

## 2020 Mid-Year: Convertible Commentary & Outlook

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### Reviewing YTD 2020 Performance

Convertibles, as an asset class, delivered stellar returns in the first half of 2020, significantly outpacing equity markets and outperforming most other asset classes. As represented by the ICE BofA All US Convertible index (VXA0), the asset class returned 7.25%, primarily driven by strong performance of the underlying equities at 5.73%. Below is a comparison of the convertible asset class vs. major equity and credit benchmarks for the first half of 2020:

YTD Performance (June 30, 2020)

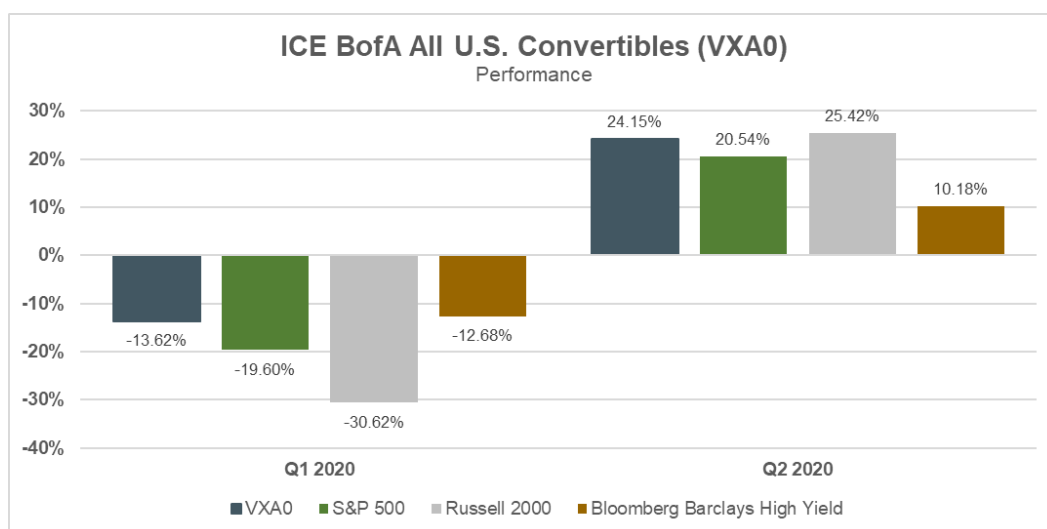
ICE BofA All US Convertible Index	7.25%
S&P 500	-3.08%
Russell 2000	-12.98%
Bloomberg Barclays High Yield Bond Index	-3.79%
Bloomberg Barclays US Corporate Inv. Grade Bond Index	5.02%

Source: Bloomberg, Barclays, Data Analytics – Global Convertibles Chartbook

The first half of 2020 experienced a highly volatile environment, both for the stock market as well as convertible bonds. Convertibles returned -13.62% in Q1, as equities plunged and credit spreads surged to 1100 bps for high yield, as a consequence of the forced shutdown of the economy in the wake of the Covid-19 pandemic. Despite being impacted by spread widening and cheapening of valuations, convertibles outperformed equity indices, with the S&P 500 and Russell 2000 returning -19.53% and -30.57% respectively. The Fed’s intervention towards the end of March to provide liquidity at an unprecedented speed and scale in treasury, muni, foreign exchange, MBS, corporate bond, and high yield markets put a floor under credit markets. Consequently, convertibles faced a favorable backdrop benefitting from multiple tailwinds in Q2. Credit markets started to tighten, equities rebounded strongly on hopes of reopening of the economy as well as the ability of companies to tap credit markets to cross the valley, and theoretical cheapness started reverting to normal levels against a stronger liquidity backdrop.

Q2 2020 was truly a remarkable quarter for convertibles, representing their best quarter since Q4 1999, and the second best quarter since the inception of the VXA0 index. The asset class returned

24.15%, with a record 39.59% return from the underlying equities vs. 20.51% for the S&P 500 and 25.38% for Russell 2000. The dramatic rebound in equity and credit markets is attributable to decisive monetary and fiscal policy that prevented the health and economic crises from turning into a financial crisis. Fiscal policy to the tune of \$2.7 trillion to replace income for those laid off and to support businesses, as well as action by the Fed to cut rates down to zero and ramp up their balance sheet from \$3.7 trillion to \$7 trillion (currently) played a critical role; as did developments in the medical field. The explanation for the outperformance by convertibles lies in attractiveness of companies underlying the convertible universe, as well as the tailwinds from reversion to the mean of credit spreads and cheapness.



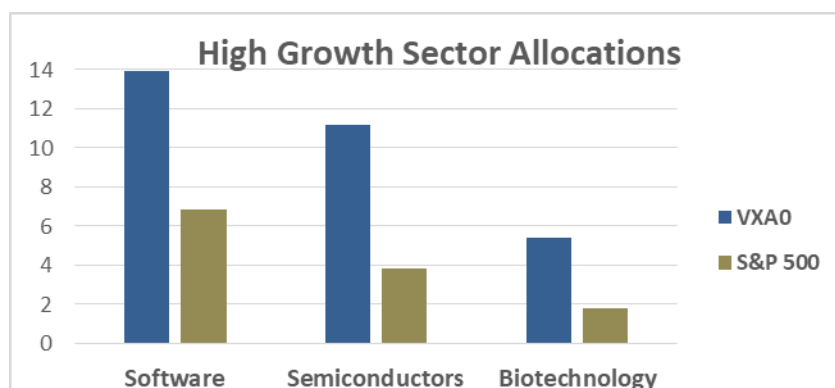
Source: Bloomberg, Barclays, Data Analytics

### Outlook for the Remainder of 2020

Our outlook for convertible bonds for the second half of 2020 remains constructive. One reason is that we believe the underlying equities of the convertible bond asset class will continue to outperform major equity benchmarks. The convertible universe has been dominated by structural growth companies in the Technology and Healthcare sectors (represent over 50%+ of the convertible market) that are disruptors with large addressable markets, benefit from accelerating economic trends and have the potential for long-lasting high growth, even hyper-growth in some cases. Some of the major structural growth themes for 2020 that have heavy representation in the convertible universe are:

- Digitization of the economy and cloud computing/SAAS (software as a service);
- Genomics, personalized medicine, gene therapy, telehealth, and biotech M&A; and
- 5G build out, data center reacceleration, artificial intelligence, and automated mobility

These themes have a significantly higher representation in the convert universe, as can be seen in the chart below:



Above chart as of 1/20/2020. VXA0 represents the ICE BofA US Convertible Index  
Source: Bloomberg, ICE, using GICS Industry Group classification

The strong returns by these structural growth companies in the first half of 2020 was a major reason for the outperformance of convertible bonds. We expect returns for this segment of the convertible market to remain strong in the second half of the year. A lot of the trends that have benefitted these companies over the last few years have actually accelerated this year, mostly due to Covid-19 and the WFH (work from home) movement. Many companies have quickened their digital transformation timelines due to the events of this year. This has led to increased bookings and backlogs for many cloud computing companies that have issued convertibles, such as Ring Central, Coupa Software, Okta, Five9, and Twilio.

A more recent feature of the convertible universe is the increased representation of cyclical recovery plays in the value segment of the market. This is due mostly to a surge of new issuance in Q2 2020 by airlines, retailers, cruise lines, and restaurants, as these companies try to make it across the abyss. Consumer Discretionary and Transportation sectors represented 24% of total new issuance YTD. Several of these new issues are from companies that were doing well before the pandemic, but came to the market with relatively depressed equity valuation relative to normalized earnings (due to the loss of business from Covid-19), priced their securities quite cheaply, and would benefit most from a cyclical recovery with the Fed supporting financial conditions before we make it past the vaccines and therapeutics. The underlying stocks rebounded in April and May, but have been weak since early June due primarily to a pickup in Covid-19 cases in the U.S.

A majority of these companies will likely perform well in the second half of the year as we get ever closer to therapeutics and vaccines for Covid-19. There are a large number of ongoing trials of

drugs, antibody cocktails, and vaccines, several of them currently in Phase 2 and 3 human trials. Gilead's antiviral Remdesivir has shown some efficacy against the virus, and Regeneron has started Phase 3 trials for its promising antibody cocktail that might act both as a treatment post infection and as a vaccine. A vaccine for Covid-19, from one of the dozen or so human trials currently in progress, is a possibility in late 2020 or early 2021. As positive data on these various trials gets released and we get closer to a medical solution, these cyclical value stocks are likely to outperform since they are the greatest beneficiaries of re-opening of the economies and a return to normal. This will in turn likely contribute to the overall performance of the convertible asset class.

While the case for a strategic allocation to convertibles rests on the asset class' unique risk-mitigated exposure in the structural growth part of the market, leading to superior risk-adjusted returns, there is currently an additional tactical case for allocation to convertibles. Elevated levels of spread and cheapness have historically led to strong outperformance by the asset class, as reversion to the mean for spreads and cheapness have provided strong tailwinds to returns in the asset class. Spreads widened dramatically, and the asset class cheapened by over 3% in the aftermath of the pandemic. BofA calculates U.S. convertibles as 3.4% cheap at the end of June. This compares to an average cheapness in Q1 2020 of only roughly 0.7%. High yield cash spreads (USOHHYTO) were 646 bps at the end of June, compared to 393 bps at the start of 2020. A reversal of spreads and cheapness towards pre-pandemic levels on the back of a recovering economy and a Fed backstop to credit is underway currently.

The macro backdrop remains supportive for risk assets. Although GDP growth could plunge at a -40% annualized rate in Q2 according to Evercore ISI estimates, it will likely rebound at a +20% annualized pace in Q3 and Q4 of 2020. Massive fiscal and monetary intervention in the US, Europe, Japan, and China has been supportive to credit and equity markets. PMIs are rebounding globally, as economies everywhere start to open up. Job growth has resumed, and nonfarm payrolls grew by 4.8 million in June on the back of re-openings. Consumer Net Worth in the US is back close to the highs on the back of a recovery in equity markets as well as housing. Consumer sentiment is starting to recover. Economic Surprise Index in the US is at a multi-year high. There are some concerns recently due to a spike in new infections in the US, while the curve has been successfully flattened in Europe and China. The recovery driven by policy support is likely to become more self-sustaining after a successful vaccine is found and deployed.

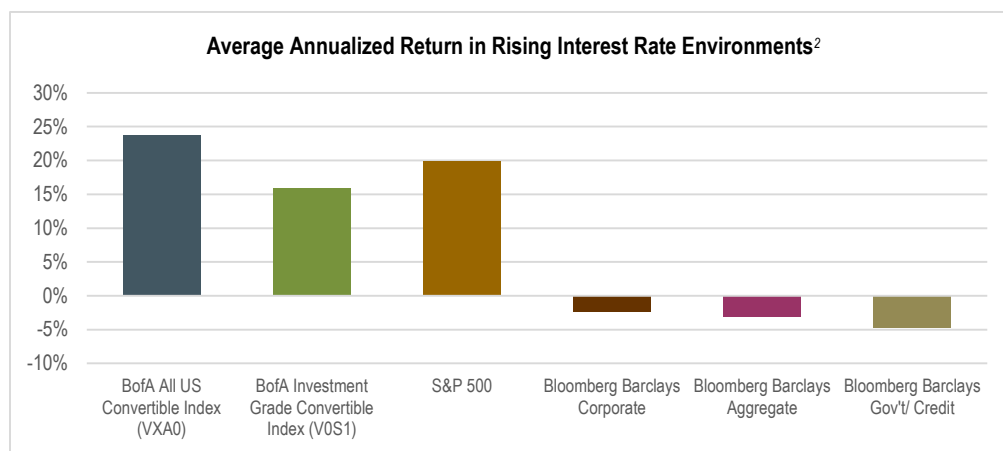
## *New Issuance*

Convertible bond issuance has been extremely strong in 2020. Through June, there has been \$71.6 billion in issuance, surpassing last year's 12-month total of \$58.1 billion. The all-time record for issuance of \$106 billion in 2001<sup>1</sup> could be surpassed this year, though issuance is expected to slow in the second half of 2020. The blend of new issues has been very attractive, with many structural growth cloud, e-commerce, and biotech companies, as well as cyclical value companies in the Consumer Discretionary and Industrial sectors in the mix. New issues are typically highly convex, and, therefore, enhance the risk/reward profile of the overall portfolio. SSI is currently deploying a "bar-bell" investing approach. On the one hand, this involves a continuing emphasis on investing in issues levered to secular growth themes, such as digitization of the economy and personalized medicine. On the other hand, it means, judiciously, investing in solid businesses in cyclical areas, such as Consumer Discretionary, that were impacted by the pandemic, and came to the market recently, to help make it across the valley.

## *The Case for Convertibles in 2020 and beyond*

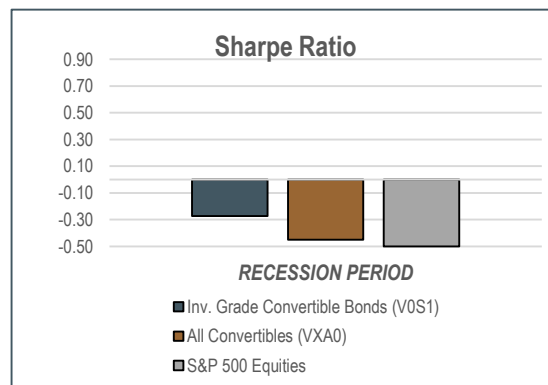
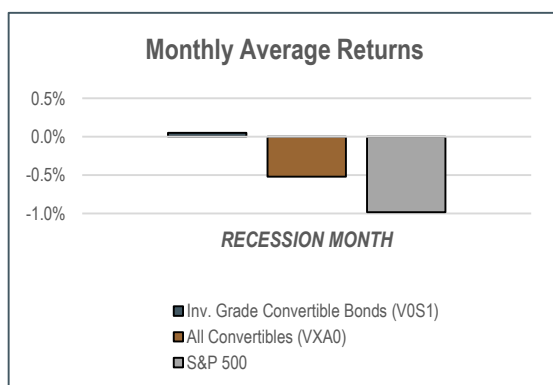
- Convertibles are one of the few asset classes that contractually **provide downside protection**, as the principal and coupon are protected and senior to equity claims.
- Convertibles provide **exposure to fast growing, higher beta equities** in the Technology and Healthcare space, **with meaningfully truncated downside** and reduced risk. They provide risk controlled exposure to some important secular trends and to disruptive companies serving large addressable markets. Currently they also provide exposure to attractive cyclical recovery stories starting with attractive equity valuations against an improving macro backdrop through attractively priced securities.
- Convertibles are **a great fit for low volatility equity** allocations. A low volatility quant equity strategy is likely to be skewed in favor of Utilities, Consumer Staples, REITS and Consumer Discretionary, with underweights in Technology and Healthcare. By contrast, convertibles have a high representation in Technology and Healthcare, along with underweights in Consumer Staples, Utilities, and Consumer Discretionary. Therefore, convertibles can provide meaningful diversification benefits to a portfolio, along with the ability to significantly truncate the potential volatility from exposure to these high growth sectors.

- Convertibles can provide **duration protection** in rising rate environments (as depicted by the chart below):



- **Convertibles outperform equities during economic recessions**, on both an absolute and risk adjusted basis. Were there to be a double dip or a W shaped recovery, convertibles are likely to do a good job of protecting on the downside, just as they did recently in Q1 and the first half of 2020, as well as in prior episodes of recessions.

### Resilience of Convertibles in Economic Recessions<sup>3</sup>



Above, we listed several reasons why we are positive on convertibles for the remainder of 2020. In general, we believe an allocation to convertible bonds usually makes sense. Convertibles are a unique asset class that offers solid participation in equity markets, yet with the downside protection of bonds. It is an ideal asset class for investors seeking growth with capital preservation as well as contractual income.

<sup>1</sup>BofA Data Analytics – Global Convertibles Chartbook July 1, 2020.

<sup>2</sup>SSI internal research; BofA 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 (periods shown in table below).

Analysis Periods				
12/21/89 - 4/30/90	12/31/95 - 6/13/96	10/31/01 - 4/1/02	12/30/08 - 6/10/09	7/24/12 - 4/29/14
10/8/93 - 11/18/94	10/8/98 - 1/21/00	6/3/03 - 6/28/06	10/6/10 - 2/16/11	7/8/16 - 2/14/17

<sup>3</sup>Bloomberg & BofA & NBER. Notes: Monthly Average Returns utilizes the average monthly return from three prior recessions: Early 1990's Savings & Loan recession (6/1990-3/1991); Early 2000's Dot-Com recession (2/2001-11/2001) and Mid-2000's Great Recession (11/2007-6/2009). Sharpe Ratios are calculated using full recession period returns.

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