

UNRATED AND LOWER-RATED CONVERTS CAN STILL OFFER VALUE

Ask the PORTFOLIO MANAGER

What explains the predominance of below-investment grade securities in the convertible market?

Transcript of a video recorded on March 21, 2019

That's a good question, because we do get questions a lot about why S&P and Moody's do not rate a lot of these securities in the convertible market.

That is important, and it can lead to some misconceptions about the market overall as well.

First off, one of the reasons that convertible investors do not demand a third-party rating agency to rate the credits is because as a convert investor, not only do we have credit, but we also have the equity optionality on top of that, so we can win in multiple ways. When we look at other fixed income markets, traditional fixed income markets, such as the high yield market, their only exposure is to credit. And so, from that perspective, a credit rating agency may be much more important to them, as they only get the credit side of it, and they don't have equity upside.

Now, that plays to the benefit of issuers, because they can actually save some time by not having to get a rating agency to rate their credit. But they can also save money from not having to pay the fees associated with that. It's also to our benefit as investors as well, because we are fully versed in a team of deep analysts and portfolio managers that are well versed in doing our own credit work and can identify the opportunities and not be reliant on third-party credit rating agencies.

At the same time, this can create some misconceptions about the market, as I said. One of those would be the perceived safety of the investment grade side. A convertible bond, as we know, is a bond plus an equity option, so an investment grade credit rating on a convertible bond that has appreciated and is actually high delta, or very equity-sensitive, may not provide the perceived safety that an investment grade investor may be looking for. For example, you could have an equity-sensitive convertible that is investment grade and the equity can underperform, leading to a principal loss. That's something that an uninformed investor who is simply looking at a credit rating may not be looking for in trading off one risk and accepting the other.

We actually think that the best way to manage convertibles is to actively monitor and manage those risks and to look at the broad spectrum of the market, nonrated as well as rated.



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Convertible Securities Risk: The value of a convertible security is influenced by changes in interest rates, with investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other factors also, may have an effect on the convertible security's investment value.

Convertible Arbitrage Risk: If the market price of the underlying common stock increases above the conversion price on a convertible security, the price of the convertible security will increase. The fund's increased liability on any outstanding short position would, in whole or in part, reduce this gain.

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