

## CONVERTIBLE IQ

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**CONVERTIBLE BONDS**  
**A CAPITAL EFFICIENT SOLUTION FOR INSURANCE COMPANIES**

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**A CAPITAL  
EFFICIENT,  
CUSTOMIZABLE  
SOLUTION FOR A  
RISING RATE  
ENVIRONMENT**

While the world continues with its rollercoaster journey through the COVID-19 pandemic, improving economic indicators, massive monetary expansion, and supply chain issues have brought inflation back into focus. Inflation leads to rising interest rates and heightened volatility. Rising rates can significantly impact a portfolio for insurance companies, which generally invest heavily in fixed income. However, due to capital reserve requirements and the corresponding embedded portfolio limits, attractive fixed income investment options for insurance companies are limited.

The unique feature of Convertible Bonds – a corporate bond that can be converted into the issuer’s equity – speaks to its value proposition for insurance companies: a capital-efficient fixed income solution that offers diversification through its principal protection, potential equity upside participation and muted interest rate risk.

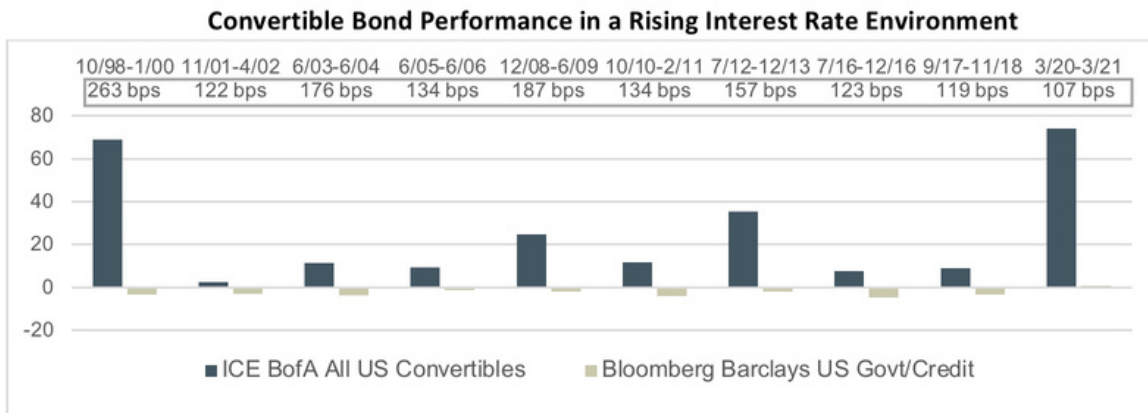
As of year-end 2021, there have been material changes to Risk-Based Capital (RBC) charges. As it relates to Convertibles, Convertibles remain a capital efficient source of return. Depending on the insurance company type, the new 20 NAIC Designation Category Bond Factors for an average Investment Grade Convertible portfolio could range from less than 0.16-0.30% to as high as 6.02-8.30%. This capital efficient advantage over Equities, which require a charge of 15-45%, is also coupled with a historical 70% upside capture rate of Equity Market (S&P 500) returns.”<sup>1</sup>

What makes the asset class especially attractive is their historical performance during periods of rising interest rates. An actively managed Convertible allocation can provide a strategic hedge against an eventual rise in interest rates due to Convertibles’ relatively lower duration profile (currently one-third that of the Barclays Aggregate Index<sup>2</sup>) and higher current yield. While Convertibles do have some sensitivity to interest-rate fluctuations, historically, they have performed well in a rising interest rate environment, as seen in the chart below.

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<sup>1</sup> Source: NAIC.org, Bloomberg, SSI internal research.

<sup>2</sup> ICE BofA All US Convertible Index (VXXAo) duration: 1.87 vs. Barclays Aggregate Bond Index duration: 6.86 (as of 12/31/2021)



*Source: SSI internal research; ICE BofA Convertible Research; Bloomberg; Barclays. October 1998–March 2021. 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. Outlined statistics represented in basis points reflect the 10–Year US Treasury yield increase along with the respective date ranges.*

## Customize to optimally allocate to all segments of the Convertible market

The Convertible market offers many unique tools to utilize, many of which can significantly enhance the diversification and risk adjusted returns within an insurance portfolio. They can serve as an option to help mitigate the impact of amortization of bond premiums, help with expanding the universe of investment grade options, and with maintaining yield in the portfolio.

While designing a Convertible Bond portfolio for an insurance company, some of the potential enhancements include the following:

**Convertible Preferreds:** In addition to investment grade Convertible Bonds, having access to investment grade Convertible Preferreds can provide further diversification by sector and by the number of investment grade securities while potentially finding securities with a strong yield profile.

**Non-Investment Grade Convertibles:** Including a small percentage of non-investment grade Convertible Bonds, while maintaining a portfolio's overall credit quality of investment grade, can benefit a portfolio by enhancing sector and security diversification, creating a more balanced and convex overall portfolio, and by controlling the amortization expense.

**Synthetic Convertible Securities:** These securities, available through banks, are created around an individual security or a basket of securities and structured as a convertible security. The basket may include names that are not currently in the universe and are attractive additions to the portfolio. Additionally, although not often, the basket may consist of securities that are present in the Convertible universe but whose bonds are trading well above par and whose inclusion would meaningfully increase amortization expense. The synthetic convertible would give an investor access to a company with a higher-priced bond in the benchmark with a more balanced structure.

Convertible Bonds provide investors with an attractive solution to successfully navigate the current challenging market environment, which include rising interest rates and the possibility of increased volatility. They offer a total source return with favorable risk-based capital charges for the outcomes. Here at SSI, we work judiciously to help clients fully understand the considerations when crafting investment guidelines, constructing customized portfolios, and managing a Convertible Bond portfolio. SSI's deep history in the insurance space and investment team help to define our expertise.

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