

Convertible IQ

Q: Why should convertibles be considered as a superior option for a low volatility/defensive equity allocation?

An allocation to low volatility strategies has been a key component for helping to reduce the overall risk levels of a portfolio. They have reduced the overall risk metrics of a portfolio by helping to limit, in some cases, the downside risk during down markets. However, they suffer from a large disadvantage when compared to convertibles. Low volatility strategies have not demonstrated the ability to participate in the upside during periods of strong market rebounds and/or exceptional market conditions such as those seen since the start of the 2020 pandemic.

It is helpful to look at how low volatility equities performed during the last few major market rallies. During the Global Financial Crisis in 2008, low volatility stocks worked as intended and delivered strong performance relative to the overall market. However, during the sharp recovery in 2009, low volatility stocks lagged cyclical stocks by a wide margin, leading to an overall disappointing 2009 and weak three-year returns despite their strong relative 2008 performance¹. Looking even further back, towards the end of the tech stock rally in March 2000, low volatility’s three-year annualized returns were 10% compared to the massive 24% delivered by the market, resulting in a three-year negative alpha of 7.8%, an all-time low for low volatility stocks¹.

As 2020 has shown, many low volatility strategies struggled before and during the pandemic because they were not able to provide

downside protection in Q1 and were unable to participate in the market upswing following the negative first quarter.

Similar to low volatility equity, convertible securities offer downside risk protection due to their defensive bond-like structure, but with a large advantage, they have been much more effective at capturing equity upside during market upswings. According to the analysis below, convertibles as an asset class, represented by the ICE BofA All US Convertibles Index (VXA0), delivered higher returns during the trailing 3 and 5 year periods than the S&P 500 Low Volatility, Russell 2000, and S&P 500 indices. Convertibles accomplished this with lower downside deviation, higher Sharpe ratios, and higher Sortino ratios than these asset classes. Convertibles’ outperformance showcases the substantial strength of the asset class, delivering true equity like returns while offering downside risk protection due to the convex nature of their return structure. By contrast, some low volatility equity strategies significantly underperformed during the same periods.

When you also consider the diversified sector exposure (including meaningful growth exposure in Tech and Healthcare) of convertibles vs traditional low volatility equity and hybrid strategies, the data below helps support why convertibles can serve as a superior option for a low volatility or defensive equity allocation.

3 Years: US Risk Adjusted Returns ² (as of 1/31/2021)	Annualized Return	Standard Deviation	Sharpe Ratio	Downside Deviation	Maximum Drawdown	Pain Ratio	Sortino Ratio
ICE BofA All US Convertible Index (VXA0)	21.69%	16.94%	1.19	9.47%	-15.98%	11.25	2.29
S&P 500 Low Volatility Index	6.73%	14.84%	0.35	10.85%	-21.38%	1.16	0.62
Russell 2000 Index	11.11%	25.71%	0.37	17.64%	-32.17%	1.09	0.63
S&P 500 Index	11.70%	18.65%	0.55	12.03%	-19.60%	2.96	0.97

5 Years: US Risk Adjusted Returns ² (as of 1/31/2021)	Annualized Return	Standard Deviation	Sharpe Ratio	Downside Deviation	Maximum Drawdown	Pain Ratio	Sortino Ratio
ICE BofA All US Convertible Index (VXA0)	19.98%	13.43%	1.40	7.37%	-15.98%	17.01	2.71
S&P 500 Low Volatility Index	10.48%	12.41%	0.75	8.54%	-21.38%	3.07	1.23
Russell 2000 Index	16.50%	21.11%	0.73	13.87%	-32.17%	2.83	1.19
S&P 500 Index	16.16%	15.03%	1.00	9.35%	-19.60%	7.17	1.73

¹ Source: “Has low volatility investing lost its mojo”, Robeco, article accessed February 2020. Link: <https://www.robeco.com/us/insights/2020/12/has-low-volatility-lost-its-mojo.html>

² Source: Bloomberg, SSI internal research as of 1/31/2021. Past performance is not necessarily indicative of future results.

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