SSi Investment Management

A Case for Convertibles: A Defensive Equity Strategy

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Introduction

In recent years the Federal Reserve has implemented unprecedented monetary policy. In addition to maintaining very low short term interest rates, the Fed has lowered the entire Treasury yield curve by aggressively purchasing longer-term Treasuries in its quantitative easing program ("QE"). This has led to a range bound 10-Year Treasury, whose yield for the most part has oscillated between 2% and 4% over the past 5 years.

This market distortion has created extraordinary challenges for investors who rely on high quality fixed income investments. Not only are yields still very low, but they seem to have bucked some conventional wisdom that as the Fed ends its quantitative easing program, rates will rise. The Fed ended QE late last year, yet currently the annual yield on the 10-year Treasury has dipped below 2% (January 2015). Nonetheless, given the absolute level of interest rates, investors need to be cautious – at some point – about a rising interest rate environment. The negative price impact on some fixed income securities can be meaningful, even with small changes in rates. For example, 30 basis point rise in the 10-year Treasury yield generates a mark-to-market principal loss that wipes out an entire year's yield.

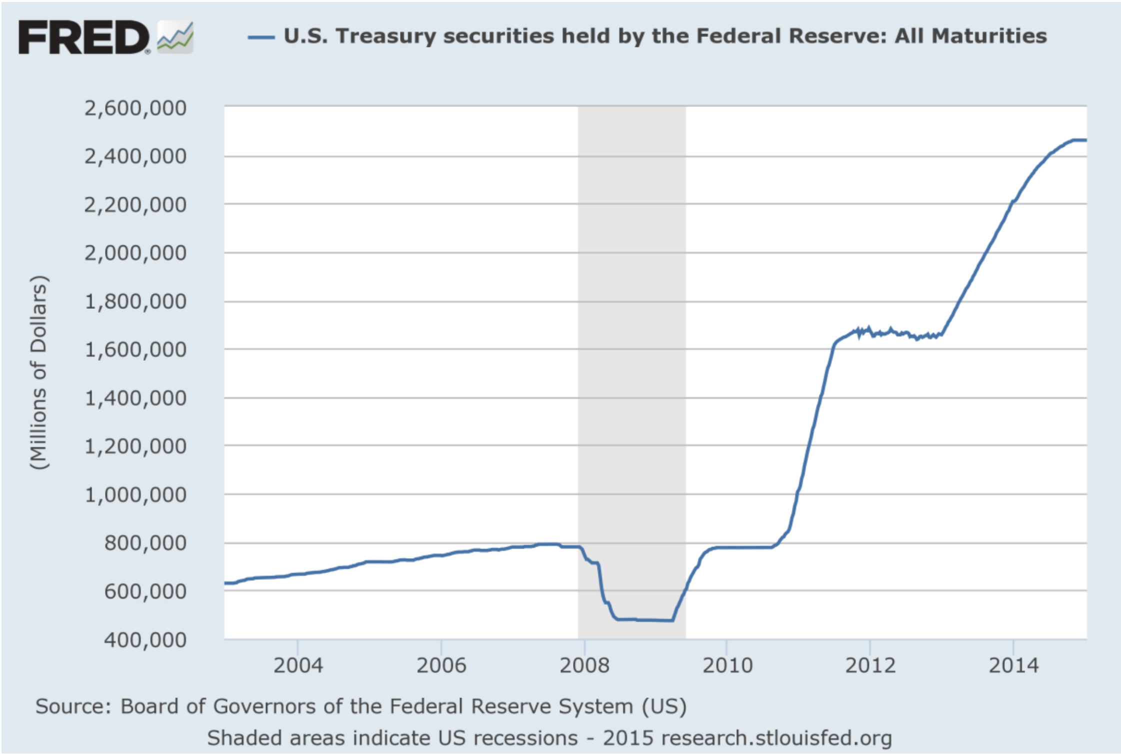
Against this backdrop, convertible securities represent a compelling investment solution. Convertibles combine the investment attributes of bonds and common stock. They offer principal protection with participation in equity returns, resulting in a convex return profile. Historically, convertibles have generated positive returns in periods of rising interest rates, providing important diversification to fixed income portfolios. Hence, convertibles offer investors a low duration investment with a yield advantage and positive optionality.

Macro Environment

Over the past several years, the Federal Reserve conducted massive quantitative easing in three stages. The most recent stage commenced in September 2012. This stage was an addition to Operation Twist and was conducted at a pace of $85 billion of purchases per month. These actions have lifted the size of Fed's balance sheet in an unprecedented fashion from $869 billion on August 8, 2007 to over $4 trillion. QE had the effect of drastically lowering 10 year bond yields from 5% to less than 2%. The process of interest rate "normalization" commenced with Fed tapering starting in December, but has a long ways to go. Recent developments in the oil markets – with crude oil dropping from over $100 / barrel to under $50 / barrel – have pressured the credit markets. This has pushed yields down once again on the 10-Year Treasury.

Currently, the combination of accommodative global monetary policy, low inflation and improving economic indicators would normally provide a favorable backdrop for the equity, credit and convertible markets. However, the collapse in energy prices introduces a source of volatility in the high yield and potentially the equity market. The combination of negative revisions in energy company earnings and foreign translation effects of a sharp up move in the dollar are likely to moderate the pace of S&P earnings growth.

Last year we believed that the 30 year secular bull market for bonds was nearing its end. Given the recent developments in the oil and credit markets, as well as our expectation for tepid economic growth in the US at least in the first half of 2015, we believe the end to this secular bull market may be temporarily delayed. Longer term, however, Treasury prices are still vulnerable to the Fed falling behind the curve and a potential pickup in inflation.


FRED
U.S. Treasury securities held by the Federal Reserve: All Maturities
(Millions of Dollars)
2,600,000
2,400,000
2,200,000
2,000,000
1,800,000
1,600,000
1,400,000
1,200,000
1,000,000
800,000
600,000
400,000
2004
2006
2008
2010
2012
2014
Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

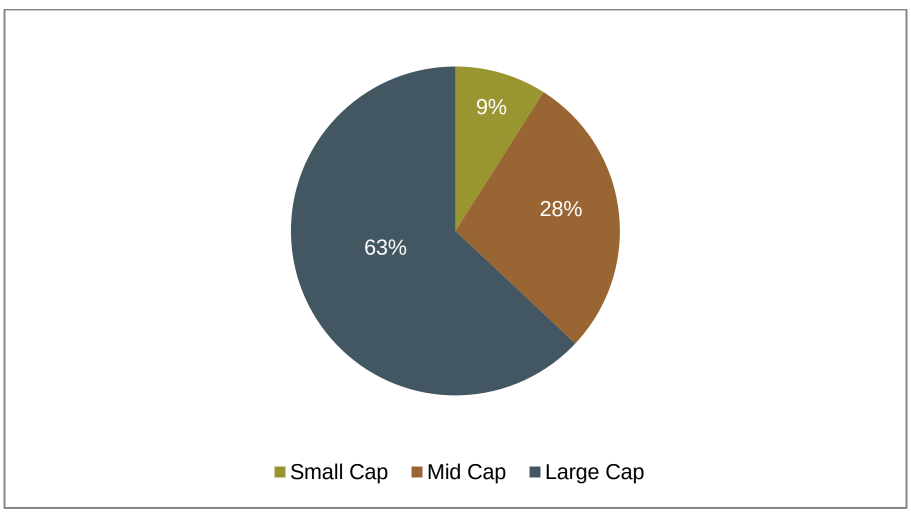

FRED
10-Year Treasury Constant Maturity Rate
(Percent)
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
2011
2012
2013
2014
2015
Source: Board of Governors of the Federal Reserve System (US)
Shaded areas indicate US recessions - 2015 research.stlouisfed.org

Opportunity Set

Issuers in the convertible securities market include a wide range of market capitalization and industry groups. Currently, large cap issuers occupy the largest segment of the market, but mid and small cap issuers are also well represented. The most well represented sectors in the convertible universe include Technology, Healthcare, Financials, Consumer Discretionary and Energy. In general, issuers in the convertibles market tend to have strong credit profiles.

Sector Allocation (as of 12/31/2014)	VXA0
Consumer Discretionary	9.39%
Consumer Staples	2.45%
Energy	5.94%
Financials	18.34%
Healthcare	18.91%
Industrials	3.71%
Materials	2.59%
Media	2.09%
Technology	29.64%
Telecommunication	1.81%
Transportation	1.59%
Utilities	3.54%

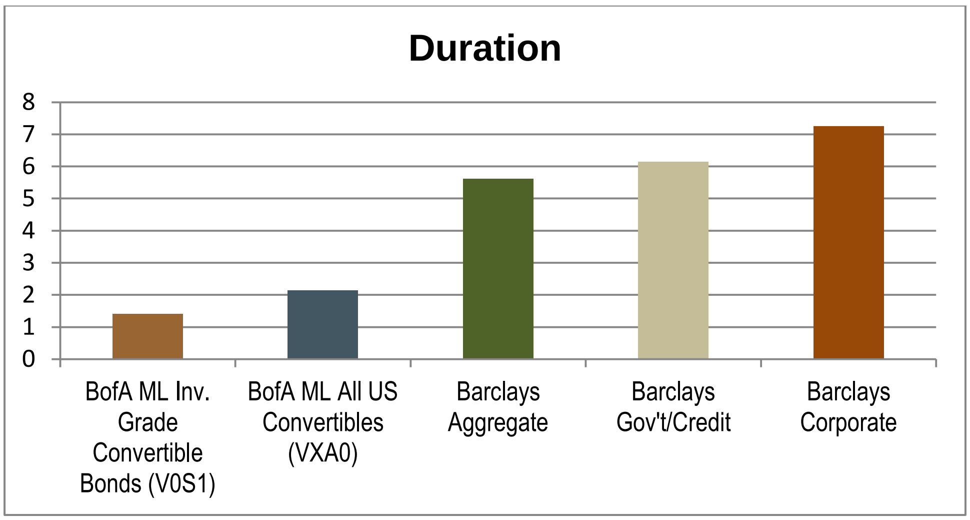
VXA0 – BofA ML All US Convertibles Index



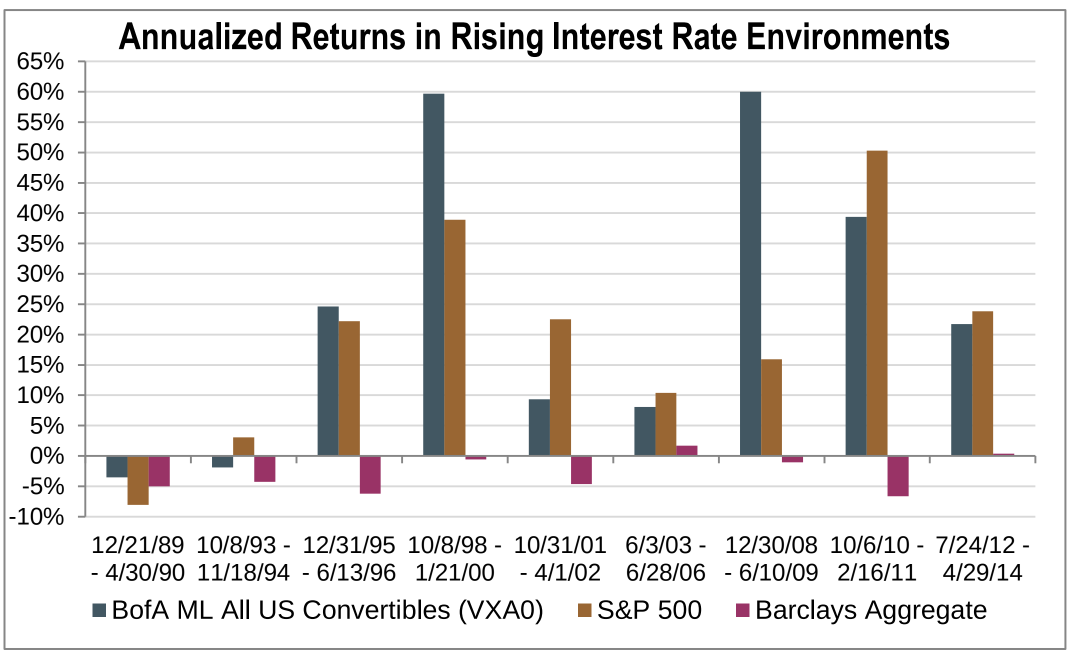
Source: BofA Merrill Lynch Convertible Research. Data as of 12/31/2014.

Performance of Convertibles in Rising Rate Environments

Convertibles significantly outperform their fixed income counterparts in rising rate environments. This is primarily due to two factors. First, equities provide much better protection in periods of rising interest rates, appreciating in nominal terms as they represent a participatory interest in a real business. The equity option imbedded in convertible bonds appreciates in a similar manner, participating in the upside of the underlying equity. Second, the effective duration of convertibles, currently close to 2 years, is very small relative to most fixed income assets. This leads to a relatively small downside impact resulting from a rise in interest rates and that impact is at least partially offset by the rise in value of the underlying equity. The end result is that convertibles, similar to equities, have often provided positive returns to investors in periods of rising rates when most fixed income assets have led to losses.



Source: BofA Merrill Lynch Convertible Research; Barclays; data as of 12/8/14
VXA0 – BofA ML All US Convertibles Index; V0S1 – BofA ML US Investment Grade Convertible Bonds



Source: SSI internal research; BofA ML Convertible Research; Bloomberg; Barclays. Rising interest rate environment periods based on SSI internal research/evaluation where the 10-Year Treasury rises at least 100 bps in a twelve-month rolling period.

Convertibles provide Equity-like returns with less risk

In comparison with their underlying stock, convertibles generally provide higher yields, greater downside protection, and seniority over common equity in liquidation. As a result, convertibles often offer superior risk-adjusted returns compared with equities over full market cycles. The Table below presents the risk-adjusted returns over the past 10 years for several common asset classes:

10 Years: US Risk Adjusted Returns
(January 2005 – December 2014)

	Annualized Return	Standard Deviation	Sharpe Ratio
BofA ML All Traditional Convertibles (VXA0)	7.11%	12.53%	0.45
S&P 500 Index	7.67%	14.67%	0.42
Russell 2000 Index	7.77%	19.75%	0.32
MSCI EAFE Index	4.91%	18.17%	0.19

Source: Zephyr StyleADVISOR

Convertibles are an efficient way to capture the equity market's upside

The upside capture of the equity market (S&P 500) by the convertible security universe over the entire period that clean data is available has averaged over 70%. For investment grade convertible bonds it has exceeded 50%, considerably better than the capture rate for straight fixed income assets. Because convertibles often exhibit positive convexity, they offer investors asymmetrical returns – that is, greater equity participation on the upside relative to the downside.

Equities historically exhibit higher correlations to equities than fixed income

Convertible securities have demonstrated a higher correlation to equities than fixed income. The chart below shows the correlations for convertibles relative to several common asset classes.

2001-2014	Barclays LT Bond Index	Barclays Int. Bond Index	90 Day T-Bills	S&P 500 Index	Wilshire 4500 Index
ML All Convertibles Index (VXA0)	**-0.27**	**-0.35**	**-0.11**	**0.87**	**0.91**

Depending on the time period, convertibles generally have a correlation of greater than 0.80 with equities, and a very low to negative correlation with most bond indices. Nonetheless, convertible bonds offer many of the same positive attributes of a straight bond: they pay a coupon, return principal at maturity, and hold a higher position in the capital structure relative to equities.

Conclusion

Convertibles offer investors many attributes which are highly attractive in the current capital markets environment: low duration, yield advantage, and positive optionality. Historically, convertibles have produced higher risk-adjusted returns relative to stocks – and over many periods have produced higher absolute returns than stocks but with less risk. In our view, convertibles provide the highly desirable attribute of participating in a rising equity market with truncated risk.

SSI Investment Management, a specialist in convertible investing, offers customized investment solutions to help investors weather these challenging times in the markets. We work with clients to develop solutions that help achieve investment objectives while meeting risk management requirements. We have multiple decades of experience in managing convertible securities portfolios for a variety of institutional clients.

