

Convertible Securities: Potential Advantages in Rising Interest Rate Environments

With active management, convertible bonds can provide compelling benefits throughout market cycles. During periods of rising interest rates, convertibles can offer added advantages as an alternative to traditional fixed-income investments.

Investment-grade bonds tend to lose value in rising rate environments, but convertible bonds have held up much better. Convertible bonds are hybrid instruments that blend features of stocks and bonds. Like bonds, they have coupons and maturity dates. But unlike bonds, convertibles can be exchanged into a pre-determined number of shares of the issuer's common stock. As a result, they can participate in the upside of their underlying equity. This equity sensitivity can make a convertible less vulnerable to rising interest rates.

Convertibles are structurally complex and require active management to maximize their benefits as an interest rate hedge. Convertibles vary in their degrees of fixed income and equity sensitivity, and the attributes of a convertible can change over time. In general, convertible securities with higher equity sensitivity are less likely to be influenced by rising interest rates.

Convertible returns have tended to more closely reflect equity returns than bond returns when rates rise. During periods when the 10-year Treasury yield rose more than 100 basis points, convertibles outperformed bonds every time. Although convertibles are influenced to a degree by interest rates, they also are affected by the price movements of their underlying stocks, which has mitigated the impact of rising rates.

WHEN INTEREST RATES RISE, CONVERTIBLES HAVE OUTPERFORMED INVESTMENT-GRADE BONDS

	OCT '93- NOV '94	JAN '96- JUN '96	OCT '98- JAN '00	NOV '01- APR '02	JUN '03- JUN '04	JUN '05- JUN '06	DEC '08- JUN '09	OCT '10- FEB '11	JUL '12- DEC '13	JUL '16- DEC '16	SEP'17- MAY '18
Yield Increase (bps)*	286	150	263	122	176	134	187	134	157	123	106
Bloomberg Barclays U.S. Govt/Credit	-5.15%	-4.08%	-3.38%	-3.09%	-3.64%	-1.49%	-2.08%	-3.94%	-2.14%	-4.88%	-3.36%
BofA ML All U.S. Convertibles	-2.28	11.97	68.85	2.29	11.49	9.46	24.68	11.63	35.49	7.58	8.69
S&P 500	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89	42.09	8.65	11.84

Past performance is no guarantee of future results.

*10-year Treasury yield. Rising rate environment periods from troughs to peak from October 1993 to June 2018. Performance shown is cumulative. Source: Morningstar.

Indexes are unmanaged, do not reflect fees or expenses and are not available for direct investment. The ICE BofAML All U.S. Convertibles Index is a measure of the U.S. convertible market. The S&P 500 Index is a measure of the U.S. stock market. The Bloomberg Barclays U.S. Govt/Credit Index is comprised of long-term government and investment grade corporate debt securities. Source: Morningstar Direct and Bloomberg.

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Active management does not guarantee that a strategy will produce its intended results. Convertible securities entail interest rate risk and default risk.

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