## friday view

The case for strategic convertible allocations

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Our experience with convertible securities dates to the volatile financial markets of the 1970s, when convertible strategies often provided better returns than the stock or bond markets. Today's mar kets are similar to those of the 1970s, as macro events fuel uncertainty and volatility. Given the current turbulence around rising interest rates, we feel con vertibles are well-positioned to weather market uncertainty and volatility due to their ability to provide equity upside with downside protection. Furthermore, widening spreads bode well for the continuation of a strong year for convertible issuance, boosting the opportunity set and overall market liquidity. We there fore believe the case for convertible securities is as strong as ever.

In simplest terms, a convertible security

is a fixed-income security that includes an embedded option. Convertibles thus offer equity market participation with potential downside resilience during equity market declines. The structural risk/ reward characteristics of convertibles allow them to support a range of asset allocation goals. However, convertibles are also complex, making active management is essential. The attributes of convertibles may differ considerably, and the characteristics of a convertible can change over time. A convertible may be more equitylike (higher "equity sensitivity") at certain periods and more fixed income-like (high er "credit sensitivity") in others. Or, they can fall somewhere in the middle ("total return" securities).

As a fixed-income security with equity attributes, convertible securities can fulfil a variety of roles within asset allocations. Often, convertible securities are thought of as a single asset class, but this ignores variations within the convertible universe. Our approach is to use different types of convertibles within different investment strategies. It is not simply the convertibles that make a strategy work, but how convertibles are managed to achieve a particular investment objective.

We often use convertibles with higher levels of equity sensitivity in lower-volatility equity strategies, providing a solution for investors who wish to participate in equity markets but are concerned about downside equity volatility. In volatile markets, the bond value of a convertible provides a floor, and through coupon income, investors are "paid to wait" for the markets to recover.

Convertibles can also be utilised as an enhanced fixed income strategy. Convertibles have historically performed well dur-

ing periods of rising interest rates and inflation. While convertibles are influ enced to a degree by interest-rate fluctua tions, they also are affected by the price movements of their underlying stocks, which has helped soften the effect of rising interest rates. As a result, convertible strategies may be used to diversify or enhance a traditional bond portfolio with higher interest rate sensitivity (i.e., gov ernment bonds). Here, we would expect to utilize a greater proportion of convertibles with more pronounced fixed-income characteristics, such as "busted convertibles." Finally, convertibles with a range of characteristics can be used within alterna tive allocations, such as hedge strategies that employ convertible arbitrage.

However, with the combination of healthy balance sheets, high cash balances, cheap financing and improved confidence of corporate America, we see these factors eventually leading to more meaningful M&A activity, and we believe event-driven equity strategies will perform even better. In essence, event driven equity has upside capture to an M&A rebound, but is not dependent on it.

Economic growth supports convertible issuance. Convertible market issuance is about capital market access; capital market access is closely tied with economic growth. As better economic prospects spur increased interest in risk assets, we would expect a resurgence in convertible issuance. Although some of this new activity will be offset by maturing securities, we ultimately believe economic trends support the long-term viability of the asset class, and that a recovering global economy provides a favorable environment for a widening pool of convertibles.

## Past performance is no quarantee of future results.

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