

The resurgence of convertibles

John P Calamos Sr, chairman of Calamos Investments, explains why core convertible allocations may be the answer to investing in a rising, but still volatile, equity market

Investors around the world are rekindling their interest in convertible securities, an asset class with roots in the US railroad boom of the mid-1800s. As equity-linked securities, convertibles provide the upside of equities with potential downside protection if markets fall. The trick to master with convertibles is creating an asymmetrical balance between risk and return, capturing more equity upside than downside over full market cycles.

Equity-bond balance

The potential benefits of convertibles derive from the ability to convert the security into a predetermined number of equity shares at a set price, paired with coupon income.

However, it is not simply the inclusion of convertibles in a portfolio which produces a desired outcome. Active management is essential. Convertibles vary in their degrees of equity and fixed income sensitivities, and the characteristics of a convertible can change over time (see case study).

After a period of rising equity markets, a convertible portfolio could feasibly have plenty of equity exposure but offer too little downside protection. Conversely, after a meaningful sell-off in the equity market, it can be easy to end up with a convertible portfolio that looks too much like a straight fixed income allocation, and does not offer enough upside participation for when equities bounce back.

In March of 2000, equity-like convertibles dominated the US market; by February of 2009, bond-like convertibles were the most popular. Today, we see a well-balanced market with a range of convertibles.

A timely solution

We are seeing encouraging signs of economic improvement in the eurozone while the US is continuing a slow and steady recovery and Japan has been boosted by Abenomics. Yet, the structural issues in the EU and Japan, combined with uncertainties about emerging markets, have led many investors to stay on the sidelines with outsized allocations to cash. For these cautious investors, a core convertible strategy may provide a more comfortable way to increase equity participation with potentially less exposure to downside volatility. However, to achieve this lower volatility profile, a degree of upside participation may be given up in exchange for greater downside protection.

Convertible securities can also provide an attractive alternative for investors paring exposure to traditional fixed income. Interest rates are still high in the eurozone, but the Federal Reserve's decision to begin its liquidity tapering sooner than many anticipated has changed the game for investors who have rate-vulnerable allocations to US investment grade corporate bonds and treasuries.

Rising issuance

Fortuitously, an upswing in global issuance has accompanied growing investor interest in convertibles. Convertible issuance is about capital

KEY POINTS

> Convertibles vary in their degrees of equity and fixed income sensitivities, and the characteristics of a convertible can change over time.

> Structural issues in the European Union and Japan, combined with uncertainties about emerging markets, have led many investors to stay on the sidelines so far.

> However, an upswing in global issuance has accompanied growing investor interest in convertibles.

market access, and economic growth provides a more favourable backdrop for companies seeking capital to grow. As the global economic landscape continued to improve in 2013, new convertible issuance reached its highest level since 2008 at \$92.9bn, more than offsetting redemptions.

Particularly encouraging is that issues ramped up as the year progressed, with 40% of annual new issuance occurring in the fourth quarter. The factors which supported this upswing – a strong equity market, rising long-term interest rates, as well as recovery – look set to strengthen in 2014.

Indeed, the outlook is bright for convertibles with Bank of America Merrill Lynch forecasting 2014's new issuance to be similar to that of 2013. Moreover, industry data suggests a decline in redemptions.

Yield curves should begin the process of normalisation as quantitative easing slows in the US. This is because convertibles typically offer a lower coupon in exchange for their equity upside participation, making them a more attractive choice for issuers when long-term borrowing rates are higher.

Evolving landscape

In addition to individual convertible's risk/reward changes over time, the convertible landscape is always evolving – in regard to the various terms and structural variants associated with convertibles, as well as the types of companies issuing them. Active management remains essential, given the complexities of the convertible structure and the diversity of issuance.

Case study: Changing characteristics of convertible securities

	Fixed income characteristics (%)	Hybrid characteristics (%)	Equity characteristics (%)
1 Mar 2000	18.9	27.8	53.3
28 Feb 2009	67.4	20.9	11.7
31 Dec 2013	26.5	38.0	35.5

Notice the large percentage of equity-sensitive convertible securities in March of 2000. By February of 2009, fixed income convertibles dominated the market. Source: BofA Merrill Lynch, All US Convertibles index (VXA0).

Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable, but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. The opinions and views of third parties do not represent the opinions or views of Calamos Investments LLC. Opinions referenced are as of the day recorded and are subject to change due to changes in the market, economic conditions or changes in the legal and/or regulatory environment and may not necessarily come to pass. This information is provided for informational purposes only and should not be considered tax, legal, or investment advice. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations.

Outside the United States, this document is directed only at professional/sophisticated investors and it is for their use and information. This document should not be shown or given to retail investors. Any entity responsible for forwarding this material to other parties takes responsibility for ensuring compliance with the financial promotion rules.

Convertible securities are subject to risk, including the potential for a decline in value during periods of rising interest rates and the risk of the borrower to miss payments.

BofA ML All U.S. Convertibles Index (VXA0) is comprised of approximately 700 issues of only convertible bonds and preferreds of all qualities. The S&P 500 Index is generally considered representative of the U.S. stock market. The Barclays U.S. Government/Credit Index is comprised of long-term government and investment grade corporate debt securities.

CALAMOS®

Calamos Investments LLC
2020 Calamos Court | Naperville, IL 60563-2787
Tel: 877.663.8056 | www.calamos.com

Calamos Investments LLP
No. 1 Cornhill | London, EC3V 3ND, UK
Tel: +44 (0)20 3178 8838 | www.calamos.com/global

© 2014 Calamos Investments LLC. All Rights Reserved.
Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.

IWCVSREP 77314B 0214O C