

2019 Mid-Year: Convertible Commentary & Outlook

Exploring Convertibles as an Ideal Vehicle to Participate in Growth Equities

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Reviewing YTD 2019 Performance

Convertibles as an asset class delivered strong returns in the first half of 2019. As represented by the ICE BofA ML All US Convertible Index (VXA0), the asset class produced a return of 14.51%, which was primarily driven by strong performance of the underlying equities (+19.94%). The underlying equities of the convertible asset class outperformed major equity and credit benchmarks, as demonstrated below:

YTD Performance

(June 30, 2019)

Underlying Equities of the Convertible Asset Class	19.94%
S&P 500	18.54%
Russell 2000	16.97%
Bloomberg Barclays High Yield Bond Index	9.94%
Bloomberg Barclays US Corporate Inv. Grade Bond Index	9.85%
Bloomberg Barclays Intermediate Treasury Bond Index	3.99%

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

The sharp rebound in the first half of 2019 was spurred by a radical Fed pivot towards dovishness, signaling no more hikes, and an earlier cessation of quantitative tightening and a progression to an easing stance against the backdrop of very light investor positioning. In particular, the Q4 correction had led to significant change in positioning with hedge fund beta falling from 95th percentile in September to 15th Percentile around Christmas 2018. Technology was the largest contributor to the convertible index in the first half with a sector return of 19.24% and the largest sector weight in the index at 35.24% of the index¹.

During 2018, the equity markets and all risk assets suffered a significant sell-off and heightened volatility in Q4 2018. The sell-off was driven by tightening monetary policy, in the face of a ratcheting up of trade tensions and slowing global growth, partly induced by the combination of monetary policy and trade frictions. Other factors contributing to the selloff included negative technical forces, such as significant systematic selling, hedging of short gamma positions, buyback blackout, and low market depth.

Convertibles, as an asset class, did an exceptional job protecting capital in this environment, and as well during the month of May 2019.

Convertibles Can Help Protect Capital During Equity Market Drawdowns		Year 2018	May 2019
ICE BofA ML All US Convertible Index (VXA0)		+0.15%	-3.28%
S&P 500		-4.39%	-6.35%
Russell 2000		-11.03%	-7.78%

Source: Bloomberg

Outlook for the Remainder of 2019

While maintaining the pace of first half returns will be a challenge in the convertible space, our outlook for the remainder of the year remains constructive. Risk assets rebounded in June and were aided by the Fed signaling in the June meeting that the next move will likely be a cut due to increased macro uncertainty and a weakening economic outlook. The market is pricing in between two and three rate cuts this year. The trade truce between the US and China and resumption of negotiations also helped. US fundamentals remain resilient and Q1 GDP came in strong at 3.1%. In the latest revision, Capex was revised up to 4.4%, driven by Intellectual Property (IP). Software, currently 41% of IP, was revised up to 17.5% growth.

Although the economy has softened lately, Evercore ISI's latest economic surveys still indicate a GDP growth rate of 2.5%, despite weakness in Europe and China². The employment picture remains strong with positive implications for corporate revenue growth, while corporate dividends are being increased, suggesting confidence by companies in increasing earnings. For the rest of the year, we expect growth trends in the economy to be a major contributor of return forecasts and continuously drive the upside potential for convertibles.

Disruptive Growth Companies: A Driver of Market Returns

The near bear market in Q4 2018 as well as the pull back in May 2019 were driven by macro headlines, including the trade war, elections, and Fed policy. These headlines hit growth equities disproportionately hard. Going into these events, positioning in growth equities was crowded. Given the continued strength of the fundamentals and the positioning turning a lot less crowded, growth equities were able to reassert themselves. The decline in long bond yields, due to the conspicuous absence of inflationary pressures, provides a further tailwind to secular growth companies with a disproportionate part of the valuation derived from future earnings.

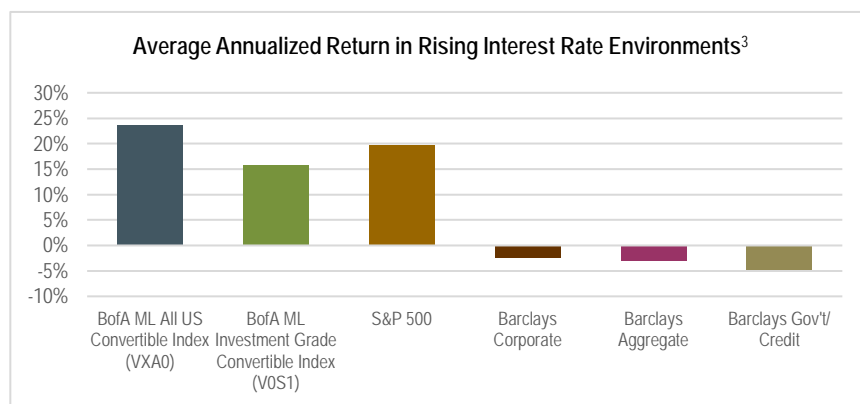
Several of these growth companies in the Technology and Healthcare space are disruptors with large addressable markets and potential for high growth rates that are likely to be long lasting. Examples of

such markets include Software as a Service(SAAS)/Cloud Computing, Artificial Intelligence, Automated Mobility and Genomics. The convertible market has a high proportion of such high secular growth companies in the technology and healthcare space. Companies in the software space, in areas relating to cloud computing/SAAS in particular, have become a more prominent part of new convertible issuance in the last 18 months and the trend is likely to continue. A new aspect of the current crop of issuers in the convertible universe is the strong financial profile of the companies, particularly in the software sector and internet space.

These companies tend not to be capital intensive, are rapidly growing revenues, and have stronger balance sheets. They are at the forefront of the digitization of the economy, have led a rebound in capex as evidenced in the recent GDP data, and they have spurred productivity growth. With an average implied volatility close to 40% in the SAAS space, large moves in the stock price (as much as 40% move or more in a year with 32% probability) are likely. Convertibles through their asymmetric risk reward can potentially meaningfully improve risk adjusted returns.

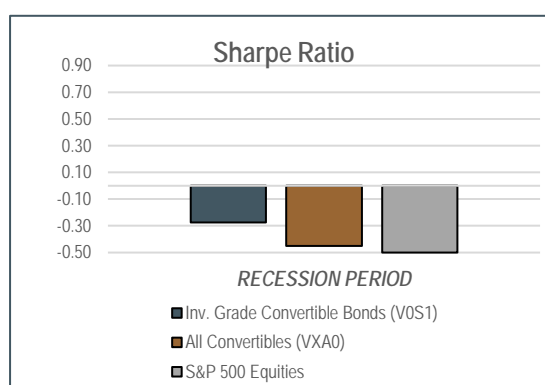
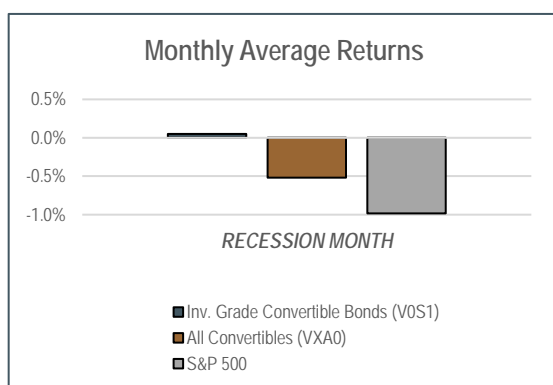
The Case for Convertibles in a Low Volatility Equity Allocation:

- 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. *Investors who are bullish on growth equities* should utilize converts as a component of their growth allocation to maximize participation while controlling risk. *Investors who are cautious on growth equities* should shift some of their growth equity allocation to convertibles to reduce risk.
- 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 great meaningful diversification benefits to a portfolio and the ability to significantly truncate the volatility from exposure to these high growth sectors.
- Convertibles can provide protection in rising rate environments.



- The current economic expansion is the longest in history. Concerns about a recession, although not conclusively borne by the data as yet, are rising. Convertibles have historically outperformed the equity market in recessionary economic environments.

Resilience of Convertibles in Economic Recessions⁴



¹BofAML Data Analytics – Global Convertibles Chartbook July 1, 2019.

²Capex data source: Cornerstone Macro June 30, 2019. Evercore ISI Company Survey Report July 12, 2019.

³SSI 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 (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

⁴Bloomberg & BofA Merrill Lynch & 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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