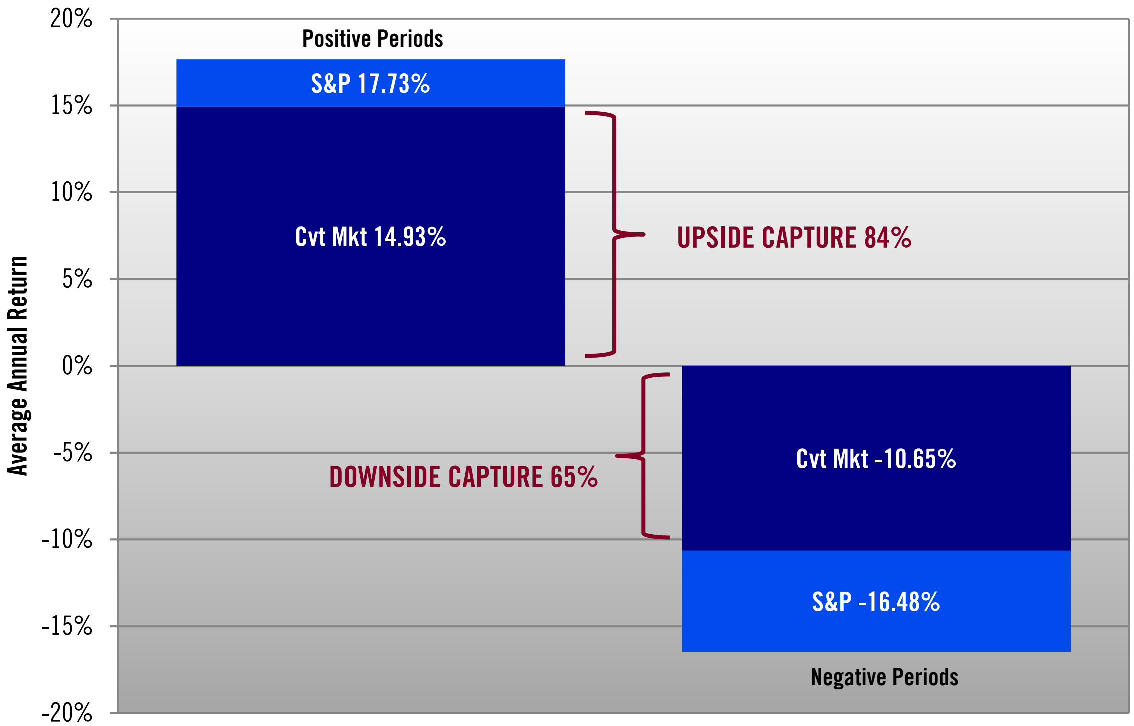
	12/31/2014	12/31/2019
High Yield Bond Spreads (ICE BofA U.S. High Yield Index)	504 bps	360 bps
Levered Loan Spreads (S&P LSTA Leveraged Loan Index)	518 bps	423 bps
S&P 500 P/E Valuation	16.4x	18.3x
Balanced Convertible Market Equity Premium (TR U.S. All-Cap Focus Convertible Bond Index)	30.8%	31.3%

Source: ICE Data Indices, S&P LSTA, Thomson Reuters.

2. Monetization of Market Volatility

Given the equity optionality embedded in convertibles, one driver of value is volatility. All else equal, as implied equity volatility increases, convertible bonds increase in value. In addition, periods of equity volatility can quickly change the attributes of a convertible, making the security more attractive at the same time as the equity price becomes increasingly erratic. This unique attribute is one reason why the convertible asset class has historically captured 85% of equity upside with 65% of the downside (Exhibit 2).

Exhibit 2



Information above was calculated using trailing 12-month performance for the S&P 500 and the Thomson Reuters US Vanilla Convertible Bond Index. Past performance is not indicative of future returns.
Source: Thomson Reuters, S&P

3. Growth Equities at a Value Price

With higher industry concentrations than traditional debt and equity markets in Software, Internet Services, and Biotechnology, the convertible market skews more heavily towards growth-oriented, less cyclical businesses. As the equities of many of these names continue to reach new highs, the corresponding convertibles can provide a prudent alternative to maintain upside exposure. An additional benefit of the resurgence in convertible new issuance has been the increase in repeat issuers; with over 20% of issuers having multiple tranches outstanding, it is increasingly possible to maintain exposure to high-returning issuers (in an attractive risk-adjusted manner) for many years.

Conclusion

With strong risk-adjusted return potential, advantages in the wake of volatility, and fundamental exposure to less cyclical businesses, the convertible bond asset class offers unique characteristics that can benefit investors. Whether looking to de-risk from equities or prudently increase exposure to growth-oriented companies, convertible bonds can be an attractive allocation for many portfolios.

Shenkman Capital believes an active management strategy, based on strong credit-based research and a focus on optimizing technicals in volatile periods, is the best approach to capture the asset class's inherent benefits.

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