

All Grade Convertible Securities: Style Analysis

Convertible securities are intriguing because they embody elements of a variety of equity and fixed income asset classes. We recently looked at a broad array of asset categories to determine the best, or closest, fit between these asset classes and the BofA Merrill Lynch All Convertibles Index (VXA0). The time period used is from April 1990 to March 2015. The asset classes we utilized include:

Equity Asset classes

- Large Cap Value Equities
- Large Cap Growth Equities
- Mid Cap Value Equities
- Mid Cap Growth Equities
- Small Cap Value Equities
- Small Cap Growth Equities

Fixed Income Asset Classes

- 3 Month T-Bills
- Intermediate Treasuries
- Investment Grade Corporate Bonds
- Barclays Aggregate
- High Yield Bonds

The Zephyr analysis showed that the best fit between convertibles and the above asset classes is represented by the following asset mix ($R^2 = .91$):

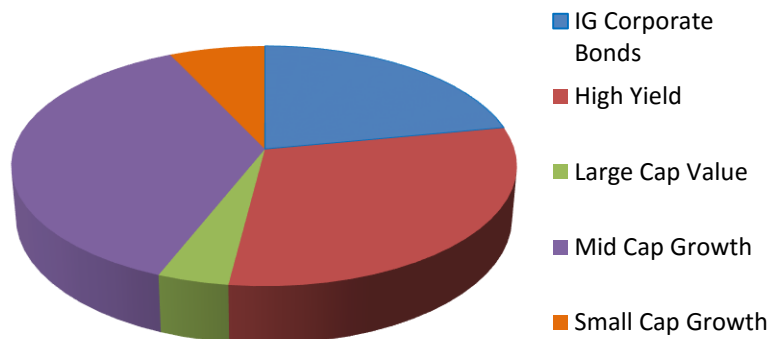
Fixed Income: 52%

- Investment Grade Corporate Bonds = 22%
- High Yield Bonds = 30%

Equities: 48%

- Large Cap Value Equities = 4%
- Mid Cap Growth Equities = 37%
- Small Cap Growth Equities = 7%

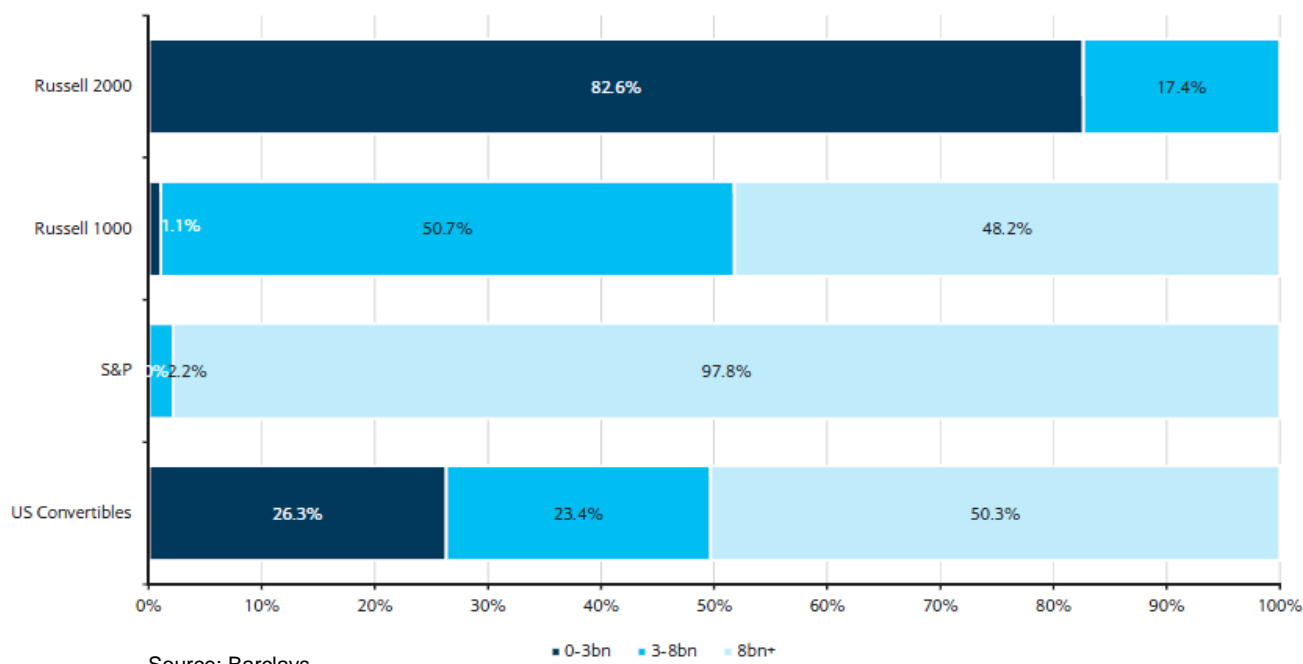
Asset Mix Closest to Convertibles



Discussion on Style Analysis Report

The style analysis is logical. Regarding the equity components, the all grade convertible universe spans the entire market capitalization range. There is a strong mid-cap presence within the universe. From an equity style perspective, there is a growth bias within the universe of convertible securities. This growth orientation is derived in part from the healthy representation of information technology and health care issuers. As shown in this style analysis, there is generally some large cap value representation which comes from a variety of companies which are restructuring or are in a transformative process.

*Small, Mid, and Large Capitalization Exposure Associated with Various Indices
 Convertibles Are Represented by about Half Large Cap Issuers and Half Mid and Small Cap Issuers*



Regarding the fixed income characteristics of convertibles, the high yield allocation is explained by the fact that approximately 73% of the all grade convertible universe is currently below investment grade. However, over the past two years during which new issuance was strong, most of the issuance emanated from below investment grade securities. As interest rates rise, we expect investment grade new issuance to increase. In addition, the average credit quality of the convertible universe is S&P BB, which is sustained by the investment grade representation. The investment grade portion of the style mix is where the investment grade corporate bonds fit in.

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Style Attributes Are Attractive

We believe that the elements of convertibles as demonstrated in this analysis are attractive. To summarize, the all convertible universe exhibits the following characteristics:

- An all cap equity universe, but with an emphasis on mid-cap growth oriented companies. We believe the mid cap area of the equity universe is attractive because these equities are still considered inefficient, but are generally well-established and large enough to maintain stronger balance sheets.
- While convertible bonds are generally more highly correlated with equities than with fixed income, they nonetheless benefit from important bond-like features. Convertibles possess a bond floor, a coupon (for most convertible bonds), and repayment of principal at maturity. Convertible bonds encompass both high quality and high yield fixed income characteristics. The overall credit quality is just below investment grade and superior to high yield. Relative to traditional fixed income indices, this is a low duration asset class. After a long, secular bull market for bonds, we believe low interest rate sensitivity is an attractive characteristic.
- Convertibles possess positive optionality. A convertible security can be described as having the dual components of a straight bond and a long equity call option (the option gives the owner the right to convert the convertible security into a pre-determined number of shares of the underlying issuer). As volatility increases, it increases the value of the call option, which is positive for the convertible bond investor.
- In aggregate, the characteristics of convertibles provide a very attractive risk-return profile. Historically, convertibles have offered investors returns similar to equities, but with less risk. The following table shows the returns over the past 10 years (July 2005 - June 2015) which have been similar for convertibles and equities. However, risk has been lower for convertibles relative to large cap stocks and significantly lower than smaller cap stocks, resulting in higher Sharpe ratios as follows:

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July 2005 – June 2015

10 Years: US Risk Adjusted Returns (July 2005 – June 2015)	Annualized Return	Standard Deviation	Sharpe Ratio
ML All Convertibles Index (VXA0)	7.87%	12.48%	0.52
S&P 500 Index	7.89%	14.74%	0.44
Russell 2000 Index	8.40%	19.58%	0.36
MSCI EAFE Index	5.60%	18.22%	0.23

Source: Zephyr StyleADVISOR

Convertibles are a unique asset class with the properties of both fixed income and equities. The fixed income characteristics provide income and downside protection, while the equity characteristics provide strong absolute returns over the long term. The result is an investment strategy that can provide a portfolio with very attractive risk-adjusted returns.



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