The Year Ahead in Healthcare Convertible Bonds

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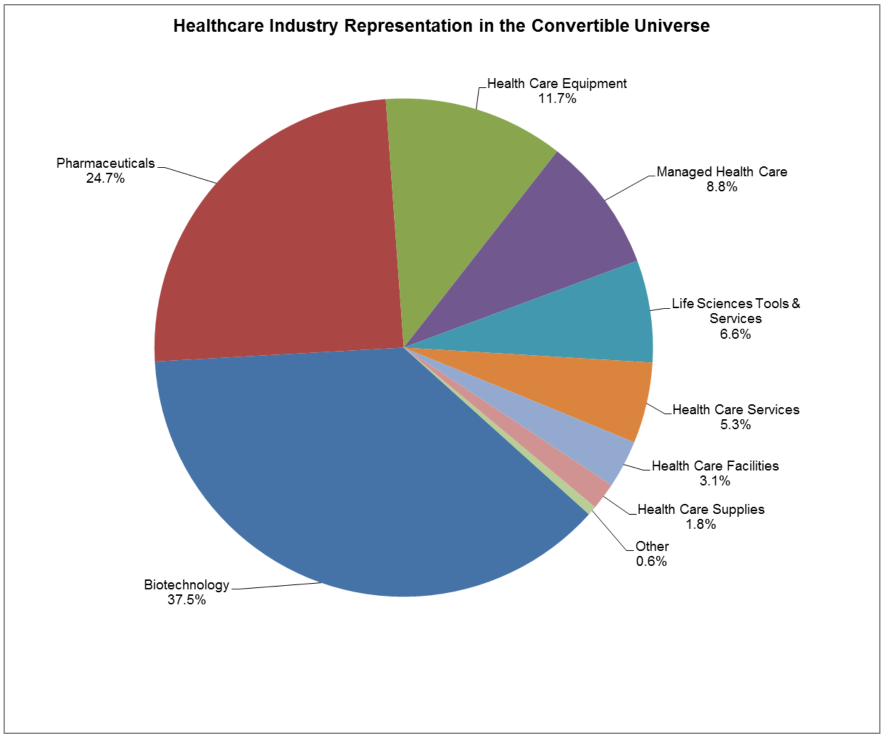
The Healthcare sector has historically comprised a large portion of the convertible bond universe. Currently, Healthcare is represented through 96 convertible securities issues accounting for $40.3bn, or 19.5% of the BAML All Convertibles All Qualities Index (VXA0), making it the second largest sector in the asset class. All major healthcare industries are represented within this opportunity set (shown below: industry as a percentage of overall Healthcare convertible market):



While past issuance has included household names like Schering-Plough (acquired by Merck & Co in 2009), Johnson & Johnson and Aetna, it is usually the smaller mid-cap growth companies that represent the most attractive risk-return propositions for the convertible bond healthcare investor. Gilead Sciences, for example, issued its first of many convertible bonds in 2000. At the time, Gilead exhibited a market cap of under four billion dollars. Since then, the HIV and hepatitis C treatment leader has grown into a $150bn large cap company. Other examples of healthcare companies that have financed their impressive growth through the use of convertible bonds are Allergan, Amgen, Celgene and Onyx Pharmaceuticals (acquired by Amgen in 2013).

While our convertible bond portfolios are generally invested across market cap and industry spectrums within Healthcare, we concentrate on convex bonds with attractive upside participation/downside protection balance and underlying equities that exhibit strong growth potential and solid credit fundamentals.

As the S&P 500 Healthcare sector has outperformed the broader market by over 50% over the last four years (through year-end 2014), and global monetary easing and lower energy prices provide the underpinnings for outperformance by other sectors, we do not necessarily expect Healthcare's dominant outperformance of the recent past to continue at the same trajectory. However, numerous industries within the sector continue to provide attractive opportunities for the convertible bond investor.

The Specialty Pharmaceuticals industry led the way in M&A activity in 2014. While this trend might continue in 2015 with some larger companies looking to address upcoming patent expirations, we expect the overall pace to slow. In particular, the fast M&A pace of 2014 was partly driven by tax inversions, which have become more difficult to execute after recent regulatory changes. However, corporate cash balances at record highs, continued low interest rates and the potential for synergies will likely drive some meaningful deal activity. Investor focus will also turn to the integration success of the acquisitions from 2014. Within Specialty Pharmaceuticals, our portfolios hold positions in, among others, Jazz Pharmaceuticals and Salix Pharmaceuticals.

The Biotechnology industry has led the sector over much of the last four years. While investor exhaustion could set in eventually, attractive fundamentals are still in place. A full upcoming clinical catalyst calendar – coupled with the potential for more M&A, in-licensing and joint ventures – will likely continue to pique investor interest. As the securities of emerging biotechnology companies (which tend to be mid-cap) are essentially long-duration assets, a continued low – or at least stable – interest environment will also help sentiment. Our biotechnology holdings include the convertible bonds of Isis Pharmaceuticals and Biomarin Pharmaceutical Inc.

The Managed Care industry, while continually subject to headline and reimbursement risks, is poised to continue its outperformance of both the broad market and the Healthcare sector. Utilization seems to have bottomed, but the trajectory of its recovery remains muted, helping the providers' medical cost ratios. Continued margin improvement is expected across segments and valuations are among the most attractive in the sector. A compromise on the Affordable Care Act (ACA) against the backdrop of a GOP-led Congress could result in the blocking of State-run Medicaid expansions and wider product offering flexibility on the ACA exchanges. Within Managed Care, our portfolios' holdings include the convertible securities of Anthem and Medicaid pure play Molina Healthcare.

Investors – in Healthcare or otherwise – dislike uncertainty. The less certain the data is that investor projections are based on, the less of a valuation multiple the related assets will be able to attain. With the 2016 election cycle looming, this will become especially important in the Healthcare sector and could manifest itself in more neutral investor positioning in the latter part of this year. We will continue to monitor sentiment closely and continue to incorporate its implications into our portfolio construction process. We do, however, believe that continued strong growth prospects for the sector, sustained M&A and capital return activity, an increasingly more expeditious and cooperative FDA and attractive valuations will provide the foundation for continued strong returns with managed risk in Healthcare convertibles.