Convertibles: An Investment Solution for Insurance Portfolios in Challenging Times

By: **Ravi Malik, CFA,** Portfolio Manager
Steve Wachtel, CFA, Portfolio Manager

The Challenge of Ultra Low Rates for Longer Periods of Time

Due to the unprecedented monetary policy by the Federal Reserve in recent years, interest rates are at extremely low levels throughout the yield curve. This has created extraordinary challenges for the insurance industry, which relies heavily on high quality fixed income investments. The Bloomberg Barclays U.S. Aggregate Bond Index currently yields only 1.15%, compared to its 44-yr average of 6.4%. It is a near certainty that fixed income returns going forward will be significantly lower than the returns enjoyed from the long bond bull market that has persisted for over 40 years.

In an environment of ultra and artificially low interest rates, risk averse insurance company asset managers feel increasingly challenged generating a 3%+ return in their investments to cover their liabilities utilizing only short duration, high quality, fixed income assets. Convertibles provide an attractive avenue for meeting that threshold by participating in the upside of the equity market in a risk controlled way while also being highly efficient in the deployment of capital.

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 offer superior risk-adjusted returns compared

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with equities over full market cycles. The Table below presents the historical risk adjusted returns for the US market:

US Risk Adjusted Returns July 1990 – June 2020

	Annualized Return	Standard Deviation	Sharpe Ratio
BofA All US Convertible Index (VXA0)	6.41%	12.45%	0.39
BofA Investment Grade Convertible Index (V0S1)	6.95%	9.21%	0.58
S&P 500	5.91%	14.97%	0.29
Russell 2000	6.69%	19.84%	0.26

Source: Zephyr StyleADVISOR

Convertibles are a highly capital 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%, considerably better than the capture rate for straight fixed income assets.

For Insurance companies, the risk based capital charge for investment grade convertible bonds and convertible preferred stock is a small fraction of the corresponding charge for common stocks (see below). This is because convertibles are treated as bonds for risk-based capital (RBC) charges due to their seniority in the capital structure and principal protection.

NAIC Life, P&C and Health RBC Charges

Bonds & Prefferreds	Life	P&C	Health
NAIC Class 1 (AAA/Aaa, AA/Aa, A/a)	0.40%	0.30%	0.30%
NAIC Class 2 (BBB/Baa)	1.30%	1.00%	1.00%
NAIC Class 3 (BB/Ba)	4.60%	2.00%	2.00%
Common Stock	**Life**	**P&C**	**Health**
Common	22.5%-45%[1]	15.00%	15.00%[2]

Source: NAIC.org as of Aug 5, 2020

[1] 30% β-weighted (min 22.5%, max 45%)

[2] Charge for Federal Home Loan Bank Common Stock = 2.3%

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Convertibles Perform well in Rising Rate Environments

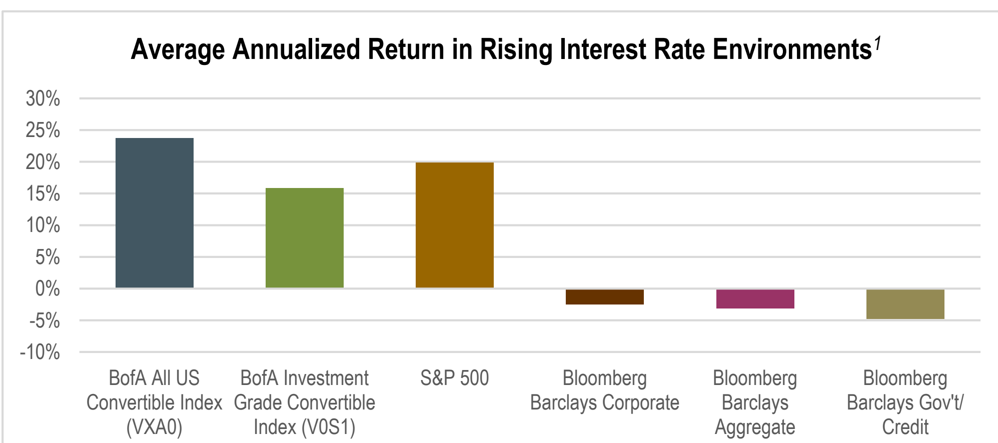
Convertibles significantly outperform their fixed income counterparts in rising rate environments. This is primarily due to two factors. First, equities provide much better protection in periods of rising interest rates, appreciating in nominal terms as they represent a participatory interest in a real 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 is very small relative to most fixed income assets.

	Duration
BofA Investment Grade Convertibles (V0S1)	1.75
BofA All US Convertibles (VXA0)	1.86
Bloomberg Barclays U.S. Aggregate Bond Index	6.00
Bloomberg Barclays U.S. Corporate Bond Index	8.56

Source: Bloomberg 8/26/20

This leads to a relatively small downside impact resulting from a rise in interest rates and that impact is partially offset by the rise in value of the underlying equity as well as the benefit to the valuation of the embedded equity call option from a rise in rates.

The end result is that convertibles have provided positive returns to investors and historically been one of the best performing asset classes, in periods of rising rates when most fixed income assets have led to losses.



Source: SSI internal research; BofA Convertible Research; Bloomberg; Barclays

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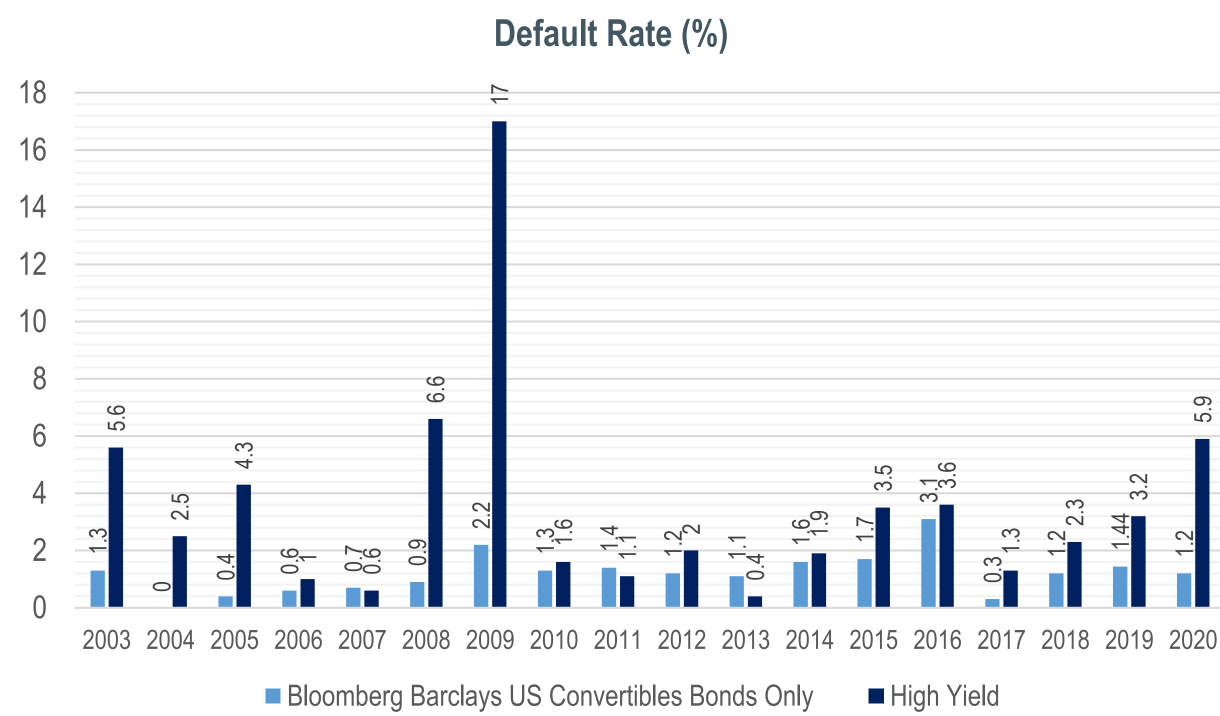
Convertibles have low correlation to Fixed Income and provide significant sector diversification relative to High Yield

Convertibles have a low correlation to other fixed income securities. There is a diversification benefit to a portfolio heavily weighted in high quality bonds. Issuers of convertible bonds represent a diverse range of market capitalization and industry groups. Convertibles have solid representation of structural growth companies in the Technology and Healthcare space that are disruptors with large addressable markets, and potential for high growth rates that are long lasting. Consequently, they provide significant sector diversification to a high yield portfolio as well. Recently, undervalued cyclical companies trying to make it “across the valley” in sectors such as Consumer Discretionary, Industrials and Transportation have provided additional attractive investment opportunities in the convertible market.

Convertibles have a strong credit profile

Convertible bonds have consistently had a lower default rate and higher recovery rates than the high yield bond market. The average default rate for convertible bonds going back to 2003 is only 1.36%. The recovery rate going back to 2003 averages 30.9%.



Source: Barclays Research, 2020 YTD as of Jun 30, 2020; US Convertible Securities' only

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[1] 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.

		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
9/7/17-4/25/18				

Unless otherwise stated, statistics included in document sourced from Bloomberg, Barclays.

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